MUNICIPAL ASSOCIATION OF VICTORIA

Submission to the Local Government – Rates Capping & Variation Framework Consultation Paper

May 2015

The MAV is the statutory peak body for local government in Victoria, representing all 79 municipalities. The MAV would also like to acknowledge the contribution of those who provided their comments and advice during this project.

While this paper aims to broadly reflect the views of local government in Victoria, it does not purport to reflect the exact views of individual councils.

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1 Introduction

The MAV welcomes the opportunity to provide comment on the ESC's consultation paper on the proposed rate capping and variations framework. The MAV and its membership do not support rate capping for the local government sector. It is the belief of the Association that rate capping will impinge on the democratic autonomy of the sector.

Notwithstanding our position, the MAV's submission attempts to respond in a constructive manner to the consultation paper by the ESC. The submission directly responds to the 22 questions posed by the ESC and also includes comments on the ESC's principles articulated in its paper and on several relevant issues.

The MAV commends the ESC on its thoughtful approach to the rate capping and variations framework. The consultation paper raises important questions about how a framework could be developed that is practicable, and addresses the sector's reasonable concerns about the autonomy of a democratically elected tier of government.

The MAV's submission is the first step in its engagement with the ESC and its members on rate capping. It looks forward to further discussing the proposed framework as the ESC's proposal develops and becomes more concrete.

2 Key issues with rate capping

2.1 Respect for a democratic tier of government

The major challenge facing the ESC in the development of a rate capping framework is reconciling the democratic nature of local government with an externally imposed mechanism that constrains council revenue raising – generally regarded as an essential component of a democratic model of governance. No other level of government constraints its total revenue.

This tension between the respect for the fundamentally democratic nature of local government and the consequences of the ESC potentially making decisions about the appropriate priorities is seen within the consultation paper. It is clear that the ESC is aware of this tension and is attempting to reconcile this disconnect in a thorough manner.

The MAV does not, as a matter of principle, support a rate capping framework for local government. It strongly believes capacity to control their own revenue raising is a fundamental tenet for a democratically elected government. This was recognised by the Bracks Government, which provided for the recognition of local government as a distinct and democratic tier of government in 2003 in the Victorian Constitution:

> (1) Local government is a distinct and essential tier of government consisting of democratically elected Councils having the functions and powers that the Parliament considers are necessary to ensure the peace, order and good government of each municipal district.
>
> (1A) Subject to section 74B, each Council—
>
> (a) is responsible for the governance of the area designated by its municipal boundaries; and

(b) is constituted by democratically elected Councillors as the governing body which is—
   (i) accountable for its decisions and actions; and
   (ii) responsible for ensuring good governance; and includes an administration which—
   (i) implements the decisions of the Council; and
   (ii) facilitates the performance of the duties and functions of the Council.

This amendment to the Victorian Constitution – along with supporting changes to the *Local Government Act 1989* – provided the sector with broad powers to provide for the good of the municipal district.

The MAV emphasises that the current method of local government rate setting is open and transparent, and exceeds the consultative mechanisms undertaken by the state and commonwealth governments. The following are key attributes of this system:

- A four-year council plan, which sets out the council's vision for its term. A council is required to finalise its council plan within six months of its election
- A strategic resource plan, which sets out the long-term financial plan of council, and is aligned to the goals and actions within the council plan
- Annual budgets, which give effect to the short-term financial plan of council
- Each of the three major planning documents include statutory requirements to consult with the community.

This process contrasts with the budgetary development undertaken by other levels of government, which are subject to announcement without community consultation.

While the ESC acknowledges the argument that councils, as a democratic sphere of government, should have a degree of autonomy in its spending and revenue decisions, the consultation paper includes inconsistent principles, such as that 'rate increases be a last priority'. There are circumstances in which rates increases may be a clear priority to cutting services, increasing charges or debt. That these tensions exist in the framework is clear and need to be reconciled in a clear manner.

It is fundamental to a democratic body that they have adequate control of their revenue sources, as this directly influences the capacity of the government to determine its expenditure priorities. The MAV believes that the framework must respect this right of councils and be sufficiently responsive to the democratic priorities of councils.

2.2 Population growth and service demands

Victoria is facing significant and sustained population growth, which is placing substantial pressure on the state's infrastructure and services. The 2015-16 State Budget, delivered on 5 May 2015, forecasts population growth of 1.8 per cent per annum for the next four years (DTF 2015), which is significantly above the long-term average for the state.

Population growth of this volume – which equates to an additional 105,000 people per year – places significant demand on services and infrastructure. About 40 per cent of the state's growth over recent years (ABS 2015) has been accommodated within the growth councils of outer Melbourne – Wyndham, Hume, Melton, Whittlesea, Casey and Cardinia.

In addition to these growth councils, the population growth in regional centres – such as Geelong, Bendigo, Ballarat and the Latrobe Valley has been significant, with consolidation in the agricultural industries, along with 'tree changers' leading to population growth in these centres. Additional population growth outside of regional centres has also been experienced, with some rural and regional locations experiencing population growth of one to two per cent annually. Metropolitan councils have also faced population growth pressures, with greater population density contributing to more services and demands for improved infrastructure, particularly along well-serviced transport routes.

These demands were concisely recognised by the State Government in its first budget, which recognised that booming population requires higher levels of government expenditure. In his Budget speech, the Treasurer specifically notes the effect of significant population growth on the cost structures of the state:

> … Victoria needs more investment.
>
> Population is growing at 1.8 per cent a year.
>
> Inflation is averaging 2.6 per cent a year.
>
> The previous Government knew this, but they still wanted to restrict expenditure growth to just 2.5 per cent.
>
> That would have sent a wrecking ball through our schools and hospitals – a decision no responsible Government could afford to make.
>
> So we'll maintain expenditure growth at a modest 3 per cent – comfortably below revenue growth of 3.4 per cent – allowing us to maintain strong surpluses over the budget and forward estimates period. (2015-16 Budget Paper 1: Treasurer's Speech)

The same drivers for increased costs for the State are also influencing council service and infrastructure demands, and the MAV believes that the framework needs to recognise how this growth affects the expenditure demands of councils.

As a general principle, the MAV argues that the population growth pressures facing Victorian councils must be factored into a rate capping framework. The pressures faced by the State mirror those of local government, and the arguments that have led to an increase in the State's expenditure should be extended to local government. Failure to include these cost pressures in the framework will lead to a deterioration of the state's standard of living through a reduction in the quality and coverage of infrastructure as well as limiting councils' ability to continue to provide high quality services.

2.3 Consequences of rate capping

2.3.1 Infrastructure and asset renewal

The consultation paper raises the issue of the consequences of a rate cap on the capacity of councils to deliver services and infrastructure. The MAV's analysis of the previous rate capping that existed in Victoria suggested that capital expenditure fell significantly in response to the cuts in rating capacity (MAV unpublished).

In the 20 years since the rate caps and cuts, the local government sector has undertaken significant effort to increase its capital expenditure, reduce infrastructure backlogs and improve the asset management process from planning to service delivery. For example, the MAV's annual analysis of councils' financial strength has shown that over time, improved renewal spending, along with enhanced asset management practice, has led to significant improvements in the underlying financial strength of the sector.

Further, it is widely accepted that the long-standing capping regime existing in New South Wales has led to substandard public infrastructure throughout the state. This is reflected in the NSW local government having the poorest financial health of any of the state jurisdictions (see, for example, PwC 2006), primarily in the form of larger infrastructure backlogs than other jurisdictions. Of greater importance is the consequence that this poor infrastructure has on the community's access to high quality public spaces, including footpaths, roads, bridges, sporting facilities, libraries, community centres and the myriad of other public infrastructure provided by local government.

Given the strong correlation between rate caps and cuts in both Victoria and NSW, the MAV wishes to raise its concerns about the potential long-term consequences of the proposed rate capping and variations framework in Victoria.

2.3.2 Employee costs as a driver for council costs

The cost structure of local government is highly dependent on direct employees, material and contract payments, and the provision of engineering and other building works. Based on the Victorian Auditor-General's Office, approximately 40 per cent of councils' direct costs relate to salaries and related on-costs for 2013-14 (VAGO 2015).

Material and contract payments provide for a range of services and goods to councils, and are frequently used by councils to deliver labour intensive services. Particularly following compulsory competitive tendering, many of councils' traditional services that were provided in-house have been outsourced. Effectively, this means that many of the material and contract costs relate to services which have costs strongly influenced by employment costs.

The rate capping framework must recognise the importance of employee costs in driving the overall increase in councils' expenditure, particularly since employment costs are typically above general household inflationary costs.

An important factor that needs to be considered by the ESC is the effect of existing EBAs on the capacity of councils to manage a cap during a transition process. Many councils will have an existing EBA that will have a legacy impact on their capacity to significantly constrain their expenditure over the life of the EBAs. We would welcome the opportunity to further discuss this matter with the ESC.

We note that the most recent Victorian Budget estimates future employment cost growth of 7.7 per cent for the year to 2015-16, and an average of 4.87 per cent per annum over the four years to 2018-19.

We would be interested in further discussing with the ESC what the allowable employee costs will be under the rates capping and variation framework. This will effectively be a key component in determining how rates can increase in the future, and what the consequences of a rate cap will be on the sector and its community.

2.4 Measures of the rating burden

As part of the assessment of the proposed rate capping framework, consideration should be given to the overall burden of rates on households and their general economic consequence.

The most recent Household Expenditure Survey was conducted in 2009-10 and identifies that the average proportion of household expenditure on rates across Australia was 1.41 per cent.[1] The equivalent figure for Victorian households was 1.31 per cent.[2]

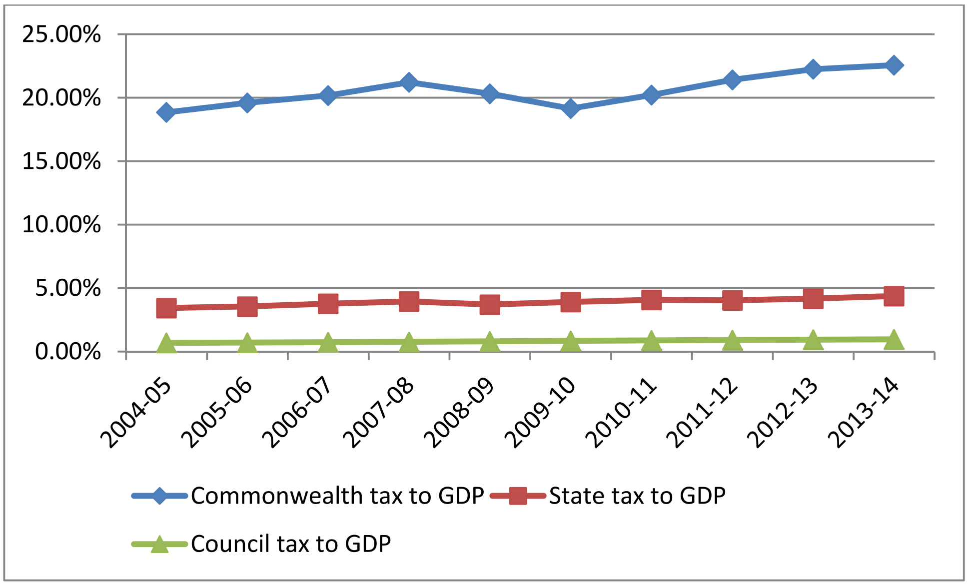
The MAV has previously undertaken research at the unit record level of the incidence of rates for residential households using the previous Household Expenditure Survey, which suggested substantial diversity in the level of rates paid by households. This research indicated that rates were likely to be a relatively small cost for most households, however, there were certain households which had more significant rate burdens (MAV unpublished). Household cohorts that displayed higher than average rating burden (as a proportion of expenditure) were single parent households and single pensioner households.

Additional measures of the significance of rates include the proportion of taxation revenue collected by each jurisdiction. This shows that rates are around 3.4 per cent of total Australian taxes, with the ABS reporting that Victorian councils collected just over $4 billion in rates in 2013-14 (ABS, 2015a).

As a proportion of gross state product, aggregate rates were 1.17 per cent in 2013-14 (ABS, 2015b; ABS, 2015c). The following graph maps the relative proportion of the economy of rates over the last 10 years compared to State, Territory and Commonwealth taxation revenue.

[1] Defined as 'local government rates' and 'rate payments (selected dwelling) nfd'
[2] The relative standard error for 'rate payments (selected dwelling) nfd' is between 25 and 50 per cent and therefore is unreliable. In this instance the majority of payments are in the 'local government rates' category and therefore the statistical unreliability is unlikely to influence the result materially.

Figure 1: Commonwealth, State and Territory, and Local Government tax revenue as a percentage of GDP[3]



Source: ABS, 2015, Taxation Revenue 2013-1, 45506.0; ABS, 2015, National Accounts, 5206.0.

The Productivity Commission also considered the revenue raising capacity of councils and concluded that councils had not reached their theoretical maximum level of taxation effort. In short, the study concluded that councils could increase their own source revenue raising capacity. This research also suggested that rural and outer metropolitan councils had the least additional 'spare' revenue raising capacity.

2.5 Technical assessments of rates

Rates have been subject to recent assessments of Australia's taxation system. The Henry Review concluded that rates had the attributes of a 'good tax' insofar as it is one of the most economically efficient taxes available. It is further a highly stable tax base and is relatively administratively efficient. The MAV's analysis of the household level cost of rates suggests they are regressive for residential households – as household expenditure increases, the proportion paid in rates decreased.[4]

Despite this characteristic, the contemporary assessments of rates have concluded that rates are an appropriate component of a modern and efficient taxation system.

3 Discussion of ESC Principles

This section provides comment on the ESC's proposed principles that would underpin a rating capping and variation framework.

[3] GST defined as a Commonwealth tax.
[4] The research suggested that rates were regressive against income and expenditure. A counter argument to this proposition is that a property-based tax is a form of wealth tax and high property values may be correlated to high lifetime income and wealth. The scope of the research excluded a lifetime measure of income and MAV therefore was not able to test this proposition.

3.1 Principle 1 – Local communities differ in their needs, priorities and resources

The MAV supports and agrees with this principle.

The current council processes around the development of the council plan, strategic resource plan, and annual budget all include consultation with the community about council priorities.

Further advice from the ESC would be useful in better understanding the proposition that ‘councils should be able to show that they have engaged with and considered their community’s and ratepayer’s views on different rate levels and service priorities.’ Additional information should be provided for discussion with the sector on the level and type of community engagement that would be deemed as sufficient to fulfil an external assessment of the adequacy of its consultation. The analysis should include the costs associated with the consultation process and the timelines required to complete the community engagement to ensure that it fits within councils’ legislative timelines for completion of their budgets.

It would be interesting to understand how councils manage prudent, but unpopular decisions within the proposed framework.

In addition, there is a fundamental question about the services that are accessed by the minority of the community. The MAV would argue that the framework needs to ensure that councils give adequate weight to minority preferences for services and infrastructure with the community.

We strongly agree with the statement that ‘the framework should be flexible to respond effectively to any major changes affecting councils and their communities.’ It is clear that the challenges faced by individual councils vary significantly and it is appropriate that the framework is sufficiently flexible to respond to these differences. These differences will amount to the suite of services delivered to the community and there is no standard group of ‘local government’ services. For example, market failures arising in certain municipalities may require councils to become involved in delivering new services. The ESC will need to consider these non-standard services in the framework.

3.2 Principle 2 – Local communities and ratepayers are entitled to hold their councils to the highest standards of accountability and transparency when setting rates

The MAV supports the proposition that communities should be able to hold their councils to the highest standards of accountability. Extensive performance reporting, financial reporting and consultation through budget development all underpin their accountability to the community. The performance reporting framework will provide the community with significant data on council services, infrastructure, and costs, which will supplement the existing reporting and accountability requirements. It is important that the ESC takes into consideration these existing reporting obligations and ensures that they are recognised in the framework. We emphasise that local government provides taxpayers with an annual bill of their entire tax.

3.3 Principle 3 – The framework should support the autonomy of councils to make decisions in the long term interest of their community and ratepayers

The MAV strongly supports this principle. However, it is difficult to reconcile this principle with a rate capping framework and the MAV would be interested in understanding how this principle will apply in practice.

3.4 Principle 4 – Councils will need to satisfy the burden of proof outlined in the framework when seeking a variation above the cap

The MAV does not have an objection to the description of this principle.

Nevertheless, there are some concerns about what a 'fully demonstrated case' means and what level of proof will be required for councils to meet this threshold. While it is pleasing that the ESC has committed to developing working definitions, criteria, guidelines and fact sheets, it will be important that what constitutes the burden is made clear to the sector and does not consume excessive resources. Further information is also required about how the ESC will make 'value' judgements about the mix and scope of services provided to councils. Each individual council is required to make value judgements which guide trade-offs between rate levels, fees and services they deliver. The MAV would welcome further discussion with the ESC on the framework they will apply to navigating the political and value judgements considered by councils.

3.5 Principle 5 – Rate increases should be considered only after all other viable options have been explored

The MAV believes further information and clarification is required about the meaning of this principle and its practical effect on the framework.

As the MAV interprets this principle, it raises interesting questions about the autonomy of councils in their selection of their pricing and debt strategies. It appears to imply that councils should seek to raise all available fees, fines and charges before increasing rates. It also may imply that councils should carry a level of debt before considering rating increases above the cap, which may not be the preference of council or their community. As a general principle, councils should make decisions about their level of debt and the framework should avoid building debt levels within the sector.

The MAV would be troubled if its interpretation is correct as it is inconsistent with the autonomy principle. An elected council may legitimately make a decision that certain services have an element of public good and hence should not be fully reimbursed through charges. The pricing policy of council should be the primary driver of councils' selection of revenue sources, not a rate capping framework. We believe that it would be perverse if this principle gave rise to an increase in fees and charges solely on the basis of the ESC rating variations framework.

It should also be noted that the capacity of many councils to raise alternative revenue sources is extremely limited. Most rural councils, for example, have little prospect of recovering significant additional funds from services charges and fees. These councils often receive a significant portion of their revenue through grants and therefore have only limited levers available to obtain additional revenue.

Growth councils receive developer contributions which aim to provide for the up-front costs of infrastructure associated with the significant population growth these communities experience. The developer contribution plans to not provide sufficient resources to meet the costs of infrastructure provision, let alone the long-term liabilities for the councils around the maintenance and renewal of this infrastructure.

Furthermore, the principle raises the possibility of detailed service reviews being undertaken by ESC to assess whether councils should be delivering a particular service. We would be troubled if this interpretation is correct.

It would be useful to understand how councils' relatively efficiency will be measured by the ESC. A perverse outcome of the previous rate capping framework imposed on Victorian councils was a more difficult operating environment for the most efficient councils through a blunt application of rate cuts and caps. A similar challenge will exist for the ESC in assessing the relative and absolute levels of efficiency in councils.

Further information is required on the standard that councils would be judged against when it comes to assessing what constitutes a 'viable option'. The MAV seeks more information about the practical implementation of this principle so they can be debated by interested parties. As it stands, it potentially undermines the concept of autonomy by requiring councils to shift their pricing and debt policies.

An additional activity that the ESC could undertake as part of this principle is the identification of excessive costs evident through their processes that are imposed by other levels of government. Through a process of iterative improvement in the regulatory framework for councils, it would be possible for the process to reduce the costs of government to the community. Examples include:

- The requirement to advertise in daily statewide media for senior employee job advertisements, tenders and budget – lots of cost across the sector, while having minor benefit to the public, given the alternative consultation mechanisms available (such as regional papers, websites, tender portals, etc)
- Inadequate indexation of planning fees since they were last set in 2000 has led to a larger proportion of the cost of these fees being borne by ratepayers. If this principle is to be given effect, then it would follow that additional flexibility should be provided to councils in their fee and charges policies, including through additional reviews of regulatory constraints of fee setting. The consequence is that due to an externally imposed pricing regime, ratepayers are subsidising developers.

3.6 Principle 6 –The framework should support best practice planning, management systems and information sharing to uphold council decision making

The MAV supports this principle and looks forward to working with the ESC on the appropriate mechanisms for councils to consult with their communities. We seek clear guidance to councils on what would constitute effective engagement with the community. The MAV would also emphasise that consultation should be with the community and not just ratepayers – as councils' constituencies are their whole communities, not just those paying taxes.

3.7 Principle 7 – The framework should be flexible and adaptable

The MAV agrees that the framework should remain flexible and believes that multi-year approvals are a key requirement of any regime. As discussed above, the council plans and strategic resourcing plans are multi-year documents that attempt to focus the strategic decisions of councils on the medium to long-term. Unless the rating variations framework also has capacity to consider the long-term financial needs of council, the rating variations framework will undermine this focus on longer-term planning. Until this occurs, the SRP will effectively be undermined by the rate capping framework.

With council elections scheduled to occur in October 2016, some consideration should be given to the planning requirements council will undertake in the first eight months of their term and how the rate capping framework will align to this strategic work. The MAV has some concern that if the rate variation process is complex, it may restrict the capacity of councils to undertake this planning and development of the legislatively required council strategic documents.

3.8 Principle 8 – There should be few surprises for ratepayers and councils in the implementation of the framework

The MAV supports this principle.

4 Response to the ESC's Review Questions

1. While a cap based on CPI is simple to understand and apply, are there any issues that we should be aware of?

A cap based on CPI is in our view an inappropriate basis to constrain councils' rate revenue growth. The reasons for this position include the following:

- CPI is based on a basket of goods and services purchased by a household. A council's equivalent will be based on an alternative basket of goods and services, with a higher proportion of expenditure on wages, material and contracts, and infrastructure construction. As such, CPI is not a reasonable basis to measure changes to councils' input costs.
- Councils' revenue raising is dependent on several major sources of revenue – including other own-source revenue (fees, fines and charges), State grants and Commonwealth grants. In many cases, these are subject to some form of constraint, such as grants being increased by CPI, or in the case of Financial Assistance Grants, subject to no indexation. Fees and fines are often subject to external restraint, which further limits councils' revenue raising capacity. These restrictions on councils' alternative revenue growth means that maintaining total revenue growth at the change in input costs facing the organisation will require increases in rates above this level.

Councils' ability to manage rate increases at CPI will differ based on the above factors. It should be noted that the rural and regional councils in particular have significantly greater restraints on their revenue raising capacity due to their dependency on grants and their limited opportunities to recoup funding via charges and fees.

2. What are some ways to refine the cap (for example, alternative indices), in line with the government's objectives?

The MAV is in the process of commissioning an alternative cost index from a respected economic consultancy. The index will be based on the expenditure composition of the Victorian local government sector, rather than a household and will therefore be a more appropriate benchmark to determine appropriate levels of expenditure growth over time.

3. Should the cap be set on a single year basis? Is there any merit in providing an annual cap plus indicative caps for the next two to three years to assist councils to adopt a longer term view in their budgeting and planning, particularly when maintaining and investing in infrastructure often takes a longer term perspective? How should such a multi-year cap work in practice?

The MAV believes that a variation should be applied for multiple years, given a Council Plan and Strategic Resource plan extend for the term of the council. This is considered above in response to principle 7 above. There has been a long-term approach from the State and councils for the sector's financial and community planning to take a longer-term perspective. This promotes more effective infrastructure planning and delivers and identifies the plan of the council for its entire term. It would be disappointing if these trends were undermined by a short-term rate capping framework.

In a practical sense, the multi-year approval should endorse (up to) a series of rate increases to cover the four-year term of council and its related council plan. Annual variations may be required in response to exceptional circumstances, including natural disasters, changes in economic conditions, or the availability of government funding.

4. Should the cap be based on historical movements or forecasts of CPI?

The MAV believes forecast figures, as produced by the State Government's Department of Treasury and Finance, should be used for the basis of establishing the benchmark for rate increases. Due to pricing fluctuations over time, using historical series will lead to inappropriate cap and variation regimes.

Forecasts of cost movements are unreliable and some consideration should be given to how any significant shifts from forecast indices are reconciled with allowable movements. The MAV would welcome the opportunity to further discuss these issues with the ESC, particularly following its commissioning of a pricing indicator for local government.

5. Should a single cap apply equally to all councils?

The cap must be sufficiently flexible for it to respond to the specific circumstances of each council. These circumstances will include a broad range of issues, including population growth, different patterns of expenditure, local employment markets and scale economies.

Councils' cost weights will differ in line with the composition of their expenditure on goods and services. As such, it can be expected that individual councils will face differing cost pressures and cost movements.

It should be further noted that existing price indices are often based on data derived from capital cites (e.g. CPI). Some consideration should be given to whether the markets for these goods and services in rural and regional areas face different cost pressures. Member councils have noted less competitive tender processes, for example, which may drive different index levels.

The MAV is aware of anecdotal evidence which suggests that some positions required by councils (such as building surveyors, environmental health officers, etc) are more difficult to fill in rural areas and may require higher salaries to attract. This matter may be of further interest to the ESC, and we would encourage further examination of this issue and potentially the identification of concrete examples from specific councils.

While these issues may be considered within the variations framework, the ESC may wish to give consideration to whether systematic differences between council cohorts could be more appropriately considered through differentiated caps in the rate capping framework.

6. What base should the cap apply to? Does it include rates revenue, service rates/charges, municipal charges and special rates/charges?

The MAV believes that the rate cap should not have any influence on a council's rating strategy. A rating strategy, which should be underpinned by the council's pricing policy, its rating objectives and an outline of its rating instruments, ultimately reflects the values of an elected council. As a point of principle, these values should not be undermined by the operation of a framework.

On the basis of the above, the cap should apply to general rates and the municipal charge. Waste management charges – where used – should continue to be calculated based on the cost of delivering the service and should not be included within the rate capping base. The ESC may wish to satisfy itself that waste charges do not exceed full cost recovery. It should be noted that many councils have long-term contracts in place for waste management with escalation clauses already determined.

Special rates and charges should not be included within the rate capping framework, since the projects funded by these revenues relate to specific projects with benefits that are concentrated in a particular group of ratepayers and is delivered over a specific timeline. The current legislative framework for special rates and charges includes appropriate constraints on the use of special rates and charges schemes – such as by clearly defining the benefits derived from the project and polls of the beneficiaries if their contribution is above the threshold level. In the view of the MAV, the special rates and charges framework therefore has sufficient checks and balances within it to justify its exclusion from the rate capping framework, particularly where its inclusion would effectively reduce the allowable general rates and charges of council.

7. Should the cap apply to total revenue arising from these categories or on average rates and charges per assessment?

The appropriate base for the assessment of a rate increase must include costs associated with increased population and service growth. Using aggregate rates as the base for capping has the limitation of not accounting for population growth, household formation or increased commercial/industrial activity in the municipality. In short, this measure does not account for any measure of council service growth. Unless population growth is included within the framework as an 'automatic' factor that is considered as reasonable, then aggregate rates is not an appropriate benchmark.

Rates per assessment has the value of including a measure of service growth in the base. As such, it is a more appropriate method of measuring rate increases. On rates per assessment, the value of this measure will depend to some extent on how supplementary valuations are treated. If annualised supplementary rates are not incorporated into the model, supplementary rates will drive the rates per assessment lower and in a manner that does not accord to the 'neutral' rates level.

Some consideration should also be given to the sensitivity of rates per assessment to changes in the composition of the properties within the municipality. For example, increasing apartment dwellings in inner metropolitan area will lead to the average valued property reducing and hence, rates per assessment may not be an accurate method of assessing rates.

The MAV believes that a third option exists that should be considered by the ESC – that the base is average rates per head.[5] Rates per head of population are a useful measure insofar as council services are often geared towards the individual, rather than property and population growth is therefore highly correlated to service cost increases. Using this as the base removes the need to formally incorporate population growth within the variation cap. The cost of taxes per head of population is also a generally accepted method of assessing the comparative burden of taxes. This base is of limited utility for councils experiencing population decline (particularly rural) which have significant infrastructure liabilities that are not influenced by population.

The apparent policy objective driving the State's proposed rate capping framework is cost of living challenges. As such, the MAV believes that whatever base is adopted by the ESC, it should include a provision for automatic cost growth associated with population and assessment growth. Failing to incorporate these issues within the framework will undermine the policy intent of the process and lead to long-term underspending on essential infrastructure and services to the community.

8. How should we treat supplementary rates? How do they vary from council to council?

Supplementary rates form an important revenue source for councils, particularly those with population growth and assessment growth (for example the growth councils). The ESC process should:

- Ensure that the treatment of supplementary rates are clear
- Not require an application to ESC for any rates collected through this mechanism
- Not interfere with councils' current practices in undertaking supplementary valuations, which varies by councils depending on the level of assessment growth they are experiencing.

The MAV believes that 'annualised' supplementary rates are the correct basis to consider supplementary rates in the subsequent rating year. This means that properties subject to a supplementary would be included in the base on their new full-year rates, not on the basis of their part-year rates. This will ensure that the 'base' for the subsequent year does not disadvantage councils solely through the collection of supplementary rates.

The MAV's ultimate position on supplementary rates will depend on how the ESC viewed the appropriate benchmark for assessing rating increases. If the base already includes assessment growth (through the basis being rates per assessment, or rates per head), then the treatment of supplementary rates will be simpler. Alternatively, if the base is aggregate rates, then some form of correction to account for additional assessments is required.

9. What are the challenges arising from the revaluation of properties every two years?

[5] That is, total rates and municipal charges divided by the council population. The intent of this measure is to ensure that councils are not disadvantaged through the rating cap due to population growth. For the removal of any doubt, the MAV is not advocating for a poll or flat rate tax to be applied to councils.

In order to assess the consequence of a revaluation on ratepayers, it is important to understand the consequences of this process. A revaluation simply reallocates the each ratepayer's proportionate share of rates, and is an important feature of Victoria's rating system to ensure ongoing equity and fairness. A revaluation ensures that the rating system levies taxes on a contemporary assessment of the tax base. In practical terms (if it assumed that no rate increase is applied) a revaluation will increase some individuals' rates, reduce others but will not affect the overall quantum collected.

This suggests that revaluations are more likely to result in issues with the community's comprehension of the rate cap and may undermine the community's confidence in the process. Those community members with rates that rise above the allowable variation because of a revaluation are particularly at risk of misunderstanding how the revaluation interacts with the rate capping framework. Both the council, the ESC, and the Victorian Government are likely to share this risk.

Ultimately, revaluations reflect a trade-off between the public perception of the rate cap and rating fairness through accurate revaluations. Of concern to the public's confidence in any capping and variations framework is the biennial frequency of revaluations, which is likely to result in these public relations challenges being experienced every second year.

The local government sector has consistently expressed a position that revaluation frequencies are currently too short and should be extended to every three to four years. This may be an issue of interest for the ESC in considering this matter.

10. What should the base year be?

It would be appropriate for the base year to be 2015-16 or the year preceding the first year of the framework being in operation. In line with our response to question 8, the base should also include annualised supplementary valuations.

11. How should the variation process work?

Given changes in council input costs and the likelihood of a majority of councils applying for a variation, the MAV believes that the variation process should have a tiered process under which the level of scrutiny by the ESC rises with the proposed rate increase. This would minimise the total cost of the ESC review for all parties, while ensuring that the original policy intent – minimising unnecessary rate increases – is retained.

The MAV believes that the variation process should operate as a three tiered approach depending on the proposed rating increase. The specific thresholds at which each tier would be dependent on the base used by ESC to measure council rate increases (e.g. whether it is rates per assessment, rates per head or aggregate rates) and the factors considered relevant for rate increases above the cap level. As such, the discussion below should be considered indicative only and will be reviewed by the MAV through further discussion and consultation with the ESC.

The first tier should be the primary benchmark for allowable increases, under which automatic approval would be granted for the rating increase. An example would be an appropriate benchmark for local government costs (e.g. a local government cost index). As per our answer to question 1, we do not believe that CPI is the appropriate benchmark for councils.

The second tier should be at a level above the first tier, but below a level that would be considered ‘excessive’. Under this scenario, it is prosed by the MAV that the ESC review process would be a ‘light touch’ approach that would test key assumptions and expense drivers of councils. It would not constitute a full review of council’s services, infrastructure program, pricing policies and other fundamental operational considerations. It would however, review the arguments presented by the council for additional expenditure and could briefly consider their position. An appropriate threshold for this approach would be, for example, the first tier plus an additional two percentage point rating increase.

The third tier would constitute a more significant review of council’s proposed rate increase. The purpose of this process would be to satisfy the ESC that the rationale for the proposed rate increase is sound. It is expected that this process would be a more in-depth analysis than the second tier and would only apply to a relatively small number of councils in any year.

We would welcome the opportunity to further discuss this framework with the ESC.

12. Under what circumstances should councils be able to seek a variation?

The following is a commitment from the Victorian Government to the MAV through the election campaign of matters that will be considered when developing the rate capping framework:

- *“Federal Liberal Government cuts to Local Government grants and their impacts.*
- *Cost shifting from Commonwealth and State Governments, such as the imposition of additional taxes or levies or increased statutory responsibilities.*
- *Any extraordinary circumstances (e.g. natural disasters, new functions).*
- *Other sources of income available to the Council and their overall financial position.*
- *The continued maintenance of essential Council services, including infrastructure maintenance & asset management. “*

The MAV believes that this should form the basis of circumstances under which a council could seek a variation. This should also be read with the MAV’s response to question 13, which further expands on the circumstances. Defined benefit superannuation shortfalls should clearly be within scope and would reflect ‘extraordinary circumstances’.

In addition to the above, there is a strong argument that all councils should have a right to make a submission for above cap increases provided it is supported by the community, regardless of the underlying reasons. This is supported by principle 3 within the consultation paper above – which relates to the autonomy of council. The autonomy of the sector will be compromised if a strict set of criteria is imposed on councils.

13. Apart from the exceptions identified by the Government (namely, new infrastructure needs from a growing population, changes in funding levels

from the Commonwealth Government, changes in State Government taxes and levies, increased responsibilities and unexpected incidents such as natural disasters), are there any other circumstances that would justify a case for above cap increases?

The MAV believes that changes in State funding levels must also be incorporated into the framework. No compelling argument can be identified by the Association for treating changes in funding levels differently solely on the basis of their source. A State Government funding cut will have exactly the same effect on councils as the same sized cut to Commonwealth funding.

Some recognition of the constraints on other revenue sources needs to be considered by the framework. As described above in our response to question 1, rates form only a portion of a councils' revenue base and if there are other constraints on the non-rating aspects, then this must be taken into consideration. Fees, fines and charges are frequently subject to constraints, either through statutory instruments (such as planning fees) or as a result of funding agreements (for example Home and Community Care program (HACC) fees for many services were constrained by less than inflation in 2014).

Population growth also has an effect on the cost of council services, not simply infrastructure. Expenditure growth can also change due to changes in councils' target populations for specific services, even if total population does not change. For example, the number of young children will drive early childhood program costs, or the number of people over the age of 65 is likely to drive HACC costs.

It may also not be possible to accurately identify the costs of new responsibilities when they are imposed. An example is restricted breed dog legislation, which has cost councils significant funds due to the impracticality of the regime and the high legal costs associated with enforcement of these laws. Some consideration should be given the 'catch ups' when these new responsibilities are shown to have a greater cost that estimated at implementation. Cost increases for existing services delivered on behalf of other parties (particularly the State and Commonwealth) should also be considered.

The MAV believes that these factors need to be considered within the context of relevant factors that influence the capacity of councils to raise revenue. Ultimately, an important consideration of the ESC is whether the framework is ultimately looking to constrain <u>expenditure</u> or <u>rates</u>. The former may be a more appropriate mechanism given the links between rates and other sources of revenue.

The MAV seeks some advice from ESC about the mechanics of the list above. If a council fulfils an exemption category, will they automatically receive an exemption?

14. What should councils need to demonstrate to get a variation approved? What baseline information should be required for councils to request a variation? A possible set of requirements could include:

a. The council has effectively engaged with its community
b. There is a legitimate case for additional funds by the council
c. The proposed increase in rates and charges is reasonable to meet the need

d. **The proposed increase in rates and charges fits into its longer term plan for funding and services**
e. **The council has made continuous efforts to keep costs down.**

We would like stakeholders' views on whether the above requirements are adequate

The MAV in principle agrees with the list of requirements as described above, although further advice would be required on the standards needed to fulfil the above list and obtain an exemption, and the circumstances in which councils would need to go through the assessment process. In particular, we are interested in the specific processes and standards of proof required by councils to confirm they have fulfilled the requirements. For example, assessing that a council has made efforts to restrain expenditure could be a significant and in-depth process that takes months to complete at significant cost; alternatively, it could be assessed in a more efficient manner by ESC. Our agreement with the efficacy of the above process would be dependent on the imposition placed on councils. We also believe that this list should be applied to the 'larger' third tier rate increase, as outlined in our answer to question 11, rather than the more modest 'tier two' increases.

We would welcome the opportunity to discuss these issues further with the ESC.

15. What does best practice in community engagement, process and information look like? Are there examples that we can draw from?

While the MAV does not propose to provide specific examples of community consultation, we would welcome the opportunity to discuss proposed models with the ESC further. The MAV believes that any community engagement should be meaningful, but should not impose significant costs on councils.

16. How should the framework be designed to provide councils with incentives to pursue ongoing efficiencies and respond to community needs? How could any unintended consequences be minimised?

The framework should provide sufficient flexibility to provide for the up-front costs of major efficiency projects, where significant investment may be required to deliver an efficiency program. An example provided by member councils are IT system deficiencies which may require the purchase of a new IT platform/system to implement a shared services model. An alternative example provided by a member council are the up-front costs associated with energy efficient street lighting – which will provide a significant an ongoing benefit through lower electricity prices.

The largest risk associated with the rate capping framework is that council infrastructure will be underfunded. The Victorian Auditor-General's Office provides an annual report on the financial position of the local government sector, which includes a number of indicators on the asset renewal performance of councils. These indicators also report on the indebtedness of councils.

The performance of councils in meeting their infrastructure renewal requirements should be monitored by assessing the trend performance against the VAGO indicators. In addition, the ESC may wish to utilise data available directly from councils on the performance of asset renewal. All councils will have an internal assessment of their asset management gap – this may provide a source of data to measure the continued performance of infrastructure renewal in an environment of rate capping.

17. A rates capping and variation process should ensure there is enough time for councils to consult with their ratepayers and for ratepayers to provide feedback, and for us to review councils' applications. To ensure the smooth functioning of the rates capping and variation framework, it is particularly important that it aligns with councils' budget processes. We are interested in stakeholders' views on how this can be achieved.

The MAV has above identified issues that may have a consequence on the timeliness of councils' budget setting processes. The exact consequences will depend to a large extent on the time required by the ESC to assess proposed rate variations and the framework it recommends.

Suffice to say, there are statutory processes in place that require public consultation on councils' draft budgets, as well as the delivery of the final budget by 30 June. The ESC will need to consider at what stage in the budget process a council would need to make an application for a rating variation. Should a proposed variation be made on a draft budget that has been circulated for public comment, the ESC will have to provide sufficient time for councils to issue a revised budget should the application for the variation not be successful.

In the first year of operation, we believe there may be some particular difficulties that exist due to short timelines around the release of the ESC's final report and the subsequent implementation of the variation arrangements that will need to be carefully considered by the ESC.

18. What transitional arrangements are necessary to move to the new rates capping and variation framework? Is there merit in phasing in implementation over a two year period to allow for a smooth transition?

The MAV believes that timelines provided for the implementation of the framework appear ambitious, given the potential significant work that would need to be undertaken by both councils and the ESC in the first half of 2016 to develop budgets, complete a review process by ESC, and adequately consult with their community.

This is particularly the case if legislative change is required for the rate capping framework and councils' preparatory work is undertaken without understanding the detailed operation of the cap.

Furthermore, the four-year council plan will be entering its last year before the council elections of October 2016. Wholesale revision of these plans, and the associated strategic resource plans, may undermine councils' long-term community and financial planning.

19. What are stakeholders' views on the respective roles of the key participants? Should the Commission's assessment of rates variations be advisory or determinative?

The MAV supports an advisory role by ESC in its assessment of variations. A determinative position will conflict directly with the above stated principle that councils are autonomous and democratically elected governments. An advisory approach by ESC will still be a powerful driver of efficiency in the sector by highlighting an independent expert's view on appropriate cost movements in a public and clear manner.

20. Is there a need for the framework to be reviewed to assess its effectiveness within three years' time?

The MAV would support a review of the rating cap to assess its operation and to identify any potential difficulties and unexpected consequences of the cap. Such a review should include all aspects of the operation of the cap – from the process with ESC and associated legislative budget processes from councils, to the interaction with council EBAs, infrastructure spend and the quality and scope of services delivered to the community. The review must consider the trajectory of the financial position of individual councils and determine whether councils have been adequately funding infrastructure renewal requirements.

21. How should the costs of administrating an ongoing framework be recovered?

The MAV strongly believes that the State Government should fund the ESC process. The imposition of this process will already result in significant costs to councils through the preparation of supporting materials for any application of a variation or rating approval. Ultimately, this policy is driven by the State Government and we believe that consequently, the State should also pay for the increased operating expenditure of the ESC.

Furthermore, the MAV argues that the cost of the framework should be entirely transparent and be publicly available. At a minimum, it is important that the ESC's total cost is made publicly available.

Should it transpire that ESC costs are borne by councils, such costs should be allowed as an automatic cost above the cap variation.

22. We are interested in hearing from stakeholders on :

- **a. Whether we have developed appropriate principles for this review**
- **b. Whether there are other issues related to the design or implementation of the rates capping and variation framework that stakeholders think are important**
- **c. Supporting information on the major cost pressures faced by councils that are beyond their control and the impact on council rates and charges.**

Items of relevance to question (a) are articulated in the previous section.

5 Conclusions

The MAV welcomes the opportunity to provide a response to the ESC's consultation paper.

As a principle, the MAV believes that a rate capping framework should not be in place for local government. It is accepted that the ESC has a responsibility to provide a framework for the government's consideration and it believes that the scope of issues contained within the consultation paper is comprehensive and considered. The MAV fundamentally believes that the democratic nature of the local government sector needs to be acknowledged in the framework and to this end, believes that the allowable circumstances under which a variation could be approved should be broad and based on council demonstrated that it has developed long-term plans (council and strategic resourcing) which reflect community values and preferences.

The Association wishes to continue to work cooperatively with the ESC to develop comprehensive responses to the issues and challenges posed by the consultation paper.

7 References

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