



# RURAL COUNCILS VICTORIA RESPONSE TO THE ESSENTIAL SERVICES CONSULTATION PAPER

LOCAL GOVERNMENT-  
RATES CAPPING &  
VARIATION FRAMEWORK

MAY 2015

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This submission is provided as Rural Councils Victoria's (RCV) input to the Essential Service Commission's consultation on the local government Rates Capping and Variation Framework.

RCV is an alliance representing the 38 rural Victorian councils, supporting and promoting sustainable liveable and prosperous rural communities.

Victoria's rural councils are responsible for 79 per cent of Victoria's land area and have a combined population of approximately 704,000 people<sup>1</sup> (June 2011). RCV's mission is to:

1. Heighten awareness and understanding of issues that impact on rural communities.
2. Assist with building the capacity of rural councils to face challenges.
3. Provide leadership on local governance.

The RCV Executive Committee - comprising two representatives, a councillor and officer from each of the six Municipal Association of Victoria rural regions - meet monthly to steer directions, identify priorities and guide the implementation of the program.

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## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

### EXECUTIVE SUMMARY

The Victorian Government has appointed the Essential Services Commission (ESC) of Victoria to develop and introduce a Rate Capping Framework from 2016/17. Rural Councils Victoria (RCV) has engaged the Centre for Local Government at the University of Technology Sydney (UTS) to assist in preparing a response to its Consultation Paper – Local Government – Rates Capping & Variation Framework. This submission addresses matters relevant to RCV and its members and responds to the guiding principles and initial responses of the ESC resulting from the Governments Terms of Reference.

RCV’s submission highlights that the proposed rate capping framework is a tax reform measure of local government rating. This submission addresses the importance of the proposed reforms complying with the principles of ‘Good Tax Design’ and the recommendations of Australia’s Future Tax System 2009 review, also known as the Henry Review. Most importantly, the report acknowledges that the rate capping measures should not be contrary to the recommendations of Australia’s Future Tax System Review 2009, which identified that recurrent land taxes and in particular local government rating are a growth tax of the future. Local Government rating is an important revenue source in lifting the tax effort of subnational government in Victoria.

It is found that the structure of the proposed rate cap must not be tied to CPI and that more indicative indices are more appropriate in setting a cap. It further highlights that the onus of proof must not be costly or a burden on local government resources. The Essential Services Commission must set out clear criteria for the determination of applications to exceed the proposed cap. The determination of applications to exceed the cap must be simple, transparent, efficient and equitable and the ESC must demonstrate the principles against a set of clear criteria.

The breadth of research used in responding to the proposed rate capping framework highlights that there is no one solution which fits the needs of all local governments across Victoria and the breadth of rural councils. Adaptability and flexibility of the proposed framework is crucial. The submission concludes that of overriding importance to the proposed reforms, is that the State government exercises the same level of transparency, integrity and consultation with local government that it expects local government to exercise with its communities in the administration of the proposed rate capping regime.

It is the objective of RCV to work with the ESC in achieving outcomes which, on balance, address ratepayer concerns while meeting the funding and financial responsibilities of rural councils. This objective is to be achieved with full cognisance of the constraints and specificities which determine the circumstances of rural councils in Victoria.



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# 1. INTRODUCTION

The Essential Services Commission (ESC) has been appointed by the State Government of Victoria to review its local government rating framework. The ESC has released a consultation paper entitled 'Local Government Rates Capping & Variation Framework.' Rural Councils Victoria (RCV), which represents 38 rural councils throughout Victoria, has engaged the Centre for Local Government, University of Technology Sydney (UTS:CLG) to assist in preparing a response to the ESC consultation paper.

RCV proposes to respond to the ESC's consultation process in two stages: the first stage responds to the adequacy of the terms of reference and factors of key importance to rural local government in Victoria. The second stage will address the Commissions draft report, due for release in July 2015.<sup>1</sup> The Commission is required to complete its review of rating in Victoria by October 2015 for Implementation in the 2016/17 taxing (rating) year.<sup>2</sup> This review results from the election commitment made by the current State government of Victoria prior to the last election, in response to the cost of living pressures of households in Victoria.

This submission introduces the guiding principles of the ESC's review followed by a summary of the stakeholders, and specifically those involved in the rating system. This is followed by a detailed examination of the terms of reference, the key issues identified by the ESC and RCV's response and input. A critique of the terms which are of specific importance to rural councils in meeting their statutory obligations and community objectives are addressed in specific detail.

In summary, it is the objective of RCV to work with the ESC in achieving outcomes which on balance address ratepayer concerns while meeting the funding and financial responsibilities of rural councils. This objective is to be achieved with full cognisance of the constraints and specificities which determine the circumstances of rural councils in Victoria.

Finally, the focus of this review is local government rates. Rates are a tax.

While often seen as a quid pro quo for services, rates should be subject to the principles of 'Good Tax Design' and hence, any review of such must comply with the robustness of these principles.

# 2. ESSENTIAL SERVICES REVIEW - GUIDING PRINCIPLES

The ESC has developed a set of eight principles which align with the Government's objectives in designing a rates capping and variation framework. In summary these principles<sup>3</sup> are:

1. Local communities differ in their needs, priorities and resources
2. Local communities and ratepayers are entitled to hold their councils to the highest standards of accountability and transparency when setting rates
3. The framework should support the autonomy of councils to make decisions in the long term interests of their community and ratepayers
4. Councils will need to satisfy the burden of proof outlined in the framework when seeking a variation above the cap
5. Rate increases should be considered only after all other viable options have been explored
6. The framework should support best practice planning, management systems and information sharing to uphold council decision making
7. The framework should be flexible and adaptable
8. There should be few surprises for ratepayers and councils in the implementation of the framework

Comments on these principles are provided throughout this response.

<sup>1</sup> ESSENTIAL SERVICES COMMISSION 2015:26.

<sup>2</sup> IBID. IV.

<sup>3</sup> IBID 15-19

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### 3. RURAL COUNCILS VICTORIA (RCV)

RCV was established in 2005 to co-ordinate the network of 38 rural councils across Victoria in their efforts to better understand, articulate and address the issues affecting them. The vision then was to create rural communities with sustainable economies contributing to the health, character and liveability of Victoria.<sup>4</sup> Rural councils are responsible for 79 per cent of Victoria's land area, which is diverse and includes many of the state's greatest natural assets and most of the biodiversity. The rural local council areas of Victoria are responsible for land which encompasses a range of natural assets and resources including the State and nation's food-bowl – also a significant export asset.

RCV provides a liaison mechanism between the rural councils and the State and Commonwealth Governments, as well as a conduit to industry, community groups, regional advisory bodies and planning committees. To this end it strives to be:

- A collective voice for rural councils, providing a platform for ongoing dialogue with rural councils and communities about their needs and be a conduit for the dissemination and exchange of information
- A collective voice speaking to other levels of government through co-ordinated advocacy campaigns, input into submissions and a presence on forums representing the views of rural councils in Victoria.
- A learning hub and to equip rural councils, leaders and residents of rural communities with the necessary information, skills and capacity to respond positively to ever changing environments
- A source of bottom up solutions and to strengthen the ability of rural councils to develop strategies to address identified challenges, such as population attraction, providing new job opportunities and enabling local business and civic enterprises to flourish.

As stewards of this vast area of natural assets, rural councils play a vital role in both ensuring the viability of local communities who are dependent on the health and productivity of these lands, waters and coasts, and communicating the significance of these assets to all Victorians.

Rural communities, industries and natural environments make an important contribution to the quality of life for all Victorians.<sup>5</sup>

LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

### 4. THE CHALLENGE AHEAD - TAX REFORM AND LOCAL GOVERNMENT

The challenge ahead for local government across Australia and, indeed, rural councils in Victoria, is two-fold. The first is the Commonwealth's freeze on the indexation of Financial Assistance Grants. This is coupled with the review and capping of Victoria's rating framework. Rates are the primary own source revenue for local government.

The first of these factors has been recognised by the ESC in scoping the problem to be addressed with its proposed rate capping reforms:

In recent years, the local government sector has experienced major cost pressures. In its 2014-15 budget, the Federal Government announced that the indexation of the Local Government Financial Assistance Grants would be paused for three years (2014-15 to 2016-17). Preliminary estimates by the Victorian Grants Commission (VGC) indicate that this will reduce funding by \$64 million (from the 2013-14 base) for councils by the time indexation resumes in 2017-18.<sup>6</sup>

Following the review of Australia's Tax System<sup>7</sup>, it was identified that recurrent land tax is one of the taxes that should contribute further to the own source revenues of subnational government. In Australia, recurrent land tax operates across two tiers of government: at the local government level in the form of rates; and at the state government level as a land tax. Their difference is that local government rates are perceived to be a benefits received tax, while state land tax is viewed as a consolidated revenue tax, with little connection to services or benefits.<sup>8</sup>

<sup>4</sup> <http://www.ruralcouncilsvictoria.org.au/about/history/#sthashjdm4jddk.dpuf>

<sup>5</sup> IBID.

<sup>6</sup> ESSENTIAL SERVICES COMMISSION (2015:4).

<sup>7</sup> AUSTRALIA'S FUTURE TAX SYSTEM (AFTS, 2009).

<sup>8</sup> MANGIONI, V. (2013) 'CODIFYING VALUE IN LAND VALUE TAXATION.'

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The ESC highlights under Principle 5 of its Guiding Principles, that 'Rate increases should be considered only after all other viable options have been explored,' but this principle stands in stark contrast to the recommendations of Australia's Future Tax System (2009). At some point, the money required to provide and maintain infrastructure and the services of local government must either be raised or repaid if borrowed. The taxation options of local government are primarily limited to the recurrent taxation of land in the form of rates. If the money is borrowed, it must be repaid. Repayment is made through tax receipts.

While user chargers are proffered as an option to increasing rates, these options are often overlaid by those removed from the realities of the delivery of local government services and infrastructure.

It was further highlighted that while constraints in revenue growth are impacted by rate capping and pegging at the local government level, no such constraint exists for increases in revenues for state land tax. In essence, the States seek to impose constraints on local government rates while allowing own source revenues from state land tax to increase in line with the site and improved values used to assess both of these taxes. In summary, while pressuring local governments to constrain their rates, there is unmet capacity to raise revenue from recurrent State land taxes; and the States provide significant tax benefits to residential property through the exemption of the principal place of residence and the land tax free threshold.<sup>9</sup>

In view of the tax policies of the States, local government should be encouraged to collect revenue foregone by the States.

This brings to the fore the challenge confronting State Government across Australia, if local government is to be the tier of government which improves revenue from recurrent land taxation. The question arises: how should a progressive local government rating system operate and perform in a modern tax system to provide adequate safeguards for ratepayers while meeting the financial commitments of local government? In this regard, Principle 5 of the ESC guiding principles is at odds with the recommendations of Australia's Future Tax System (2009). It also highlights the fact that there is no base line measure for determining the point at which a rate cap should apply.

A key question for ESC must be: what is the appropriate point at which rates should be determined in each local government area of Victoria, and to which a rate capping framework may then apply?

Victoria is not alone in the absence of benchmarking local government rating within the communities to which it imposes this tax. In federated structures of government similar to Australia, recurrent land tax has progressively been divested to local government, as is the case in the United States and Canada. In these countries, recurrent land tax is the domain of local government and the tax effort from this source is double Australia's tax effort from state land tax and local government rating combined.<sup>10</sup> The current dual recurrent land tax system in Australia is out-dated.

RCV proposes that structural tax reform is needed in relation to property tax in general, rather than just local government rating powers.

<sup>9</sup> MANGIONI, V. (2014) 'EMERGING TRENDS IN STATE GOVERNMENT LAND TAX AND LOCAL GOVERNMENT RATE REVENUE IN AUSTRALIA.'

<sup>10</sup> MANGIONI, V. (2016) FORTHCOMING BOOK 'FISCAL REFORM OF SUBNATIONAL GOVERNMENT IN AUSTRALIA'.

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## 5. STAKEHOLDERS AND STATUTORY OBLIGATIONS

There are several stakeholders of local government and the rating system in Victoria. These include the Valuer-General, who issues values (Site, Improved and Assessed Annual) for the assessment of rates. The Commonwealth and State Grants Commissions and the ESC each play an important role in the administration and operation of this tier of government.

This section provides a summary of the role of each stakeholder and highlights their importance to the funding of local government, and their specific importance to rural councils in Victoria.

### 5.1 The Valuer-General

The Valuer-General of Victoria issues land and property values on a biennial basis in Victoria. The valuation process is robust and encompasses the broadest bases of value on which rates may be assessed. Annexure 3 highlights the bases of value determined and on which rates may be assessed in Victoria.

The bases of value allows local government to select the most relevant base or bases on which to assess their rates. Site value is the most common base used in Victoria to assess local government rates. The bases of value used for assessing rates is important and underlines the objectives of a council, to ensure the equitable imposition of rates and charges across the diverse range of local governments in Victoria.

RCV supports the retention of the current bases of value used to assess the rating system in Victoria.

### 5.2 The Grants Commission

The Grants Commission is an integral part of the functionality of rural government in Victoria. While there are opportunities to apply more efficient rating policy in metropolitan and some regional local government areas, Commonwealth funding and the distribution of that funding by the Victoria Grants Commission is essential to, and indeed the lifeline for, many rural local governments.

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The susceptibility of rural local government to natural disasters, population loss and the limitations on revenue growth render them reliant on Financial Assistance Grants well above and beyond their metropolitan and regional city colleagues. It is noted that Australia wide, Victoria receives 24.8 percent of General Purpose Grants and 20.6 per cent of Local Roads Grants and that a greater proportion of grant revenue is allocated to rural local government on a per capita basis.

Rural local governments in Victoria have very limited capacity to improve their tax effort from rates and other user charges. Through its Rural Council Sustainability project, RCV will continue working with its constituent members and Local Government Victoria to refine financial strategies and policies, to improve revenue and to consult with their communities. This said, the importance of grant revenue and the formulae used to distribute this limited financial resource among councils must reflect the potential tax effort of local government across Victoria.<sup>11</sup>

The objectives of local government as set out under the Local Government Act 1989(Vic):<sup>12</sup>

#### Objectives of a Council

- (1) The primary objective of a Council is to endeavour to achieve the best outcomes for the local community having regard to the long term and cumulative effects of decisions.
- (2) In seeking to achieve its primary objective, a Council must have regard to the following facilitating objectives—
  - (a) to promote the social, economic and environmental viability and sustainability of the municipal district;
  - (b) to ensure that resources are used efficiently and effectively and services are provided in accordance with the Best Value Principles to best meet the needs of the local community;
  - (c) to improve the overall quality of life of people in the local community;
  - (d) to promote appropriate business and employment opportunities;
  - (e) to ensure that services and facilities provided by the Council are accessible and equitable;
  - (f) to ensure the equitable imposition of rates and charges;
  - (g) to ensure transparency and accountability in Council decision making.

<sup>11</sup> VICTORIA GRANTS COMMISSION 2014, ANNUAL REPORT 2013/14.

<sup>12</sup> SECTION 3C - OBJECTIVES OF A COUNCIL, LOCAL GOVERNMENT ACT 1989 (VIC)

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## 6. RURAL COUNCILS VICTORIA – RESPONSE TO THE TERMS OF REFERENCE AND ESCs ISSUES AND INITIAL RESPONSES

In responding to the issues which stand to impact rural councils of Victoria, we have aligned the Government's Terms of Reference (ToR) with the ESCs issues and initial responses to these terms, as set out as Annexure 1. We address each of the ToRs and ESC responses in commenting on their impact on rural councils and how RCV may contribute to meeting these objectives.

Terms of Reference 1 to 3 – Impact of successive rate increases above CPI on ratepayers, the proposal to cap increases at CPI and refinements to the application which could better meet the Governments objectives.

The ESC suggests that councils are best placed to make decisions in consultation with communities on their mix of services and infrastructure. However the ESC further suggests that prioritisation of these commitments is important, and that a cap on rates will impact such prioritisation. On this point, the RCV responds by highlighting that due to the limited rate capacity of its council members, the impact of a cap will have a relatively greater impact on its ability to meet its already over stretched commitments than would be the case for larger metro and regional city councils. To this end, the application of a rate cap on rural councils must be attended with greater sensitivity and flexibility for councils to meet their already over committed financial position as they strive to meet their legislated obligations to their communities.

Accepting the broader objectives of reform, RCV and its Council members will review current rating policies and systems with a view to identifying areas for refinement and better articulating the case for an increase in rate revenue.

<sup>13</sup> EXTRACTED FROM THE MAV WEBSITE 12-5-15 <http://www.mav.asn.au/about-local-government/local-government-finance/pages/cost-index.aspx>

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### LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

The fact remains, however, that many rural councils are already financially strained and working hard to streamline and modernise their operations to enable them to do more with less and meet the many new and emerging challenges, including a rapidly changing global economy, shrinking and aging populations, skills shortages, the centralisation of services, climate change and the increasing incidence of natural disasters, to name a few.

It is therefore recommended that a financial model is constructed to test the combined impact of freezing Financial Assistance Grant indexation and rate capping on smaller councils, as well as their capacity to absorb further shocks.

The ESC highlights that the use of CPI is an inappropriate benchmark on which to assess increases in the rate revenue of local government in Victoria. This sentiment was further extended by Professor Graham Sansom in his address to the Victorian Local Government Association VLGA and representatives of local government across Australia in April 2015. Professor Sansom highlighted the importance of flexibility in the development of a cap and that CPI was one of the poorest benchmarks on which to assess the movement in rate revenues. The ESC has identified alternatives to the CPI and refers to the Local Government Cost Index (LGCI) compiled by the Municipal Association of Victoria (MAV) as one alternative.

The LGCI was introduced in 2007 by MAV and has been an important guide for benchmarking and estimating costs of local government services. The 2013 critique of this Index by the Auditor General's Office suggests it is of limited value for a number of reasons. The MAV further highlights the relevance of the LGCI over CPI in the following.

Research indicates that local government costs typically increase by around one per cent above the consumer price index (CPI).

The CPI is a weighted basket of household goods and services. But, council services are quite different to household services, since a greater proportion of costs are directed towards providing infrastructure and social and community services.

These costs generally exceed other cost increases in the economy.<sup>13</sup>



## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

The ESC further acknowledges the difference between CPI and the LGCI proposed by MAV and highlight that the differential between the two indexes is also noted in New South Wales and South Australia. The ESC in addressing ToR 3, will examine options including the use of multiple caps, adopting simpler arrangements during the 2016-17 transitional year and the use of multi-year forecasting of the cap.

RCV emphasises the importance of not using CPI, but an index more in line with the movement in local government commitments. It further emphasises the need for the articulation of an index for rural councils and supports the option under consideration by the ESC for a multi-cap system which will better reflect the costs of rural councils. RCV further supports the use of multi-year indexes to assist council's better forecast and plan for the medium term.

In summary, RCV will support an articulate reform of an index that reflects the needs and commitments of its councils and welcomes further research and participation as to how this would be achieved to meet the diverse needs of its constituent councils.

Terms of Reference 4 & 5 – Simplicity of a rate capping framework tailored to meet the needs of a diverse local government sector, which accounts for governments short and longer term outlook, including (population growth / change, cuts to Commonwealth funding, additional statutory responsibilities, natural disasters, other sources of income available to councils. And monitoring of ongoing financial management on a sustainable basis, the monitoring of quality and sustainability of services and infrastructure and councils financial position.

In response to these Terms of Reference, the ESC has identified two factors to be addressed resulting from a rate capping proposal. The first is the monitoring of infrastructure in view of its potential to run down if rates are capped to CPI. The second addresses the potential for perverse incentives, which are defined broadly as unintended consequences for communities.

The ESC highlights that the outcome of rate capping will largely depend on how individual councils respond to it. It further states in referring to NSW, that potential for infrastructure backlogs may increase as some councils refrain from applying for funding above the cap or peg.

The RCV welcomes the opportunity for councils to be able to demonstrate their financial competence in the application process to exceed a cap, however RCV emphasises the importance of a simple and economically efficient process for councils to apply to exceed a proposed rate cap. Professor Graham Sansom highlighted the need for a clear structured criteria for councils to follow in making application to exceed the cap. He further highlighted the time and cost resources required in NSW, which would be of particular concern for most rural councils already struggling with limited resources.

The Chairperson of ESC responded at the presentation with Professor Sansom by highlighting that it was not apt for the ESC to create a tick the box approach to applications made to exceed the future cap. It was clear that different councils would have different rationales and criteria for exceeding the cap when necessary. It was suggested that the success of applications would be better assessed on the merits of the application. It is understood that for a period of reviewing initial applications to exceed the cap, that the ESC would progressively establish a criteria and guide for councils to follow.

RCV believes that better engagement with local communities to prioritise their service and infrastructure requirements, and on this basis set rating policy, should be a key pillar of the new framework.

RCV also asks that transparency and guidance be provided by the ESC in its determination of applications to exceed the cap.

Terms of Reference 6 & 7 – The processes and guidance to best give effect to the recommended approach for the rates capping framework and a practical timetable for implementation and options for ongoing funding to administer the rate capping framework, including the potential for cost recovery.

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## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

The ESC expects to work closely with councils to identify the best way in which the new requirements could be integrated into existing arrangements or how existing arrangements could be modified to support the new rates capping and variation framework. The benefits forecasted by the ESC would be a well-designed cap and variation process to prioritise and efficiently deliver services, contain rate increases and demonstrate their disciplined approach to ratepayers.

RCV asks that the ESC give thorough consideration to the resourcing implications of the new framework and the capacity of rural councils to find these resources. RCV would be pleased to work with the ESC on these initiatives to the point that local governments maintain decision-making processes and autonomy.

While constraints are imposed, it will be demonstrated in many cases that the backlog of existing and new infrastructure projects well exceeds the income capacities of many councils and the forward commitment of grant revenue yet to be received. Working with the ESC will give councils the opportunity to demonstrate the gravity of their revenue shortfalls and will provide a greater appreciation of the level of financial strain rural local governments are under.

It is acknowledged that in addressing this problem there is 'No Magic Pudding' for the funding of infrastructure projects.<sup>14</sup> It is further emphasised that funding rather than financing of infrastructure is a critical prelude to finding solutions to this problem.<sup>15</sup> Hence the two primary sources of funding infrastructure are taxes or user charges,<sup>16</sup> to which several financing options may be used to address the gap between the initial shortfall in tax revenue or revenue to be derived from user charges. While several options are proffered for the financing of infrastructure in Australia, these options must be funded either at their initial phase of the development or in servicing the sources of finance used.

Where the ESC is able to provide alternate forms of financing infrastructure projects, RCV welcomes the assistance in finding solutions.

The issue of static or shrinking populations warrants particular attention here, with many rural councils already at or below population thresholds at which services can be delivered cost effectively even with user charges, and significant subsidy must be found. Added to this, the distances to be covered by service providers add considerably to the costs of service delivery, well above and beyond the costs to metropolitan and regional city councils.

RCV requests that the issue of the minimum costs of providing services is benchmarked to aid in setting rating policies, and that consideration of the size of population to be serviced and travel distances inform the formula.



<sup>14</sup> COMMITTEE FOR MELBOURNE - DISCUSSION PAPER ON FUNDING AND FINANCING INFRASTRUCTURE IN VICTORIA

<sup>15</sup> IBID.

<sup>16</sup> PRODUCTIVITY COMMISSION 2014, PUBLIC INFRASTRUCTURE.

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## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

### VAGO's assessment of 12 councils' rating practices

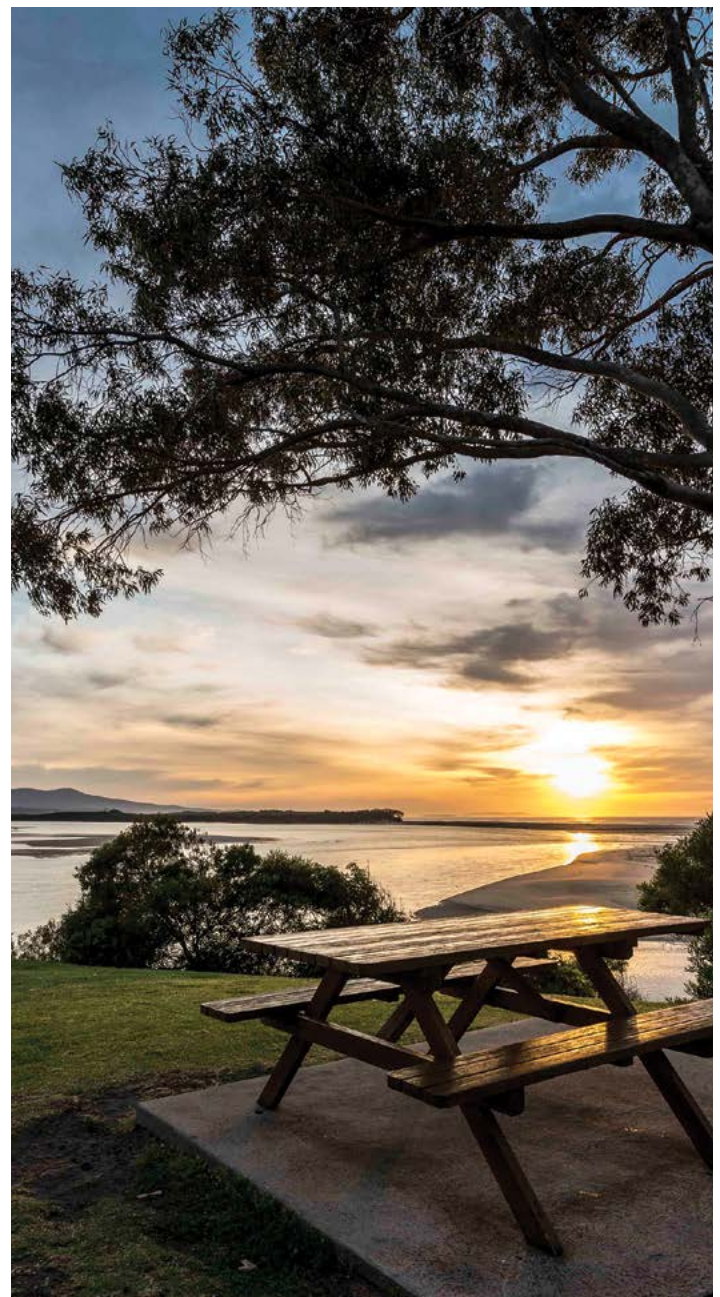
A further key issue identified by the ESC, which is not part of the State Government's Terms of Reference but included in the ESC's Consultation Paper, is the Auditor General's Review of Rating Practices in Victoria 2013. In this review, the rating practices of 12 local governments were analysed and among the conclusions, it was found that there is limited assurance that councils:

- Systematically and rigorously consider the information and evidence needed to adequately understand the impact of their rating proposals on their communities,
- Consistently calculate, and transparently report, key rates and charges data in a manner that allows scrutiny of decisions, and comparability between councils.
- The variation in revenue from rates between rural and metropolitan councils varied between 40 and 80 per cent, with the rural councils at the lower end and the metropolitan councils at the higher end of this range.
- There is little consistency in the way the councils report rating data, including medians, averages which in some cases included all property, including residential and non-residential rate revenue.
- Not all components of rates are included or reported i.e. surcharges, special rates or rate rebates.
- Rate modelling is not undertaken on the same basis across councils.

Among the recommendations for reform made by the Auditor General of Victoria include:

- Councils should undertake a periodic review of rating strategies.
- Department of Planning and Community should consider making rating strategies mandatory and better define how ratepayers should be engaged.
- Comply with the requirements of the Local Government Act 1989 in responding to submissions on the rate proposals in their budgets.
- Develop and implement comprehensive ratepayer communication and engagement strategies.

In addressing the matters raised by the Auditor General, RCV supports the broad recommendations for consistency in the reporting, strategies and community engagement in developing councils' rating strategies.



### Further Information:

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## 7. Principles of 'Good Tax Design' – Designing reform of local government rating in Victoria

In this section we consider the proposed opportunities for reform and the development of a rate capping framework which accounts for the factors of importance and relevance to RCV and its constituent members. In making a contribution to this strategy, we first consider the importance of the overarching principles of Good Tax Design, which dictates the operation and application of the reform of this tax (rates). We also refer to the ESC Consultation Paper and the questions provided which assist in the development of a proposed rate capping framework.<sup>17</sup> It is appropriate to commence with the most recent reviews of State taxes in Victoria and New South Wales.

While viewed as different taxes, local government rating and state land tax are defined as recurrent land taxes. The perceived purposes of these taxes while considered to be different in some quarters, are similar in their assessment, operation and administration. The most common element shared by these taxes is their salience and exposure and in contrast to other taxes such as income taxes which are collected and remitted by employers or consumption taxes, which are subsumed within the cost of goods and services. In contrast recurrent land taxes are directly imposed on and paid by the property owner.

The review of tax systems, and in particular individual taxes, requires benchmarking against criteria, more commonly referred to as principles of 'Good Tax Design.' These principles, comprise simplicity, transparency, equity and efficiency. In more recent reviews, a fifth principle of robustness or buoyancy has emerged which assesses the stability of tax revenue to government. These principles have both theoretical underpinnings and practical application.

In the application of these principles to land tax and local government rating, a number of state government tax reviews have provided context in ranking these taxes against these principles. In their seminal publication on public finance, Musgrave and Musgrave (1976:211) outlined the criteria that a good tax structure should exhibit including:

1. The distribution of the tax burden should be equitable. Everyone should be made to pay their 'fair share.' (Equity)

2. That should be chosen so as to minimize interference with economic decisions in otherwise efficient markets. Imposition of 'excess burdens' should be minimized. (Efficiency)
3. At the same time, taxes may be used to correct inefficiencies in the private sector, provided they are a suitable instrument for doing so. (Efficiency)
4. The tax structure should facilitate the use of fiscal policy for stabilization and growth objectives. (Stabilization and growth)
5. The tax system should permit efficient and non-arbitrary administration and it should be understandable to the taxpayer. (Transparency)
6. Administration and compliance costs should be as low as is compatible with the other objectives (Simplicity)

The most recent review of state taxes in New South Wales<sup>18</sup> and Victoria<sup>19</sup> have examined and ranked land tax against the principles of 'Good Tax Design.' In each review, land tax ranks as the most efficient of all state taxes with an overriding provision in the Victorian review. The Victorian tax review ranks land tax as the most efficient tax in theory, of which several matters impact its operational efficiency. The NSW state tax review highlighted the weaknesses in the taxation of land under the principles of transparency and simplicity, as shown in Figure 1. Contributing to poor performance against the criteria of transparency and simplicity is concern that taxpayers have poor information about their assessments. Impeding land tax further under these principles, is the availability of information to taxpayers as to how land value is determined, being the base on which their state land tax and local rates are assessed in New South Wales.<sup>20&21</sup>

On the principles of equity and efficiency, the tax in principle ranks high however in practice and as per the NSW tax review as shown in Figure 1, the tax scores lower. This is primarily due to the tax being applied to such a narrow number of property owners due to the exemption of the principle place of residence applied in every state. This factor impacts the principle of equity, to which the tax free threshold for investors further erodes the principle of equity. The Victorian tax review further adds the exemption for primary production land as a further ground impacting equity of this tax.

<sup>17</sup> ESC 2015, PG21-24

<sup>18</sup> IPART (2008)

<sup>19</sup> STATE BUSINESS TAX REVIEW COMMITTEE (2001)

<sup>20</sup> WALTON (1999)

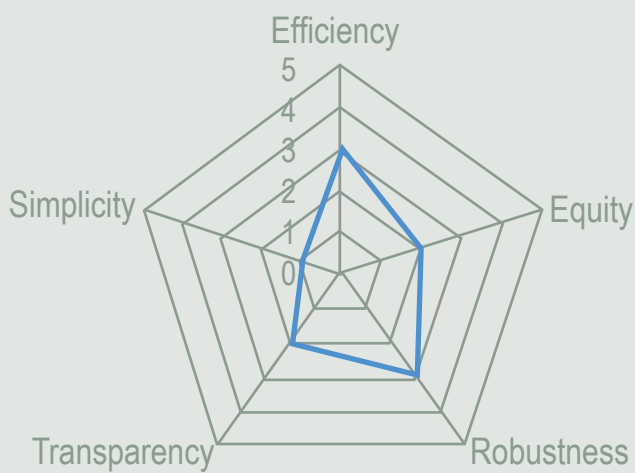
<sup>21</sup> NSW OMBUDSMAN (2005)

### LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

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Figure 1: State land Tax & tax design principles



A further negative impact of land tax raised in the Victorian review which sits outside the principles of good tax design, is the impact of cash-flow difficulties on asset rich and income poor taxpayers. This matter is addressed to a limited degree by Local Government Victoria which highlights the differing perspectives in its Better Practice Revenue Raising Strategies<sup>22</sup> Victoria has innovative provisions which allow local government rates to be deferred until property being subject to rates is disposed of or as otherwise determined by council.<sup>23</sup>

Victoria is in a strong position to increase its tax effort from local government rates. To this end rate capping policy which is poorly designed and dismissive of good tax design principles would adversely impact the requisite reforms needed to bring local government taxation policy into the 21st Century.

The prospect of capping rates must also apply to the application of state land tax, under the same tax principles of equity and efficiency. To allow recurrent land tax imposed by local government to be capped, while the tier of government imposing the rate cap on local government, is permitted to allow its land tax revenue to increase unfettered and inline the increase in values, should be reviewed by the Commonwealth Grants Commission, in the broader review of Australia's tax system.

In summary, local government rates in contrast to state land tax rank higher on the principles of economic efficiency, robustness and equity. On equity rates are imposed with very few exemptions however can falter to some degree on this principle where rating differentials distort the distribution of the tax burden. While the States score low on simplicity and transparency in the imposition of State land tax, the respective Offices of State Revenue have made quantum improvements in these principles.

The use of taxpayer education and seminars, online calculators, fact sheet and in some States, worked examples of how state land tax is both assessed and calculated have improved the perceptions of State land tax. In improving the image of local government rates, local government has scope to build public confidence in articulating the way rates are assessed, how values influence rate assessments and a broad overview of where rate revenue is spent by local government. It is not the role of government to explain where rates or taxes are spent to the level of minutia perceived by some critics. No tier of government provides a detailed account of where individual taxes are spent, State and Commonwealth taxes are viewed as consolidated revenue taxes and local government rates in principle are no different, although in practice do differ.

Rates are a primary revenue source of local government, which are broadly imposed on all property with few exceptions.

RCV will work with rural councils to improve taxpayer's perceptions of rates as a tax and not solely as a quid pro quo earmarked to specific services.

<sup>22</sup> LOCAL GOVERNMENT VICTORIA (2014)

<sup>23</sup> SECTION 170, LOCAL GOVERNMENT ACT 1989.

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## 8. Initial Response to ESCs Relevant Questions for the Review

ESC has developed 22 questions under 10 headings to assist and inform the development of a rate capping framework. RCV provides commentary on a number of these questions as follows:

### 8.1 The form of the cap and base to which the cap applies

As highlighted earlier in this response, the MAV Local Government Cost Index is may be a more relevant index for assessing increases in rates. CPI is an inarticulate and irrelevant index for determining movements in local government rates. To provide certainty, the capped increases need to be determined for a 3 to 5 year horizon to allow councils to plan and budget into the medium term and secondly, to contain the cost of preparing a submission for a rate pegging variation, which in NSW is upwards of \$40,000, a cost beyond many rural councils.

Given the freeze in indexing of grant revenue, the cap should encompass a component for the loss of increase as well as a component for organic growth of a council's expenses. On the question as to whether the cap should be based on historic or forecast movements in CPI, ESC must consult with rural local governments to understand that the future grant revenue foregone, has been accounted for in the maintenance and renewal of infrastructure. Given the capital intensity of such infrastructure councils should be able to accrue tax revenue for up to 3 to 5 years without being penalised in the assessment of applications to exceed the proposed rate cap.

The base on which the cap would apply, should not be fixed, but adaptable to allow for the diversity of rationales for which it would be sought by the diverse range of local governments seeking such variations. A review of how rates are determined by local government may assist in addressing the best approach for establishing flexible options for rate cap variations. This is particularly relevant where unmet capacity to raise rates is not maximised by councils.

## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

On the matter of valuations, Victoria has a responsible biennial valuation program and a diverse range of bases on which to assess its local government rates and state land tax as set out in annexure 3. A review of the frequency of valuations for the assessment of council rate increases is also recommended, particularly under a rate capping framework where rates are not strictly tied to movements in site, improved or annual values. Such a review may result in the frequency of values sought for rates being extended to 3 years. The current biennial valuation frequency in Victoria impacts state land tax but not local government rating.

The state must avoid bringing in annual valuations under the guise of reforming local government rating, in fact the opposite may be more prudent, for example extending the valuation cycle to triennial as suggested. Maintenance of multi bases of value for the assessment of rates and taxes must be maintained, as the adaptability of the base between highly urbanised, regional and rural local governments requires alternate bases of value. New Zealand is a good example of a jurisdiction where land value is used to assess rates in regional New Zealand, while Improved Value is used to assess rates in the four capital cities.<sup>24</sup>

The optimum period between valuation cycles is 2 to 3 years.<sup>25</sup> This is despite annual valuations being used in New South Wales and Queensland. These states are not the models on which recurrent land tax reforms at both the state and local government levels should be based. Victoria's recurrent land tax policy at both state and local government levels has distinct advantages over New South Wales and Queensland.

<sup>24</sup> MANGIONI, V. 2013 CODIFYING VALUE IN LAND VALUE TAXATION.

<sup>25</sup> IBID.

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## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

### 8.2 The Variation Process

The variation process should not be predicated on a predetermined rationale as the reasons for increases in rates are numerous and not always predictable. A broad grouping of infrastructure, community services and increases in administrative costs are among the broad groupings under which some of these groupings could be established. On the point of administrative costs, councils do not run on goodwill alone: wages and salaries of council staff and employees are a legitimate rationale for increases as well. Councils should not be frowned upon for properly remunerating and resourcing their operations.

ESC highlights population growth factors in adjusting local government funding levels from the Commonwealth. This must also apply to population declines which occur in rural local government areas. The options set out under Question 14 are reasonable considerations and in particular point 4, in which councils should actively be allowed to accrue revenues for longer term plans. Revenue and funding neutral annual budgets are not a progressive way to encourage local governments to be proactive in planning for the future. Where councils demonstrate initiative in serving their communities this should be encouraged.

This point ties in with question 16 on Incentives. Rather than taking a negative perspective on what councils might do, or the unintended consequences of perverse outcomes, all councils should be given the opportunity to show initiative and reform. The election process is a democratically robust process and is the best arbiter for dealing with unintended matters.

### 8.3 Timing and transitional arrangements

This is a most important and yet often over looked component of tax reform across all tiers of government. Timing and rationale have two dimensions in the roll out of a proposed rate capping reform. The first addresses the imposition of the framework and the second addresses options for how rate increases may be rolled out. The roll-out of the framework, while due to commence in the 2016/17 taxing year, could be progressively phased in over 2016/17 and 2017/18 years. Where councils can demonstrate in their budgets that future tax revenues have been earmarked to projects, these revenue increases should be excluded from the proposed cap.

### 8.4 Roles

On the question of whether the Commission's assessment of rates should be advisory or determinative, it is recommended that the Commission play a dual role and undertake both advisory and determinative roles at least in the early stages of the new policy. In assessing applications, it should be resourced to provide feedback to councils on the development of their rate variation applications in the initial phase until sufficient applications have been deliberated on by the Commission and the approach taken is well understood (eg for a 12-18 month period). Each application regardless of its success or rejection should also be made available to the public.



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## 9. Conclusion

RCV agrees in principle with the intent of the Commission: that local government becomes a more operationally efficient tier of government in cases that such reform is warranted. As the tier of government at the coalface of the community, communication and community engagement are important in building a well-functioning and transparent local government. It is important that State Government in Victoria builds a collaborative and consultative working environment with local government and does not take a combative and dictatorial approach.

RCV disagrees with Principle 5 of the ESC for the reasons set out in this response. It is a regressive principle which is contrary to the recommendations of Australia's Future Tax System (2009), limits the already narrow options available to rural local governments to fund themselves. Further it is counter to the contribution of local government in modernising Australia's Tax System and improving its tax effort. It is imperative that the review of rates - which are a tax - is done so within the principles of good tax design, which are absent in the Commission's consultation paper. It is further noted that the States exercise the same restraint in the imposition of land tax and that the reform of local government rating is not at the expense of revenue increases by the State.

RCV will support an articulate reform of an index that reflects the needs and commitments of its councils and welcomes further research and participation as to how this would be achieved in meeting the diverse needs of its constituent councils. This is subject to a financial model being constructed to test the combined impact of freezing Financial Assistance Grant indexation and rate capping on rural and smaller councils.

## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

RCV supports the retention of the current bases of value used to assess the rating system in Victoria which suits the assessment of rates across the diversity of urbanising and fully urbanised local government areas. It supports the retention of biennial or the possible introduction of triennial valuations, but strongly opposes the introduction of annual valuations. In addressing the matters raised by the Auditor General, RCV supports the broad recommendations for consistency in the reporting, strategies and community engagement of councils rating strategies.

RCV believes that better engagement with local communities to prioritise their service and infrastructure requirements, and on this basis set rating policy, should be a key pillar of the new framework. Where the ESC is able to provide alternate forms of financing infrastructure projects, RCV welcomes the assistance in finding solutions. RCV requests that the issue of the minimum costs of providing services is benchmarked to aid in setting rating policies, and that consideration of the size of population to be serviced and travel distances inform the formula adopted by ESC in determination of rating variation applications.

RCV also asks that transparency and guidance be provided by the ESC in its determination of applications to exceed the cap.



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# ANNEXURE 1 – Essential Services Commission terms of reference and ESCs relevant considerations

## LOCAL GOVERNMENT- RATES CAPPING & VARIATION FRAMEWORK

### In conducting the inquiry and providing its advice, the ESC will have regard to:

1. the role of local government in the provision of infrastructure and services to the community and the general efficacy with which they currently perform this task;
2. the differences between rural, regional and metropolitan local councils in terms of costs, revenue sources and assets maintained;
3. the Revenue and Rating Strategy guide and Local Government Performance Reporting Framework to be administered by the Department of Environment, Land, Water and Planning;
4. matters regarding rating practices and asset renewal gap raised by the Victorian Auditor-General's Office (VAGO);
5. Department of Treasury and Finance's Victorian Guide to Regulation and Victorian Cost Recovery Guidelines; and
6. any relevant insights from the experience of rate pegging in New South Wales, including any reviews or evaluations that can suggest ways to minimise any unintended consequences.

### Terms of Reference

1. Available evidence on the magnitude and impact of successive above-CPI rate increases by Victorian councils on ratepayers.
2. Implementation of the Government's commitment to cap annual council rate increases at the Consumer Price Index (CPI) with councils to justify any proposed increases beyond the cap, including advice on the base to which the cap should apply (e.g. whether to rates or to general income).
3. Any refinements to the nature and application of the cap that could better meet the Government's objectives.

### ESC - Issues identified and initial response

#### **Autonomy of councils should not be compromised by rates capping**

We are of the view that councils, in consultation with their communities, remain best placed to make decisions regarding the mix of services and the infrastructure they provide. We are not seeking to interfere with councils' consultations with their communities on decision-making regarding priorities, resource allocation and service delivery. A cap arrangement recognises that communities and their councils have limited resources and that councils themselves must be disciplined in how they prioritise their activities and pursue efficiently delivered services.

#### **CPI is not the appropriate index of council costs**

We will examine the merits of using an alternative index. The LGCIs separately developed for Victoria (by MAV), NSW and South Australia appear to be between 0.5 to 1.0 percentage point higher than the CPI, on average, over the last five years.<sup>16</sup> We will examine whether these or alternative indices are more reflective of the underlying cost drivers in the Victorian local government sector and we will assess the relative merits of using an index other than CPI. Should our analysis show that it would be beneficial to do so, we will include refinements to the cap that better meet the Government's objectives, as required under the terms of reference (TOR 3).

#### **We will also examine the merits of:**

- not being confined to a single cap
- adopting a simpler arrangement during the 2016-17 transition year,
- adopting multi-year forecasts of the cap to better assist council planning.

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# ANNEXURE 1 – Essential Services Commission terms of reference and ESCs relevant considerations

## LOCAL GOVERNMENT- RATES CAPPING & VARIATION FRAMEWORK

### Terms of Reference

4. Options for the rate capping framework should be simple to understand and administer, and be tailored to the needs of the highly diverse local government sector. The framework should take into account factors that may impact on local governments' short and longer term financial outlook, such as:
  - a. actual and projected population growth and any particular service and infrastructure needs;
  - b. any relevant Commonwealth Government cuts to Local Government grants;
  - c. any additional taxes, levies or increased statutory responsibilities of local governments as required by the State or Commonwealth Governments;
  - d. any extraordinary circumstances (such as natural disasters); and
  - e. other sources of income available to councils (for example, ability to raise user fees and charges from non-residents).
5. Consider how local governments should continue to manage their overall finances on a sustainable basis, including any additional ongoing monitoring of council service and financial performance to ensure that any deterioration in the level, quality or sustainability of services and infrastructure and councils' financial position is identified and addressed promptly.

### ESC - Issues identified and initial response

#### **Quality and level of service will deteriorate and infrastructure will run down if rates and charges are capped at CPI**

The terms of reference require us, in designing the rates capping and variation framework, to take into account factors that may impact on local governments' short and longer term financial outlook including any particular services and infrastructure needs (TOR 4(a)). We must also take into account the need for any ongoing monitoring to ensure any deterioration in the level and quality of services and infrastructure is identified and addressed promptly (TOR 5).

#### **Rates capping may create perverse incentives**

We recognise the limitations of simply imposing an external constraint without having regard to the constantly changing circumstances of councils. We will carefully design a rates capping and variation framework that maximises the incentives for councils to pursue ongoing efficiency and respond to community needs. At the same time, we expect councils will examine their own decision-making and management systems to ensure they support the long term interests of their communities and avoid any unintended consequences under the framework. Reporting on best practice engagement with communities and their satisfaction levels in regard to service delivery will be another important part of the framework.

#### **There are lessons from NSW's rate pegging**

We have heard numerous claims that rate pegging in NSW has caused infrastructure backlogs, particularly in circumstances where it was necessary to spend above the rate peg to address those backlogs. According to this view, rate pegging has created a situation where councils are reluctant to apply for a special rate variation, even when necessary, because of political risks. We have also been advised that some NSW councils have accepted rate pegging and treated it as a useful discipline to operate efficiently and strengthened their systems to make better financial and operating decisions. Other councils have appeared to shy away from applying for special rate variations.

We will heed these observations and will develop a tailored rates capping and variation framework for Victoria. We will design a framework that seeks to minimise the perverse incentives for councils to run down their critical and productive infrastructure. We are concerned by suggestions that some councils could choose not to apply for a rate variation in order to avoid scrutiny, even if this results in service deterioration and under-investment in critical infrastructure. We will therefore consider building appropriate safeguards into the Victorian local government rates capping and variation framework.

Ultimately, the outcome of rate capping depends on how councils respond to it.

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# ANNEXURE 1 – Essential Services Commission terms of reference and ESCs relevant considerations

## LOCAL GOVERNMENT- RATES CAPPING & VARIATION FRAMEWORK

### Terms of Reference

6. The processes and guidance to best give effect to the recommended approach for the rates capping framework and a practical timetable for implementation, including:
  - a. the role of councils, the ESC and the Victorian Government and the expected time taken by local governments and by the Victorian Government or its agencies, for each step in the rate capping process;
  - b. any technical requirements including the information requirements on councils that request exemptions from the cap;
  - c. any guidance required to give effect to the rate capping options (including in relation to consultation with ratepayers) and to improve accountability and transparency; and
  - d. any benchmarking or assessment of the effectiveness of the regime, including options to continuously refine the regime and improve council incentives for efficiency.
7. Options for ongoing funding to administer the rate capping framework, including the potential for cost recovery.

### ESC - Issues identified and initial response

#### **An additional layer added to the council budgetary and planning cycle**

We expect councils to work closely with us to identify the best way in which the new requirements could be integrated into existing arrangements or how existing arrangements could be modified to support the new rates capping and variation framework. Where benefits outweigh costs, we will recommend changes to the legislation and regulations to accommodate any new timelines for council and Commission processes. At the same time, we will seek to use existing information systems and planning processes to minimise any new requirements on councils for information and process.

#### **Ratepayers are concerned with historically high rates and wasteful or unnecessary spending by some councils**

A well-designed cap and variation process will work as a useful and independent discipline on councils to prioritise and efficiently deliver services, contain rate increases and demonstrate their disciplined approach to ratepayers.

#### **VAGO delivered a critical assessment of 12 councils' rating practices**

In 2013, VAGO reported, among other conclusions, that there is limited assurance that councils:

- systematically and rigorously consider the information and evidence needed to adequately understand the impact of their rating proposals on their communities,
- consistently calculate, and transparently report, key rates and charges data in a manner that allows scrutiny of decisions, and comparability between councils.

#### **Our initial response:**

We will carefully examine these deficiencies and consider how a new rates capping and variation framework may address these issues. In particular, we will issue guidelines and fact sheets to promote greater transparency and consistency for councils to set and report on rates.

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## ANNEXURE 2 – Rural Councils Victoria, 38 rural councils network:<sup>26</sup>

### LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

- 1 Alpine Shire Council
- 2 Ararat Rural City Council
- 3 Bass Coast Shire Council
- 4 Baw Baw Shire Council
- 5 Benalla Rural City Council
- 6 Buloke Shire Council
- 7 Campaspe Shire Council
- 8 Central Goldfields Shire Council
- 9 Colac Otway Shire Council
- 10 Corangamite Shire Council
- 11 East Gippsland Shire Council
- 12 Gannawarra Shire Council
- 13 Glenelg Shire Council
- 14 Golden Plains Shire Council
- 15 Hepburn Shire Council
- 16 Hindmarsh Shire Council
- 17 Indigo Shire Council
- 18 Loddon Shire Council
- 19 Macedon Ranges Shire Council

- 20 Mansfield Shire Council
- 21 Mitchell Shire Council
- 22 Moira Shire Council
- 23 Moorabool Shire Council
- 24 Mount Alexander Shire Council
- 25 Moyne Shire Council
- 26 Murrindindi Shire Council
- 27 Northern Grampians Shire Council
- 28 Pyrenees Shire Council
- 29 Borough of Queenscliffe
- 30 South Gippsland Shire Council
- 31 Southern Grampians Shire Council
- 32 Strathbogie Shire Council
- 33 Surf Coast Shire Council
- 34 Swan Hill Rural City Council
- 35 Towong Shire Council
- 36 Wellington Shire Council
- 37 West Wimmera Shire Council
- 38 Yarriambiack Shire Council

<sup>26</sup> RURAL COUNCILS VICTORIA - <http://www.ruralcouncilsvictoria.org.au/wp-content/uploads/governance-framework-endorsed-version-22-october-2010-rcv-ammended-2013.pdf>

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# ANNEXURE 3 – Bases of value on which council rates are assessed

## LOCAL GOVERNMENT-RATES CAPPING & VARIATION FRAMEWORK

### Bases of value used to assess recurrent land tax in Australia

Group <sup>a</sup>	Method	NSW	Vic	Qld	WAb	SA	Tas	NT
A	Assessed Annual Value (AAV)						✓	
	Annual value (AV)					✓ <sup>c</sup>		✓
	Capital improved value		✓					
B	Capital value					✓	✓	
	Improved capital value							✓
	Gross rental value (GRV)				✓			
C	Net annual value (NAV)		✓					
	Site Value (SV)		✓	✓		✓ <sup>c</sup>		
D	Land value (LV)	✓					✓	
	Unimproved capital value (UCV)							✓
E	Unimproved value (UV)				✓			

<sup>a</sup> Various terms used across jurisdictions to describe methods that are essentially the same and these are grouped together.

<sup>b</sup> Two methods are used in Western Australia, but these are restricted by land type: UV for rural only and GRV for non-rural only.

<sup>c</sup> The AV and SV methods can be used in South Australia if the council declared rates for that land on that basis for the previous financial year, or if the council declares rates for that land on the basis of capital value for the previous three financial years.

N.B. Qld moved from UCV to SV in 2010

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