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1. INTRODUCTION

Property taxes and user charges are the main sources of revenue of local governments in New South Wales (NSW) and in Australia generally. It is critically important for councils, ratepayers and service recipients that sound taxing and charging regimes are in place, and transparent and justifiable revenue-raising decisions are made. This paper examines these issues in the context of the NSW local government rating legislative frameworks. It has regard to the current practices of NSW councils and considers the potential to generate additional sources of revenue. It draws in particular on the recent Australian Centre of Excellence for Local Government Working Paper, “In Our Hands, Strengthening Local Government Revenue for the 21st Century” (ACELG “In Our Hands” Working Paper) that was written by the same author, and the associated research.1

2. FINANCIAL PERFORMANCE AND THE QUANTUM AND SOURCES OF REVENUE

In 2010/11 NSW local governments generated 33% of total GFS revenue from taxation and almost as much (32%) from sales of goods and services (user charges).2 Nationally local governments generated 37% of total GFS revenue from taxation and 25% from sales of goods and services (user charges).3

On face value it would appear that NSW councils generate a slightly higher percentage of revenue from their own sources than the national local government average. Care needs to be taken in making any conclusions between revenue-raising by local governments in NSW and elsewhere. For example GFS revenue includes capital revenue and the proportion of capital revenue generated by local governments is likely to vary between jurisdictions.4 Also the extent of local government involvement in provision of water supply and wastewater collection and treatment (both of which can generate material user charges) varies across Australia. Similarly NSW councils commonly apply a waste service charge but this is less common in other states (effectively elsewhere more additional taxation revenue is generated to offset associated costs).

The focus of this paper is on methods of revenue raising not the quantum of revenue that is raised or needs to be raised. Nevertheless an understanding of the latter is important to help set a context for and better consider the former.

TCorp (New South Wales Treasury Corporation) has recently undertaken an assessment of the financial sustainability of the NSW local government sector. Information below has been sourced from its Report of April 2013.

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1 Readers are referred to the ACELG “In Our Hands” Working Paper for more elaborate coverage of many of the principles and general issues discussed in this report.

2 See ABS Cat No.5512.0 Table 331.

3 See ACELG Table 1.

4 Capital revenue includes both money and physical assets 'donated' by another party. It includes grants from other spheres of government and contributions from developers for acquisition of capital stock. Publicly available information on the performance of the local government sector net of capital revenues in each jurisdiction does not exist.
In 2011/12 NSW local governments generated total operating revenue (excluding capital revenue) of $9.245 billion. The breakdown of this revenue by source is shown in Table 1 below and highlights that on average councils generate the majority of their operating revenue from sources they ‘control’.  

**Table 1: Sources of Operating Revenue**

<table>
<thead>
<tr>
<th>Source of Revenue</th>
<th>% in 2011/12</th>
</tr>
</thead>
<tbody>
<tr>
<td>rates and annual charges</td>
<td>52%</td>
</tr>
<tr>
<td>user charges and fees</td>
<td>19%</td>
</tr>
<tr>
<td>Operating grants</td>
<td>19%</td>
</tr>
<tr>
<td>Other</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Total Operating Revenue</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

TCorp also identified that councils collectively generated operating deficits (exclusive of capital revenues) of $288 million in 2011/12. Note however that if it hadn’t been for the early payment in 2011/12 of Commonwealth Financial Assistance Grants (FAGs) that were not due to be paid until 2012/13 then the operating deficit would have been $469 million.  

An ongoing underlying breakeven operating result is key to maintaining financial sustainability. The FAGs prepayment adjusted operating deficit of NSW councils in 2012/13 still only represents 5% of operating revenue. In other words if councils in aggregate had generated about 7% more own source revenue (that is revenue from rates, annual charges, user charges and fees) then they would have achieved a breakeven operating result (net of the early FAGs payment). It does need to be stressed however that this is an overall average. TCorp for example notes that in 2012 only one third of Councils (50) reported an operating surplus and that only 52% had an operating result of better than negative 4%.  

TCorp’s report also shows financial data for the sector for 2008/09 – 2010/11. It indicates a modest decline in FAGs prepayment adjusted operating performance over the 4 year period (the FAGs prepayment adjusted operating result in 2008/09 was a deficit of $299 million). Nevertheless the data also reveals that the sector at least on average is achieving reasonable financial performance and that with modest overall real (that is, over and above inflation) increases in revenue relative to operating expenses it could achieve satisfactory ongoing performance. However, many councils are unlikely to be able to achieve the necessary improvement on their under-lying operating result.

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5 Rate pegging imposes limits on rate revenue raising by NSW councils but councils can seek approval to apply increases in excess of the rate peg and many have successfully done so in recent years. As such it is the author’s view that this is a source of revenue that councils have a reasonable degree of influence over.

6 See TCorp Table 11.

7 See TCorp Table 4.

8 See TCorp Graph 13.

9 Ideally councils should strive to generate a small operating surplus on average over time to provide a buffer for risk and uncertainty.

10 Given that own source revenue represents 71% of total revenue it would need to increase by about 7% to generate 5% more revenue assuming real quantums of other sources of revenue remain unchanged.

11 See TCorp p.7 and p.40.
through efficiency improvements alone. They will require increases in rate revenue in excess of the annual rate peg and/or reductions in service levels in some areas.

TCorp also highlights that the sector reports that it has significant asset renewal backlog needs. The key to being able to address any asset renewal backlogs is firstly to be able to progressively improve financial performance such that in the longer-term an ongoing underlying operating surplus can be maintained. If this is possible then warranted asset renewal needs can be addressed by expending monies often held ‘in reserve’ and raising additional debt finance if required. Real additional increases in operating costs from addressing genuine asset renewal needs are likely to be manageable in most cases. There will be some financing related costs (and/or forgone interest revenue) but depreciation and maintenance costs should not rise materially.

TCorp also considered a range of other factors in its assessment of the financial sustainability of councils. It concludes that currently approximately 75% of councils have a moderate or better financial sustainability rating and 25% have a weak or worse rating.12 However, it also found that the outlook for the financial sustainability rating of councils is positive for only 3% of councils, neutral for 49% and negative for the remainder.13 This means that 48% of councils could have a weak or worse rating in 3 years’ time.

The above information taken collectively indicates that most councils will need to improve their financial performance over time. This is likely to require cost containment efforts through both pursuit of efficiency improvements and strategic decision-making regarding expenditure and affordable long-run service levels. It will also involve exploring opportunities to generate more revenue. Councils need a legislative framework that ensures they have the capacity to be able to equitably raise sufficient revenue to offset the long-run cost of their communities’ preferred affordable service levels. Such a legislative framework requires flexibilities to enable councils to utilise rating and charging options that best suit the variability in their operating environments and the circumstances and character of their communities.

The ACELG “In Our Hands” Working Paper suggests that there is a strong case why other spheres of government should provide more support to local governments in all jurisdictions. It warns however that the Commonwealth and the states have their own financial challenges and that it would be imprudent for local governments to base their revenue-raising and expenditure decisions on an assumption of more financial support for the local government sector as a whole from other governments in the foreseeable future.14 That paper argues that many councils nationally will be able to achieve satisfactory financial and service level outcomes with improvement from strategic but incremental changes in revenue and expenditure over time. It recognises too though that some councils, often serving large land areas with small population bases and a low own source revenue share of total revenue, need more help.

The ACELG “In Our Hands” Working Paper suggests that there is a case to reduce the minimum per capita amount all councils are guaranteed under the Commonwealth’s Financial Assistance Grants

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12 See TCorp Table 1.
13 See TCorp Table 2.
A lower minimum grant would allow distribution of a greater share of the pool of funds to those councils with relatively greater financial needs and disadvantage. There is also scope for the NSW Local Government Grants Commission to review its grant distribution methodology to see whether it could improve horizontal equalisation between councils independent of any change in Commonwealth imposed minimum per capita grant constraints. It is understood for example that the existing NSW methodology results in a much lower proportion of councils receiving the minimum grant than is common in some other jurisdictions. If the methodology used by the NSW Commission resulted in more councils receiving the minimum grant it would also therefore result in other councils with higher assessed relative needs receiving a larger grant.

Councils may understandably perceive that rate pegging legislation constrains their ability to generate more rate revenue. The reality is though that the provisions do enable councils to apply and be granted approval to set rate increases beyond the specified cap where justified. Whilst the approval process is arguably resource intensive for councils they nevertheless should not be reticent to apply for additional increases where necessary to provide and sustain service levels that are supported by their communities. Not doing so is not in their communities’ long-term interests.

It is hard to be definitive about average rating levels of NSW council compared with those in other states. NSW councils apply a separate charge for kerbside waste collection services whereas councils in other states more commonly don’t do so. As a result ‘general’ rates are necessarily higher elsewhere to compensate. Interstate comparisons of combined local government rating and charging is also obscured by the fact that the extent of water supply and waste water collection and treatment (and therefore rating and charging for same by councils) varies significantly within and across jurisdictions.

3. RATES AND CHARGES - THEORETICAL CONSIDERATIONS AND AUSTRALIAN LEGISLATIVE FRAMEWORKS

3.1 Taxes versus user charges

Council rates are a form of taxation; they are not a fee-for-service. However, councils also have the power to impose various user charges, and in many cases do so.

Generally speaking, governments should consider whether the characteristics of services they provide are predominantly those of ‘public goods’ or ‘private goods’. Public goods are those goods where (i) the use of or enjoyment by one person does not diminish their availability to, or enjoyment by, others (that is, they are non-rival); and (ii) it is not practical to exclude access to them. Fresh air or national defence are examples of pure public goods. Parks and road and footpath networks are examples of local government provided goods that have predominantly public good characteristics. Where governments provide private goods (i.e. goods which are rival in consumption and excludable), it is generally efficient to price such goods at cost and charge users a fee accordingly. Consumers, through their decision to purchase or not, will reveal whether they consider the benefits of such goods exceed their cost.

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Pricing public goods and charging individuals for their usage is inefficient and often impractical (it is why they will not be produced in the marketplace without government intervention). It is appropriate that their provision be funded via taxation.

In deciding the proportion of revenue to be raised from taxes and charges, a government should therefore have regard to the character of goods and services it provides. In some instances this can be problematic because many goods and services provided by governments have a mix of both public good and private good characteristics.

The recent ACELG paper highlighted that academic writings and government reports and inquiries considering the issue of appropriate sources of local government revenue continue to favour property taxes as a prime source. This is primarily because large proportions of local governments’ outlays protect and enhance the value and amenity of property. Most writers also favour property taxes being in the mix of taxes collected by the government sector of a country more generally. All taxes have relative strengths and weaknesses and having a mix of taxes helps to mitigate the downsides of over-reliance on particular taxes.

3.2 Tax design criteria

When designing and applying a taxation system the relative effectiveness of a tax and the incidence of its impact on different taxpayers needs to be assessed against generally accepted public finance taxation design theory considerations. Henry emphasises five criteria:

i. **Equity**;

ii. **efficiency**;

iii. **simplicity**;

iv. **sustainability; and**

v. **policy consistency.**

The Victorian Department of Planning and Community Development recently engaged Deloitte Access Economics to assist it to develop background material to inform the development of differential rating guidelines for Victorian local governments. Deloitte Access Economics suggested six tax design principles, consistent with Henry, that are particularly relevant for local government rating decisions:

i. **Equity**: this requires consideration of how the tax burden falls across different classes of ratepayers and needs to consider both;

   a. **Benefit principle**: where the distribution of benefits is not uniform, should those who benefit more contribute more?

   b. **Capacity to pay**: are those ratepayers with greater economic capacity in fact contributing more?

ii. **Simplicity**: Is the system practical and cost-effective to administer and enforce and simple to understand and comply with?

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iii. **Efficiency**: does the rating methodology significantly distort property ownership and development decisions in a way that results in significant efficiency costs?

iv. **Sustainability**: does the system generate sustainable, reliable revenues for councils and is it durable and flexible in changing conditions (that is, can it adequately withstand volatility)?

v. **Cross-border competitiveness**: to what extent does the rating system undermine the competitiveness of the council/state as a place to live and/or own a property or operate a business?

vi. **Competitive neutrality**: are all businesses conducting similar activities treated in similar ways within the municipality?

It is important that councils be aware of and have regard to relevant tax design criteria in their rating and charging decisions. Doing so enables decisions to be objectively defended and helps councils objectively weigh up inevitable requests for favourable treatment by various interest groups and better defend actual decisions.

### 3.3 Property valuation base for taxation purposes

In Australia there is wide disparity regarding valuation bases used for rating between jurisdictions. Land Value (LV) is currently mandated in NSW and Queensland (Qld). In Western Australia (WA), Annual Rental Value (ARV) is required to be used within the Perth metropolitan area and LV elsewhere. There is choice between all three bases in the other jurisdictions but in the Northern Territory only LV data is available. In two of the others (South Australia (SA) and Victoria (Vic)) councils overwhelmingly favour Capital Improved Value (CIV), and in Tasmania all choose ARV.17

Each of the valuation bases has both advantages and disadvantages for local government rating purposes relative to the others and different impacts for individual ratepayers. For example residents of high-value apartments are likely to pay lower rates than those of an average free-standing house in many districts when applying LV but more when using CIV.

The advantages, disadvantages and impacts of different valuation systems are discussed in more detail in the ACELG “In Our Hands” Working Paper.18 The literature does not present a compelling argument in favour of one particular valuation method. Each has its relative advantages. The preferred method essentially depends on trade-off choices between the weighting of the tax design criteria ‘capacity to pay’ (which is best reflected by CIV as there is often reasonable correlation between property values and occupiers incomes) and ‘benefits received’ (which is best reflected by LV because it better correlates with the relative value of local government services enjoyed by a property). Arguably CIV might be more appropriate in some circumstances (for example where there are a large proportion of high value apartments in the council’s area) and LV in others. Providing

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17 There are three main property valuation bases used in Australia. They are known by various different names and have slightly different basis of determination in different jurisdictions. For convenience this paper assigns them three generic names: capital improved value (“CIV”), land value (“LV”), and annual rental value (“ARV”). LV reflects the ‘land’ value only of a property, i.e. its worth net of any built improvements. CIV takes account of all improvements to a site and thus should approximate a property’s market value. ARV is based on an estimate of the annual rental worth of a property and has regard to the existence of structures and other improvements made to it.

18 See ACELG “In Our Hands” Working Paper p.31-32.
choice regarding valuation base could therefore enable a council to better address tax design criteria principles, but choice would potentially detract from the simplicity of the overall local government rating system.

It also needs to be borne in mind that property values, whether calculated based on CIV or LV, are not perfect indicators of either relative capacity to pay or relative municipal service-type benefits received. For these reasons regardless of whatever basis of valuation is applied it is important that councils consider utilising various other rating tools that result in the relative amount that any individual ratepayer pays not being determined solely by the relative assessed value of their property.

3.4 Frequency of property valuation cycle
In NSW properties are re-assessed every 3 to 4 years to determine their value for rating purposes. Revaluations occur more frequently in some jurisdictions and less often in others. 19

Even with annual revaluations it is not possible to keep valuations up to date in times of property booms. This issue obviously becomes more severe with less frequent revaluation periods. What matters for rating purposes is not so much whether absolute values are reasonably reliable, as whether relative valuations between properties are reliable.

Less frequent revaluations mean that at any point in time the valuation base used for rating and taxing purposes is less reliable. This means that some entities that have experienced a relative increase in value will be required to pay less than they otherwise would have and vice versa. The optimal frequency of the revaluation cycle therefore boils down to an equity/cost trade-off.

Normally less frequent revaluations will have negligible overall equity impacts but the exception is in periods where there is significant movement (up or down) in property prices. Even in such cases the long-run equity impacts are likely to be minor because the problem is resolved at the next revaluation. Nevertheless such situations can generate considerable ratepayer disquiet.

In Qld councils may choose to apply valuations averaged over a two or three year period or apply the current year’s assessed value. 20 It effectively means that rate increases due to a property experiencing a relative increase in assessed value are phased in over time. This option is not available to NSW councils but they can effectively and more transparently achieve a similar outcome by applying a ceiling to rate increases for such properties. 21

3.5 Differential rating
Use of differential rates can be appropriate where particular classes of property impose higher costs on the council/community or where their owners have greater capacity to pay. However, these factors are often difficult to objectively assess and leave determination of relative differentials subject to the political power of different classes of ratepayers.

All jurisdictions allow differential rating based on land use but the range of categories varies. Most also allow differentiation by location. Only Victoria and WA impose limits on the rate of differential.

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19 See ACELG “In Our Hands” Working Paper p.35.
20 See Regulations 74 – 76, Queensland Local Government Regulation 2012.
21 See NSW LG Act 5.601. Technically a council is required to be satisfied that a ratepayer would suffer “substantial hardship” before applying this provision.
differentiation between property categories.\textsuperscript{22} Up until recently no jurisdiction had provided guidance on the application of differential rating but Vic has recently done so.\textsuperscript{23} In all states where data has been able to be accessed (NSW, Vic, SA and Tas) it is clear that most councils utilise differential rating and typically apply higher differentials for commercial/industrial properties and lower ones for primary production properties. The reasons for use of differential rates where stated by councils often tend to be inconsistent with tax theory considerations. For example the claimed rationale often includes:

a) \textit{Differences in accessibility to services} (for example, a lower rate for rural properties or properties outside of townships). It is likely that any material difference in relative access to council services is already factored into property values. Differences in access to and availability of local government services is therefore not a factor warranting consideration in determining differential rates in circumstances where relative property values reasonably reflect these differences (all other things being equal).\textsuperscript{24}

b) \textit{The perceived tax deductibility of council rates for owners of commercial and industrial properties as a reason to apply a higher differential rate to such properties}. At the same time, many councils also set lower rates for primary production properties that are also used for generating taxable income. The reality is that councils do not know the tax status of ratepayers in different classes. Many residential properties are also owned by landlords who rent them out and claim a tax deduction for rates paid, yet councils usually charge a lower differential rate on residential properties compared with commercial and industrial properties. Views differ but there is a strong argument that the obligations of various classes of ratepayers to pay other taxes (or not) should not be a factor relevant to the setting of council rates.

c) \textit{Attempts to equalise the quantum payable (or achieve some other targeted relativity in amounts payable) or the percentage increase in amount payable between different classes of ratepayers and thus reduce or negate the influence of relative property values (or relative movements in property values)}. This undermines the consideration of relative capacity to pay in determining the amount payable by various classes of ratepayers.

The diversity of the services provided by councils and the character and circumstances of communities means that the availability of differential rating is a powerful tool that should be available to councils. Its use can enhance rating decision equity, provided it is applied in the context of other available and utilised tools and with due regard to taxation design criteria principles. These conditions are rarely met. All too often differential rating is over-used when other more ‘finely grained’ tools that can provide more nuanced outcomes would prove better choices.

\textsuperscript{22} In Victoria the highest differential rate can be no more than four times the lowest one. Refer Vic LG Act s.161. In Western Australia councils cannot impose a highest differential rate more than twice the lowest one unless Ministerial approval to do so is granted. Refer WA LG Act s.6.33(3).

\textsuperscript{23} Furthermore the Minister for Local Government may take steps to prohibit a differential rate if it is considered to be inconsistent with the Guidelines.

\textsuperscript{24} The Victorian Guidelines argue that differences in accessibility to services are an appropriate consideration in determining the application of differential rates.
3.6 Base charges and minimum amounts of rates payable

All jurisdictions allow the use of a base charge (called a ‘fixed charge’ outside of NSW) and/or a minimum rate to generate a share of rate revenue. Some allow the use of one but not the other and others provide choice. NSW allows use of both different minimums and/or different base charges for different land uses/localities. This provides additional flexibility in determining the distribution of the rating burden. It potentially enables better accommodation of ‘equity’ considerations but at the expense of the criteria of ‘simplicity’. Greater flexibility also leaves a council more vulnerable to lobbying for favourable treatment by special interest groups.

A base charge is a fixed fee levied equally against all properties. Rates based on property value are then levied to provide the additional revenue required by the council. The effect is to reduce the influence that property values have in determining the relative amounts paid by different ratepayers. By contrast, a minimum rate applies only to those properties with a value below a set threshold. The amount of rates payable by all properties with a value above that threshold is therefore determined solely by relative property values.

A base charge is likely to be a superior policy choice compared to a minimum rate, particularly when CIV or ARV is being used as a valuation base. Where CIV or ARV is used a minimum rate will be regressive as it effectively results in owners of lower-valued properties paying a higher rate of tax and performs poorly in regard to the tax design criteria of capacity to pay and benefits received. Where LV is applied the use of a minimum rate may be a superior choice depending on the nature of the distribution of assessed property values and the extent of correlation of LV with capacity to pay and benefits received. A minimum rate may for example more readily generate more rate revenue from flats and apartments.

The higher the amount of a base charge or a minimum rate the lower will be the ad valorem rate for any given revenue target. As a result higher valued properties may incur a greater or lesser share of the total rate burden depending on the level of the base charge or minimum rate. Applying a base charge will result in a different distribution between low, medium and high valued properties relative to the application of a minimum rate.

Graph 1: Illustrative impact of base charge and minimum rate on rates payable relative to property value
Some jurisdictions put limits on the proportion of revenue that may be generated by a base charge or minimum rate and others do not. This may be because to do so prevents rating outcomes that could be considered to be ‘inequitable’ or would be open to legal challenge.\(^{25}\)

In NSW rather than specifying a maximum proportion of properties that a minimum rate may apply to there is a prescribed minimum rate ceiling (currently $458). Councils may however make application to the NSW Independent Pricing and Regulatory Tribunal (IPART) for a higher minimum, stating the perceived justification of same. For example a council could possibly reasonably seek to do so if it has a high proportion of flats and apartments that may otherwise pay very low amounts of rates relatively to residential properties on single allotments. The Department of Local Government’s guidelines encourage councils to be mindful of the ceiling limit (50%) of revenue that can be generated from a base charge and of past legal decisions when seeking permission to apply a minimum rate in excess of the default maximum.\(^{26}\)

### 3.7 Special rates and user charges

In New South Wales councils that provide water supply and wastewater disposal/treatment services are required to charge separately for such service. This is common elsewhere. NSW councils are also required to separately charge for waste services. Such a practice is less common elsewhere, but should be followed by councils Australia-wide, as it improves transparency and accountability.

Wherever councils do provide significant private good type services they should generally seek to recover the full additional costs of provision of the service from recipients. Where there are sound reasons why this is not considered appropriate, councils should have clear internally consistent policies regarding why and in what circumstances concessional charging will be offered. These reasons may include capacity to pay considerations or the perceived indirect social benefits from encouraging usage. Increased reliance on user charging of citizens for service provision and of sporting and community groups that use local government provided facilities needs to be tempered with implications for access to, and use of, services. Where concessions are provided, these should be objectively determined and transparently applied in the form of explicit subsidies.

Opportunities to better utilise user-pays pricing of services and facilities will vary between councils. For example, inner-city councils may have opportunities that are not available to others to charge for car-parking on local roads. Wherever demand for a service or facility that offers primarily private benefits to recipients exceeds available supply, pricing should always be considered to help balance supply and demand.

As with any proposed increase in general rate revenue, a substantial increase in user charges or user rates may generate adverse reaction from service users. Councils need to ensure that not only such decisions are well thought through but that they are able and willing to justify and defend them and, where warranted, subsequently make refinements based on objective consideration of any feedback.

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\(^{25}\) Local government legislation typically describes rating as ‘ad valorem’ (properties with higher assessed values pay more). Courts have upheld challenges to rating decisions that have been significantly at variance from this ad valorem basis.

\(^{26}\) See Division of Local Government Council Rating and Revenue Raising Manual, Section 9.4.
3.8 Rating concessions and exemptions

Given that council rates are a tax, it is appropriate that some concessions be available for disadvantaged ratepayers. However, it needs to be borne in mind that local government rates represent only 3.5% of total tax revenue by all Australian governments.\(^\text{27}\) Other spheres of government are far better placed to effectively achieve income redistribution and social justice objectives because they have both more income and a broader base of taxpayers across which to equalise than do individual councils.

In all jurisdictions, there are mandated concessional arrangements applying to rates payable on the principal place of residence of aged pensioners. The cost of these mandated concessions are met by state governments in all states except NSW. Some councils in all states offer additional concessions to pensioners and wear this cost of in terms of revenue foregone.

In NSW pensioners are eligible for a concession of up to $250 on the combined ordinary rates and waste management charge applied by councils. However, councils are only reimbursed for 55% of the actual cost. The total cost of this concession was $64 million in 2012/13, compared with total general rate revenue of $3.6 billion (that is, exclusive of special rate revenue and user charges).

The public policy rationale requiring NSW councils to incur the cost of a large share of the mandated pensioner concessions is hard to understand. The cost is effectively being funded disproportionately by ratepayers that live in councils that have a higher percentage of eligible pensioners in them than the state average. It would be more equitable if this concession was funded by the state government or perhaps even through a uniform State-wide levy against all properties. The current policy if not varied is likely to become more inequitable over time with the expected demographic ageing of the NSW population. This ageing trend will no doubt also generate calls sooner or later for an increase in the amount of the mandated concession.

One of the few criticisms of local government rates in the literature is that they can adversely impact on those who are asset rich and income poor. The most equitable solution in such circumstances is not to relieve such ratepayers of the obligation for the payment of this tax and therefore require others (who may have more current income but less overall wealth) to pay more, but rather to allow such ratepayers to defer payment (for example for a principal place of residence until a change of ownership), which would be more equitable for all ratepayers and need not have any cost for a council.

Before offering additional discretionary rebates and exemptions to aged pensioners or other classes of ratepayers, councils should give careful consideration to longer-term financial and equity implications. Rate deferral arrangements (even long-term) for ratepayers with capacity to pay constraints (for example retirees on limited incomes) can be structured to have negligible or no cost to other ratepayers.

Legislation in place in all Australian jurisdictions provides rating exemptions and concessions for properties owned by the crown and either exemptions or concessions (rebates) for properties owned by various benevolent institutions and charities. Arrangements do not appear to vary significantly between jurisdictions.

\(^\text{27}\) Refer ACELG Table 7.
Whenever a property owner or class of property owner is exempted from paying rates it means that other ratepayers must either pay more and/or receive lower levels of services than would otherwise be the case. The granting of exemptions must detract from satisfaction of at least some tax design principle considerations. There needs to be compelling reasons therefore to show that on balance any exemption is warranted.

In some jurisdictions rates are able to be levied on properties that are under the care and control of some (but not all) government business enterprises and in other jurisdictions this is not so. There is no logical reason why government business enterprises should not pay local government rates other than that traditionally it was once accepted that spheres of government did not tax each other. In particular there would seem to be a strong argument for the payment of rates where their activities impose significant additional costs on a local council.\textsuperscript{28} The local government sector does need to be mindful however that it often is not required to pay taxes imposed by other spheres of government (for example income tax on commercial activities or stamp duty or payroll tax).

In the case of benevolent institutions and charities the argument for an exemption or concession would be stronger if the property was used by the entity to serve primarily the local community (in such cases the community that enjoys the benefits would effectively be bearing the cost). If the entity uses the property to serve a broader community or for commercial activities to help fund its wider activities then it seems more appropriate again that any concession deemed warranted should more appropriately be funded by the state.

In the interests of transparency it would also be more appropriate for rebates to be applied rather than exemptions. This would make it clear to stakeholders the concession provided and the burden on other ratepayers (in terms of either additional rate payments that they are levied and / or losses in service provision).

Deloitte Access Economics has recently been engaged by Local Government NSW to investigate current mandated rating exemptions and concessions that apply in NSW. This will also cover the issue of non-rateable land in rural areas. That work may hopefully inform further objective consideration of what is invariably a sensitive and emotionally charged issue.

4. RATING AND CHARGING PRACTICES AND CHOICES OF NSW COUNCILS

Many of the services delivered by local governments are generated by long-lived infrastructure. It is critical that councils have regard to medium and longer-term needs when making their annual budget decisions. In NSW the Local Government Act requires councils to comply with an Integrated Planning and Reporting Framework. Its intent is to encourage community input into the development of a long-term Community Strategic Plan by councils and for such plans to drive the development of their medium-term resourcing proposals and annual operational plans and budgets.

\textsuperscript{28} An example could be a state owned commercial forest where logging activities adversely impact on the cost of maintaining a local road network.
The NSW Division of Local Government maintains an up-to-date database of the rating and charging decisions of NSW councils. Practices applied in 2011/12 have been analysed and key findings are discussed below.

4.1 Sources of rate related revenue
As highlighted in Section 3.6, NSW councils may apply a base charge as well as an ad valorem rate against the value of a property to generate rate revenue. If councils don’t apply a base charge they may instead apply a minimum rate. Councils can apply a base charge against some land uses and a minimum rate against others.

Graph 2 below shows the number of councils that generate varying proportions of total general rate revenue from base charges, minimum rates and the ad valorem rate. It illustrates that most councils generate only a very modest share of their total rate revenue from either base charges or minimum rates. This suggests that many councils have scope for greater reliance on these mechanisms should the circumstances of their ratepayer base suggest that this could enhance overall outcomes relative to tax design policy criteria. For example in council areas with a large proportion of high density residential properties (e.g. flats and apartments) there may be equity grounds (in terms of either capacity to pay and/or benefits received) to warrant such an approach.

Graph 2 also shows that a small proportion of councils (22 in number) generate more than 50% of their total rate revenue from the minimum rate. Moreover, in 2011/12 at least 45 councils had at least one minimum rate that was above the ‘default’ ceiling (i.e. they had justified the case to do so). Councils should always consider whether alternative rating strategies (for example involving use of base charges, differentials and special rates) may better satisfy equity and other tax design criteria and produce an overall superior outcome.

Graph 2: Proportions of General Rate Revenue: Base Charge, Minimum Rate and Ad Valorem Rate
Although some councils rely heavily on a minimum rate most in fact generate only a small proportion of their rate revenue from either a base charge or a minimum rate. The relatively modest share of rate revenue generated by the base charge and minimum rate revenue consequentially must mean that the actual level of the base charge or minimum rates applied by councils is also quite modest in most instances. This is confirmed in Graph 3 and Graph 4 below. Graph 3 shows the number of councils that have an average value of their base charge (many have more than one base charge) in varying value ranges. Graph 4 shows the number of councils that have an average value of their minimum rate (many have more than one minimum rate) in varying value ranges.

**Graph 3: Average Base Charge per council**

![Graph 3: Average Base Charge per council](image-url)
4.2 The number of base charges and minimum rates applied by councils

Councils are permitted to apply differing base charges or differing minimum rates for any class of property where a differential rate applies. Many councils have a very large number of bases charges and minimum rates as is shown in Graph 5 and Graph 6 below.

Eighty six councils apply one or more base charges. The highest number of base charges is 25 by one council. Graph 5 shows the number of councils that have between 1 and 25 base charges.

Eighty nine councils apply one or more minimums. The highest number of minimums applied is 27 by one council. Graph 6 shows the number of councils that have between 1 and 27 minimum rates.

As highlighted in Section 3.6 above it is possible that having multiple base charge and minimum rates could theoretically enhance satisfaction of overall tax design criteria even though it detracts from simplicity. Nevertheless the number of different minimums and different base charges applied by many NSW councils seems high and such an approach is more likely to detract from rather than improve the achievement of satisfaction of overall tax design principle considerations. It would be interesting to understand why councils that apply a large number of different base charges and minimum rates do so. Prima Facie there would appear to be merit in curtailing the use of a wide number of base charges and minimum rates by a council.
Graph 5: The number of base charges applied by councils

Graph 6: The number of minimum rates applied by councils
4.3 The number of differentials applied by councils and the extent of differentiation

Councils may apply a different ad valorem rate in four different land use categories, being:

- Farmland;
- Residential;
- Mining; and
- Business.

Councils may also apply further differentials in any number of land use sub-categories which effectively can allow for different rates in different localities. Many councils apply a very large number of differential rates as is shown in Graph 7 below.

Applying more rather than fewer differential rates could theoretically enhance satisfaction of tax design criteria but this seems unlikely where many differential rates are applied. Councils are usually not well placed to make informed judgements of the capacity to pay and costs imposed on/benefits received by highly refined classes of ratepayers.

Graph 7: The number of differential rates applied by councils

Not only do NSW councils apply a large number of differential rates but the range of the differentials applied by individual councils is also very high. In Victoria and SA for example the majority of councils that apply differential rates would have a highest differential that is no more than four times (and often no more than two times) the lowest differential. In NSW all councils apply
differential rates and only 13 have their highest at double or less than the rate of their lowest. In fact less than half of all councils (62) have their highest at five times or less than the rate of their lowest.

There is no consistent pattern as to land use categories that are levied with the highest differential rate in NSW. In some cases it is mining properties but in others it is for example residential, commercial or irrigated horticultural properties (including in councils that have a mining differential rate). It would be more understandable if mining properties often had a higher differential rate than other properties since the value of the property may often be relatively modest (since it won’t take account of the value of mineral rights) relatively to capacity to pay and use of such properties may generate significant costs for councils (for example the impacts on the local road network).

It appears likely that at least some councils are using differential rates to achieve particular revenue targets for specified classes of properties. If so this would imply that they are viewing rates more as a ‘service charge’ than as a tax. It is also likely that the degree of political lobbying exercised by various classes of ratepayers is a factor in influencing the relative differentials applied to all ratepayers in at least some councils.

Graph 8 shows the number of councils that have a ratio of highest to lowest differential rate in varying value ranges. It is unlikely that having a very high variance between the highest and lowest differential applied by a council would enhance overall satisfaction of taxation criteria principles in most instances. If councils wish to apply differential rates it is important that they are able to articulate the rationale for their decisions relative to rating theory considerations. It is suggested that councils be required to set out the reasoning for their differential rating decisions whenever adopting differential rates.

**Graph 8: Ratio of highest/lowest differential by councils**
4.4 The use of special rates
Section 495 of the Local Government (LG) Act allows councils to levy special rates to meet the cost of any works, services, facilities or activities (except for domestic waste services for which the LG Act provides for separate charging provisions). The number of councils that levy one or more special rates and the number of special rates they apply is shown in Graph 9 below. Only 47 councils apply one or more special rates and the majority of these apply only one or two.

Graph 9: Special rates by councils

Where special rates are currently applied they are used generate funds for a wide range of purposes such as:

- Provision of car parking (e.g. in town centres);
- Environmental programs;
- Main street upgrades and town centre improvements;
- Tourism programs;
- Library facilities;
- Infrastructure upgrades;
- Supporting facilities;
- Bushfire mitigation works;
- Levee banks;
- Open space acquisition;
- Economic development initiatives; and
- Community safety programs.
The most common reason across all councils for application of a special rate is in relation to business district upgrade works.

In theory any relative difference between properties in the provision of and access to local government services will be reflected in relative property values. As such it could be argued that there is no need to levy special rates as all other things being equal beneficiaries of the service will already pay extra in general rates to offset the cost of the additional benefits they enjoy. Property values though are also influenced by a wide range of other factors and relative property values are unlikely to increase proportionately to the value of any specific works undertaken that they benefit from. It is still therefore likely to be more equitable for ratepayers that clearly directly benefit from ready access to provision of specific public goods be charged a special rate for such services.

Special rates can also be appropriate for the funding of provision of public goods that reasonably equally benefit all ratepayers by promoting greater transparency and accountability. Ratepayers sometimes find it more acceptable to pay more in overall rate revenue if part of any increase was raised by a special rate, for example for projects with tangible benefits and high levels of community support.

Only a minority of councils currently apply special rates but they do so for a wide range of activities that are also commonly provided by other councils too. This suggests that there is considerable potential for greater utilisation of special rating powers by many councils. Such an approach is likely to enhance the achievement of satisfaction of tax design criteria principles of rating and charging decisions.

4.5 Rate Pegging

As highlighted in Section 1 of this report many councils need to generate more revenue if they are to sustainability maintain service levels on an ongoing basis. Whilst efficiency improvements may help bridge the gap between operating revenues and operating expenses they are unlikely to be more than a part of the answer. If as is likely there isn’t material increases in grants from other spheres of government then councils themselves will need to generate more revenue from ratepayers and service recipients.

Rate pegging has helped encourage a perception amongst councils that they are not responsible for the financial predicament that many find themselves in. Ideally rate pegging should be discontinued and replaced with a legislative framework that ensures effective engagement between councils and their communities in the determination of the balance between service levels and resulting necessary revenue – raising. The existing Integrated Planning and Reporting Framework provides a sound framework but needs to be strengthened. For example to better ensure that councils have prime regard to accrual accounting information (and particularly forecast operating result outcomes for the current year and projected into the future) rather than cashflow needs when setting rates and charges.

If rate pegging is to continue, it needs to be applied within a framework that ensures councils are making well informed and fiscally responsible decisions about their revenue needs and mix. They should not resile from making application for increases beyond the cap where this is warranted. They are doing their communities no favour by not doing so. It would also seem reasonable that where a council seeks to introduce a special rate to offset the cost of an additional service or to
upgrade an existing service for a select group of ratepayers, and has effectively consulted with them regarding the proposed levy, the additional revenue be exempt from the rate peg.

4.6 Summary

NSW local government rating and charging frameworks are broadly consistent with those of other Australian jurisdictions. All provide a reasonable degree of flexibility to allow councils to tailor rating and charging decisions to the diverse range of service level and community character circumstances that can exist. It is important though that flexibility is applied in ways that have regard to overall satisfaction of tax design principles. There is considerable diversity in the rating practices of NSW councils and many councils apply a large and arguably complex mix of rating strategies. It is probable in most instances that a simpler approach with generally greater reliance on base charges, minimum rates (but with a lesser range of base charges and minimum rates) and special rates and less reliance on differential rates could enhance consistency with tax design considerations relevant to local government and thereby enhance overall community welfare.

5. THE WAY FORWARD

Over the next 25 years some NSW councils will experience significant population growth and others substantial decline. There will be a continuing strong trend to higher density living in many urban environments. Certainly many councils will experience in situ ageing of their populations, and a significant number will also receive an influx of retirees. Some will see new mining projects. A well designed rating framework needs the flexibility to best suit the diverse character of communities of different councils and changes that occur over time.

There is no silver bullet for strengthening local government revenue raising capacity in NSW. Property rates and charges are likely to remain the primary own-source revenue for almost all councils, and are a highly appropriate local government revenue source. Most councils are unlikely to have potential to generate considerable increases in revenue from other sources. Rate pegging imposes some additional constraints for NSW councils, but as elsewhere in Australia NSW councils need to focus primarily on applying a soundly based property tax system and basing service levels on long-term affordability.

Regardless of the quantum of rates and charges revenue raised, councils need to be able to clearly and persuasively demonstrate that the strategy they choose to apportion the levying of this quantum between various classes of ratepayers and service recipients is appropriate.

Any rating system will inevitably involve trade-offs between various taxation policy design criteria considerations. The system that best reasonably optimises fulfilment of tax design criteria considerations will vary between councils and for any given council over time. This is because rating and charging decisions need to have regard to both the character of the community served and the nature of the services provided.

Care needs to be taken in generalising based on available broad brush data but having regard to rating and charging theory considerations and the current rating practices of councils there appears to be a need for improvement in local government rating and charging legislative frameworks and council decisions. This includes the following:

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NSW LOCAL GOVERNMENT RATING AND CHARGING SYSTEMS AND PRACTICES
April 2013
i. Local government rates are a tax
The LG Act currently stipulates that the imposition of rates by councils should be fair.\textsuperscript{29} It doesn’t stipulate what ‘fair’ means. Presumably it means equitable. It would be better if the LG Act explicitly stated that local government rates are a tax and that councils need to have regard to generally accepted tax design criteria in the structure of their rating and charging decisions. This would indirectly help reinforce that local governments are a sphere of government and therefore have the associated accountabilities that come with being a government and not just a ‘utility service provider’. To this extent it would be reasonable for guidelines to be prepared that explain tax design considerations and how the application of a mix of different rating tools can enhance (or detract from) the overall reasonable optimal achievement of all relevant criteria.

ii. Rating valuation base and frequency
Rating using CIV would help councils better correlate amounts payable by ratepayers with their capacity to pay. LV also though has advantages and given the costs of transition to CIV considerable further research would need to be undertaken before seriously contemplating a switch to CIV based rating. Providing choice of either LV or CIV would arguably detract from overall simplicity but would enable those that believe there are on balance good grounds to apply CIV to do so.

It would be worth exploring the costs and benefits involved in more frequent re-assessment of property values, for example to every 2 to 3 years compared with the current 3 to 4 years. More frequent revaluations would enable councils to make more equitable rating decisions but such benefits need to be weighed against the additional costs that would be incurred.

iii. Explicit rating policies
All councils should adopt specific rating policies that explicitly indicate the rationale for their choice of rating tools including why they believe that this mix best satisfies overall taxation policy theory considerations. Such a policy should be regularly reviewed to take account of changing circumstances, for example as part of councils’ integrated planning and reporting obligations.

iv. Base charge and minimum rates
If CIV was to be applied then a strong argument would exist to abolish application of the minimum rate. If LV is retained then it would be reasonable to retain both the base charge and minimum rate options for use by councils (since application of a minimum rate may better reflect capacity to pay considerations when LV is the basis of rating). Simplicity would be enhanced if a council was only able to apply a base charge or a minimum rate but not both.

There is likely to be value in providing guidance to councils on the factors that should be considered in determining when to apply:

- a base charge or a minimum rate,
- multiple base charges or multiple minimum rates,

\textsuperscript{29} See NSW LG Act S.8(1).
• base charges or minimum rates that generate a minor or considerable share of total rate revenue.

Rather than continue to prescribe a maximum value for the minimum rate a more flexible approach that would better suit the circumstances of individual councils and their communities would be to specify a maximum proportion of rateable properties to which a minimum rate determined by a council could apply. This would mean that a council could set a minimum rate up to but not beyond a level at which the ceiling proportion of affected properties would be exceeded. Further research would need to be undertaken to ascertain whether provision should be retained for a council to be granted approval to set a minimum rate above this ceiling in certain circumstances. (This would depend in part on what other rating related legislative reforms are proposed).

v. Differential rates
Differential rates should be considered for application whenever there is reason to believe this would enhance correlation of amounts payable by ratepayers with capacity to pay or offset costs directly or indirectly imposed by some classes of ratepayers on councils in excess of revenues otherwise generated. Consideration of the use of differential rates needs to have regard to other rating tools used or available.

The merit of the rationale for the large number of differential rates currently applied by councils and the high variation between lowest and highest differential rates commonly applied by individual councils warrants further investigation. Such findings could help inform decisions as to whether legislative refinements (for example to restrict highest differentials being above a certain multiple of the lowest differential) and/or whether additional guidance material may be warranted.

vi. Concessions and exemptions
The work currently being undertaken by Deloitte Access Economics for Local Government NSW should inform consideration of reforms in this area. Consideration though should be given to removing the requirement of councils to fund 45% of the mandated pensioner rating concession and also facilitating through explicit legislative provision rate deferral arrangements for the principal place of residence of pensioners.

vii. Special rates
Councils should be encouraged to make greater use of special rates. In particular they should consider applying special rates whenever material projects are undertaken or services provided to an identifiable specific class of property owners. Consideration should be given to exempting special rates from the rate-pegging limit where there is a high level of support for their introduction amongst contributing ratepayers.
REFERENCES


Department of Planning and Community Development State Government of Victoria, Apr 2013, Differential Rates Discussion Paper and Draft Ministerial Guidelines.

