PROPERTY COUNCIL of Australia

Australia's property industry
Creating for Generations

Property Council of Australia
ABN 13 00847 4422

Level 1, 11 Barrack Street
Sydney NSW 2000

T. +61 2 9033 1900
E. nsw@propertycouncil.com.au

propertycouncil.com.au
@propertycouncil

13 September 2019

Mr Tim Hurst
Chief Executive
Office of Local Government
Locked Bag 3015
NOWRA NSW 2541

Email – lgratingsystem@olg.nsw.gov.au

Dear Mr Hurst

IPART Reviews into Local Government

The Property Council welcomes the opportunity to provide comments to the Office of Local Government (OLG) on the final reports of the Independent Pricing and Regulatory Tribunal (IPART) into the local government system in New South Wales (NSW). This submission will primarily focus on the *Review of Local Government Rating System Report* released in June 2019.

As Australia's peak representative of the property and construction industry, the Property Council's members include investors, owners, managers, and developers of property across many asset classes. This includes commercial offices, residential development, industrial development, tourist accommodation and retirement living facilities.

The following comments for consideration by the OLG:

Interim Government Response

The OLG's decision to seek further views from the community on the three reviews conducted by IPART before making any decisions regarding their recommendations is welcomed.

As the interim response indicates, these reviews and particularly the review of the local government rating system, involve very serious and complex reforms and require serious consideration. It is noted that the Government has already ruled out the implementation of those recommendations that would have an adverse impact on the most vulnerable members of the community or have a substantial financial impact on taxpayers or the broader community. This decision is supported.

IPART Review of Local Government Rating System Report

The Property Council has considerable interest in this review of the local government rating system. Submissions were made to IPART in response to the Issues Paper (April 2016) and Draft Report (October 2016). Copies of those submissions are attached for reference purposes.

The focus of this and earlier submissions is the recommendation to mandate the use of Capital Improved Value (CIV) as the basis for setting council rates. This change is not supported as it would effectively become a tax on jobs. Currently, the business community carries a disproportionate amount of the rates burden and we would caution strongly against allowing changes to the policy that will further exacerbate this issue. A tax that increases the burden on businesses will ultimately be reflected by reduced levels of employment.

IPART's primary recommendation is that the NSW rating base should be modified from longstanding unimproved valuation (UV) to the capital improved valuation system (CIV). The Final Report does not provide a clear explanation or definition from how the CIV will be determined apart from a note that it "includes the value of permanent capital structures, but does not include the value of production processes, moveable capital or economic goodwill".

CIV versus UV

The IPART report has indicated that CIV is more consistent with international best practice than UV and that the majority of Australian jurisdictions have overwhelmingly opted for CIV over UV. In many cases those jurisdictions have a history and established structures in place for the use of CIV (or a dual system comprising both the UV and CIV) for determining council rates and other taxes such as Land Taxes. NSW does not have any history of using CIV for the purpose of council rates or land taxes.

Cost of Transition to CIV

A significant challenge for the State Government should it decide to proceed with a transition from UV to CIV would be the cost of establishing a new register of property values. Because New South Wales (NSW) does not currently have a register of the CIV properties, establishing one will involve significant costs due to the vast amount of data required. At a public hearing held in 2016 as part of this review, the then Valuer General noted the costs involved in transitioning to a CIV rating system would be in the tens of millions of dollars.

Also, the added layer of complexity in valuing both the land and its capital improvements would make obtaining the CIV of a property more difficult than just the UV. It is likely that the greater diversity in capital improvements will preclude the Valuer General from using 'component grouping' to assess changes to the values of multiple properties simultaneously – rather, an individual valuation may have to be conducted for each property on a yearly basis. This will become another expense that will further increase the costs of maintaining a CIV database for NSW properties.

Rating land occupied by apartment buildings

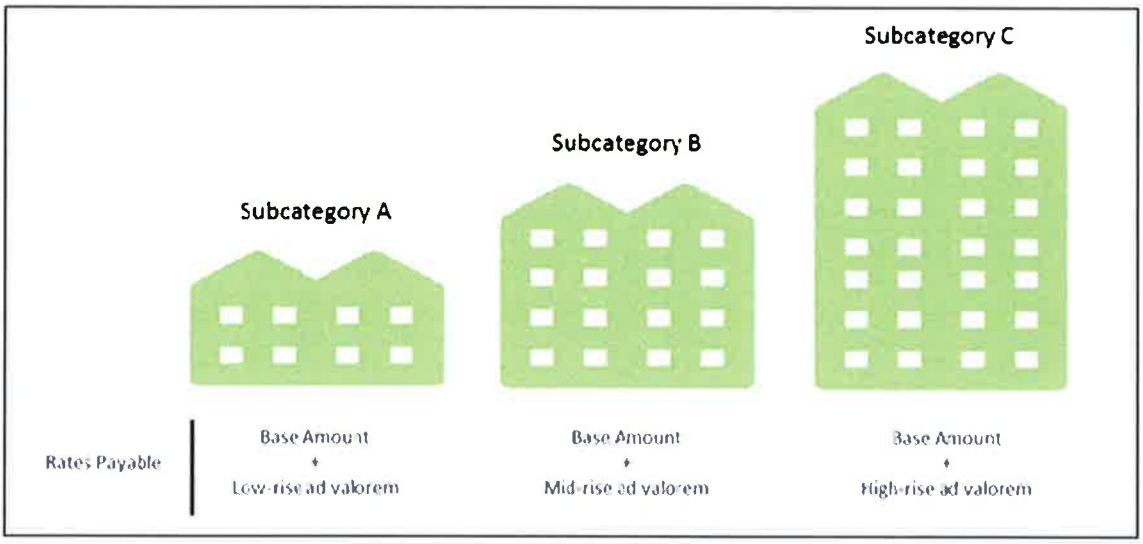
IPART has acknowledged there is a currently a revenue issue caused by the current means of rating land occupied by apartment buildings. Council submissions to IPART have identified the use of UV prevents councils from raising rates equitably and efficiently in urban areas with a high share of apartments. It is clear that the current method of land valuation is not suitably designed and does not appropriately account for the contribution owners of apartment buildings should make towards council revenue. For this reason the NSW Government should consider amending the rating system to address this issue.

The Property Council addressed this issue in our response to IPART's draft report. In that submission, we warned against a knee-jerk overhaul of the entire rating system which, aside from this, appears to be working well and to simply address this particular flaw. This approach will save time and money while still achieving the desired outcome.

Based on the IPART analysis, under the current system there is a significant number of multi-residential apartment buildings captured by the imposition of a minimum amount of rates. A fairer contribution from apartments could be achieved by applying differential ratings to residential apartments – that is, a different level of *ad valorem* contribution based on unimproved land value.

In the submission made to IPART on its draft report, by the Property Council provided an example of how this would work in the diagram below, although further research would be needed to set exact parameters around the sub-categories.

Differential rates payable based on sub-categories using UV.



This would be an effective way of addressing not only inequalities in contributions between stand-alone houses and apartments, but also between individual apartments. Apportionments of the rates could then be split as they are currently through unit entitlements – or potentially through other systems, such as gross market rent.

Build to Rent

The State Government is currently considering the policy framework for the establishment of a Build to Rent sector in NSW. Build to Rent focuses on increasing the supply of rental housing through improving investment options and outcomes for institutional investors. Developers and their financiers build multi-unit buildings and, instead of selling the units, retain them to rent to tenant households. The viability of Build to Rent in NSW requires the removal of a number of taxation and regulatory barriers.

Should the current review of the local council rating system lead to a change to the method of determining local council rates for apartments, it is important that it not disadvantage the establishment of this developing and diverse asset class.

Should you have any questions in respect to this matter, please contact Troy Loveday, Senior Policy Advisor, on (02) 9033 1907 or tloveday@propertycouncil.com.au

Yours sincerely

Jane Fitzgerald
NSW Executive Director
Property Council of Australia

Attachment 1 – Property Council submission to IPART on Issues Paper (13 May 2016)
Attachment 2 – Property Council submission on IPART Draft Report (14 October 2016)

Property Council of Australia
ABN 13 00847 4422

Level 1, 11 Barrack Street
Sydney NSW 2000

T. +61 2 9033 1900
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IPART review of the Local Government Rating System

Submission from the Property Council of Australia

13 May 2016

PROSPERITY | JOBS | STRONG COMMUNITIES

Executive Summary

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

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

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

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

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

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

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

About the Property Council of Australia

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

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

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

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

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

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

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

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

The current status

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

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

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

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

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

Summary of recommendations

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

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

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

Recommendation 4: **It should be mandatory for councils to spend development levies in full, on-time and for the purpose they were collected. Unspent levies should be seized by the Local Government Grants Commission.**

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

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

Retaining valuation based on unimproved land value

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

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

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

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

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

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

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

The logical outcome of a shift from unimproved land value to CIV is a substantial redistribution of the rate burden to heavily improved or high value properties. There is a common misconception that this increased rate burden is borne by major property owners. Typically lease structures facilitate the recovery of council rates from lessees and ultimately the additional burden is shared across property owners, lessees (business) and ultimately the community.

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

Multi-unit dwellings

The Issues Paper raises the findings of the Independent Local Government Review Panel that the rating of apartments in Sydney is inequitable. This is because the unimproved value of the land occupied by a block of apartments is split between the owners of individual dwellings (strata titles), such that each is rated on only a small fraction of the total value.

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

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

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

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

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

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

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

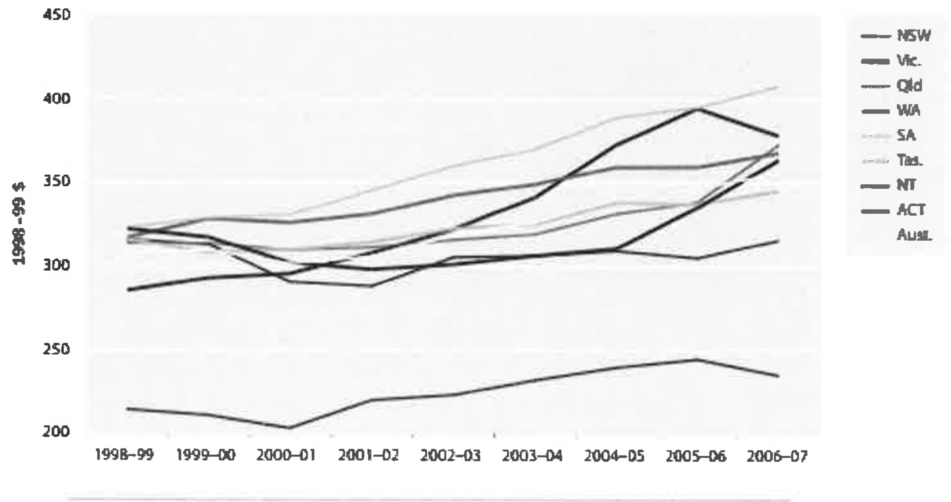
Abolish the rate pegging system

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

Rate pegging was introduced by the Wran Government in 1977. Under this approach, the NSW Government determines the maximum amount by which councils can increase their annual general income. NSW remains the only state in Australia where rate pegging is still in use.

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

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



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

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

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

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

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

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

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

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

Rate pegging impacts local government in the following ways:

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

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

- **Infrastructure backlogs**

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

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

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

Additionally, it has prevented councils from participating in the rejuvenation of brownfield sites and the creation of new and exciting urban renewal programs.

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

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

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

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

The removal of rate pegging would:

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

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

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

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

Greater use of debt financing

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

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

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

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

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

- a ten year Community Strategic Plan, which identifies long term priorities
- a Resourcing Strategy (comprising a Long Term Financial Plan of at least 10 years, an Asset Management Plan and a Workforce Plan)
- a four year Delivery Program, which identifies service and works at a program level that are to be funded, and
- a one year Operational Plan (containing an annual budget).

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

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

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

Alternate sources of revenue

Spend development levies

Recommendation 4: **It should be mandatory for councils to spend development levies in full, on-time and for the purpose they were collected. Unspent levies should be seized by the Local Government Grants Commission.**

It should be acknowledged that rates are not the only charge that is levied by local government.

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

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

Trial the use of Growth Area Bonds

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

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

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

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

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

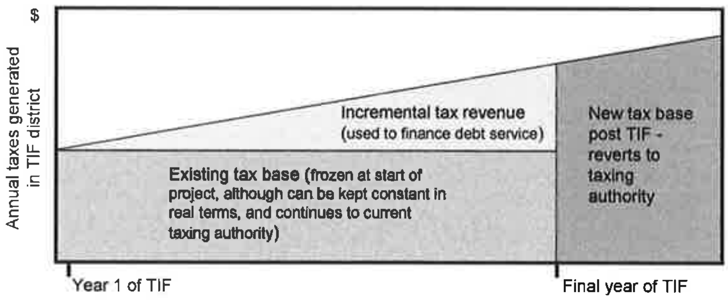
The steps in establishing and operating a Growth Area Bond are:

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

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

The figure below outlines the model.

Figure 1: The Basic TIF Model



Growth Area Bonds provide the following benefits:

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

Growth Area Bonds should be trialled immediately.

Alternative ownership structures for local government assets

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

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

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

Rate path freeze and establishing rates after the freeze

The risk with freezing rates for four years after council mergers is the inability of councils to fund the infrastructure needs of their communities for the duration. The current level of rates is often unrealistic to service infrastructure needs and we already see a backlog of infrastructure under the current rating system. If the rating system is not reformed to better align rates with infrastructure needs then we would support the proposal for Special Rate Variations during the rate freeze period for new infrastructure.

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

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

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

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

Contacts

If you would like to discuss any element of this submission, please -contact:

Jane Fitzgerald

NSW Executive Director

Property Council of Australia

Phone: 02 9033 1906

Email: jfitzgerald@propertycouncil.com.au

Evelyn Subagio

NSW Policy Advisor

Property Council of Australia

Phone: 02 9033 1909

Email: esubagio@propertycouncil.com.au

PROPERTY COUNCIL of Australia

Property Council of Australia
ABN 13 00847 4422

Level 1, 11 Barrack Street
Sydney NSW 2000

T. +61 2 9033 1900
E. info@propertycouncil.com.au

propertycouncil.com.au
@propertycouncil

IPART review of the Local Government Rating System

Submission from the Property Council of Australia

14 October 2016

Introduction

Revenue generated by rates is generally the greatest source of income for local councils and supports vital services and infrastructure for residents.

The Property Council supports a fair and transparent system whereby rates are raised equitably from all four categories of land use as laid out in the *Local Government Act 1993.* Our view is that the current system is working well and that with some minor changes it could deliver an even more sustainable income stream to local councils without excessive burden to rate payers.

We are concerned however that a significant structural change to the rating system is being recommended by IPART to ensure a 'fair contribution' from multi-residential units. In this submission we suggest alternative ways of addressing this issue that will not have the same severe negative impacts.

Our recommendations also extend to the potential impacts of introducing CIV as a base for the rating system, growth outside the rates peg and policy around exemptions.

More generally, we would make the following observations on the process to date:

- IPART's draft report focuses strongly on the residential aspect of the rating system but in many local government areas, non-residential categories bear in excess of 50 per cent of the rates burden. More consideration is needed for the impacts of a rates change on these non-residential categories.
- We would recommend that research be conducted into the flow-on effects of that the recommendations of the draft report may have on tenants and business associated with commercial property owners. It is likely to be substantial and should be a key consideration of the IPART report.
- The Property Council deems the comments made by IPART on the Emergency Services Property Levy (ESPL) well outside the scope of the review. The tax is levied by a different level of government and has been finalised in its current form. It should not be the subject of any recommendations from IPART as part of the current review.

About the Property Council of Australia

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

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

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

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

In particular, our members contribute to local government infrastructure through significant development levies. In 2014-15, councils collected $601 million via these levies – with over $1.3 billion in levies sitting unspent in council accounts across Sydney's 39 councils.[1]

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

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

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

[1] Property Council of Australia – Regular Audit 2014-15

The current status

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

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

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

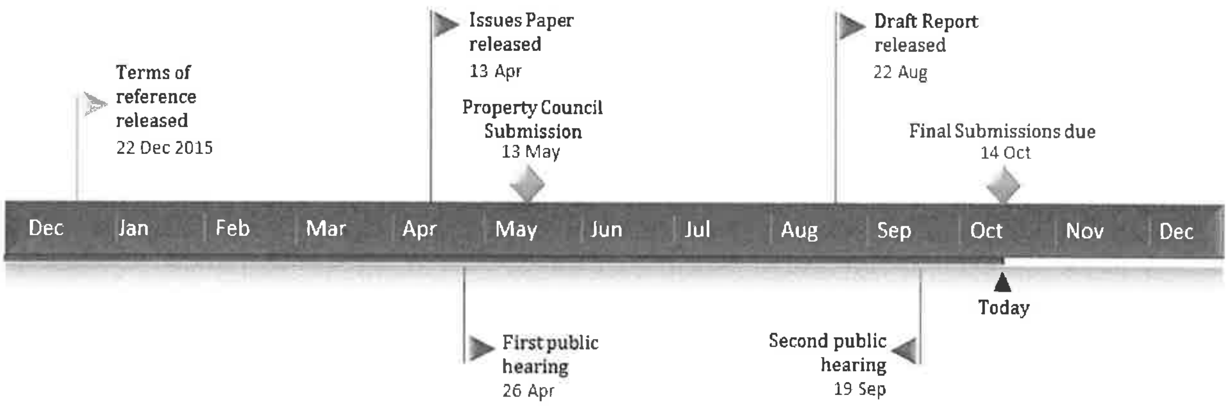
The NSW Government's *A Plan for Growing Sydney* has a vision for Sydney being a strong global city and a great place to live.

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

In December 2015, IPART was requested by the Premier to undertake a review of the local government rating system in NSW. The aims of the review as laid out in the Terms of Reference are as follow:

- Enhance the ability of councils to implement sustainable and equitable fiscal policy; and
- Provide the legislative and regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly merged councils.

Timeline snapshot



Areas addressed by the Property Council's submission

The Property Council welcomes the opportunity to provide a further submission as part of the ongoing review into the rating system currently being undertaken by IPART. Our comments will be relevant to the following recommendations made in the draft report:

- The rating burden across and within communities, including consideration of apartments and other multi-unit dwellings;
- The appropriateness and impact of current rating categories and exemptions, mandatory concessions and rebates;
- The land valuation methodology used as the basis for determining rates in comparison to other jurisdictions;
- The impact of the rating system on residents and businesses of a merged council and the capacity of the council to establish a new equitable system of rating and transition to in a fair and timely manner.
- The objectives and design of the rating system according to recognised principles of taxation.

Property Council Recommendations

Recommendation 1: **Retain a rates system predicated only on unimproved land value.**

Recommendation 2: **Capture multi-residential apartments based on sub-categories**

Recommendation 3: **Growth outside the peg should be based on population growth and applied equally within rates categories.**

Recommendation 4: **More targeted exemptions should be implemented.**

Recommendation 5: **Differential rates across a local government area should not be implemented.**

Retaining a fair valuation system to underpin council rates

Recommendation 1: **Retain a rates system predicated only on unimproved land value.**

A tax on jobs

The status quo is that the business community carries a disproportionate amount of the rates burden and we would caution strongly against allowing changes to the policy that will further exacerbate this issue. A tax that increases the burden on businesses will ultimately be reflected by reduced levels of employment.

One of IPART's key recommendations is that the NSW rating base should be modified from the longstanding unimproved valuation (UV) to the capital improved valuation system (CIV). As part of the process of preparing this submission, the Property Council engaged M3 Property to model what the effects of this change will be.

The concept of CIV is not clearly defined in IPART's documentation to date where it is described as *'a method, which values the property based on the market value, or the value inclusive of all capital improvements'*. This definition is not accurate enough and should be refined to ensure that it won't generate further confusion. For the purpose of this paper, we will consider the definition of CIV to be the following as described in the Victorian *Valuation of Land Act 1960*:

"Capital improved value means the sum which land, if it were held for an estate in fee simple unencumbered by any lease, mortgage or other charge, might be expected to realize at the time of valuation if offered for sale on any reasonable terms and conditions which a genuine seller might in ordinary circumstances be expected to require."

While it is hard to achieve a high level of certitude within the parameters of the review, based on the assumptions listed in the report delivered by M3 Property, the key findings are as follows:

- It is likely the shift away from a UV to CIV rating system would impact the proportion and level of rate charges, particularly so for commercial and rural property owners.
- In Victoria councils have utilised similar changes in rating base to redistribute the rate burden to Business and less to Residential.

By redistributing the rating burden to capture more valuable/highly developed properties, businesses will be disproportionately affected. Ultimately this will have the effect of being either a tax on jobs or a tax on urban renewal, neither of which is a desirable policy outcome.

Cost of establishing and maintaining a CIV register

NSW does not currently have a register of the CIV of properties. Establishing one would be a costly exercise due to the vast amount of data required. The NSW Valuer General, Simon Gilkes, at the public hearing held in May as part of this review noted that the costs involved in transitioning to a capital improved value rating system would be in the 'tens of millions of dollars'. Further, the additional layer of complexity in valuing both the value of the land and its capital improvements would make obtaining the CIV of a property more difficult than just the

UV. It is likely that the greater diversity in capital improvements will preclude the Valuer General from using 'component grouping' to assess changes to the values of multiple properties simultaneously – rather an individual valuation may have to be conducted for each property on a yearly basis. This is another expense that will further increase the cost of maintaining a CIV database for NSW properties.

Due to IPART's recommendation that 'growth outside the peg' should only be calculated using CIV, councils would have to invest in a both a UV and a CIV register regardless of the valuation method chosen as a basis for rates. This is further reinforced by the fact that land tax and the ESPL will continue to be calculated using UV.

Whether these costs are to be passed onto land holders through the rating system or funded through general consolidated revenue, we would suggest it would be an unreasonable and unnecessary financial impost when the current system is continuing to work well in most respects.

A simpler solution

One of the key principles of good taxation outlined by IPART's issues paper is 'simplicity' - that is that the tax imposed on a group or community can easily be understood by those who have to pay it. Currently there are a number of existing taxes that are calculated using unimproved land value including – land tax and the ESPL. No taxes in NSW are currently using a system of CIV. Making a change to the system will make it unnecessarily more complex for tax payers to understand. A study published in 2013[2] has established that there is a clear correlation between taxpayers understanding taxes and complying with them. Therefore there is a strong incentive for the rates system to remain predicated on an established and widely understood and accepted valuation system.

[2] The influence of understanding taxes and taxpayer perception to taxpayer compliance (2013) Sari, Diana; Huda, Riri Nurul.

Ensuring an equitable contribution from multi-residential units

Recommendation 2: **Capture multi-residential apartments based on sub-categories.**

There is a drawback in the current system which IPART identifies as the inability *"to equitability and efficiently raise rates revenue from residential apartments"*. The issue with raising sufficient revenue from multi-residential units is at the heart of this review and should be addressed in a measured and equitable fashion without unnecessarily altering the fundamental basis upon which rates are calculated. Essentially, the Property Council warns against a knee-jerk overhaul of the entire rating system – which, aside from this, appears to be working well – to address this flaw.

According to IPART's analysis, under the current system, a significant number of multi-residential apartments are captured by imposing a minimum amount on rates. This is being used as an imperfect tool by local government to create a more equitable distribution of the rates burden between units and standalone dwellings.

Councils could better access a fairer contribution from multi-residential units by applying differential ratings to residential apartments – that is, a different level of *ad valorem* contribution based on unimproved land value. An example of how this could work is provided in the diagram below, although further research would be needed to set exact parameters around the sub-categories. IPART could further investigate this issue as part of this review to inform the bounds of the sub-categories. This would be an effective way of addressing not only inequities in contributions between standalone houses and apartments, but also between individual apartments. Apportionments of the rates could then be split as they are currently through unit entitlements – or potentially through other systems, such as gross market rent.

Differential rates payable based on sub-categories using UV.

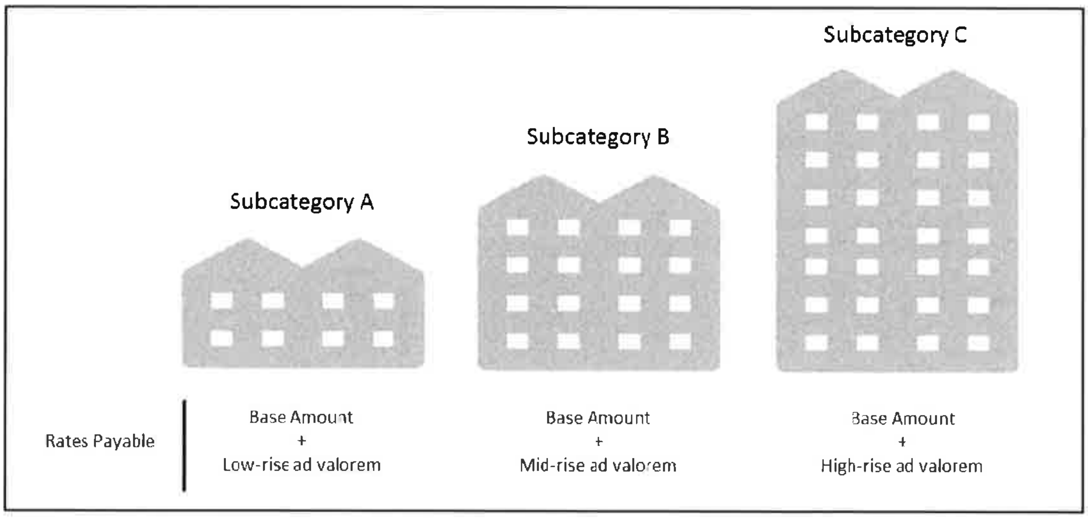


Figure used for indicative purposes only. Further research will be required to establish more precise sub-categories.

Balancing revenue generated from rates and S94 Levies

Section 94 of the Environmental Planning and Assessment Act 1979, enables local councils or other consent authorities to levy contributions for public amenities and services required as a consequence of new developments – in particular for multi-residential units. Any increase in rates for new developments would be added to the existing burden of Section 94 Levies. Ultimately this will have the effect of taxing developers and rate-payers twice for the provision of services and infrastructure. If councils are able to generate higher rates from multi residential buildings, then section 94 contribution plans should be revised to reduce upfront levies applied by councils on new multi-residential developments. IPART should be tasked with monitoring and reporting on such a reduction in levies.

Growing councils' income in a sustainable manner

Recommendation 3: Growth outside the peg should be based on population growth and applied equally within rates categories.

IPART's draft recommendation is that a council should be able to grow their revenue outside the rate peg by multiplying its general income by the proportional increase in CIV from supplementary valuations.

While the Property Council does not object to the principle of raising revenue outside the rate peg to address the issue of insufficient rates income, there are more cost effective ways of achieving this without recourse to fundamental changes to the rating system.

One key downfall of the proposed method of increasing a council's revenue in accordance with CIV is the fact that, regardless of whether the rating system is predicated on UV or CIV, the council will have to invest in a CIV register. As discussed above, the establishment and maintenance of a CIV register is a costly endeavour.

The Special Rate Variation (SRV) is already in place and can be used effectively by councils to raise additional income. In 2015-16, there was a 100 per cent approval rate for local council applications for SRVs. If however the uptake of SRVs in not strong enough, growth outside the peg could be linked to population growth (or an associated factor) in a local government area. Population growth would have a direct influence over the requirement for additional services and infrastructure and would therefore be a good indicator for the need for additional revenue.

The IPART draft report states that:

"Using population to scale changes in rates income would require relatively precise and timely information on population at the LGA level, which would incur additional cost and would not be as useful for other purposes."

Population projection data by local government area in NSW however is readily available[3] and already being used across multiple levels of government. The Department of Planning & Environment has projected increases in population over the coming years taking into account

[3] Estimates based on Australian Bureau of Statistics data and the *2014 NSW population project 2031*.

historical data as well as assumptions based on births, deaths and migration. This information is used for *'assessing future needs for residential and commercial land, housing and public utilities.'* If the projections are being used successfully for planning public transport and utility needs, they could be used to the same effect for setting rates outside the peg. While by their nature, the accuracy of projections decreases over time, the census provides a point of reference on a five-yearly basis thus ensuring a high degree of precision.

In NSW state legislation enables councils to set different rates for particular rates categories and while there is a rate peg across all income there is no mechanism to prevent disproportionate distribution of burden. Ultimately the impact will be determined on an individual council basis however modelling and evidence from councils[4] who have switched to CIV shows an inevitable shift in the rates burden to high value properties. Experience from Victorian councils also shows that councils have utilised the change in rating base to redistribute the burden to business and less to residential[5]. In Victoria the highest differential rate cannot be more than four times the lowest differential rate declared by a council. We submit that while this is a step in the right direction, there is no justification for businesses to be levied excessively to subsidise other rate contributors. Of all the councils using CIV that were surveyed in Victoria, none of them had a lower differential rate for business in comparison to residential. An extreme example of this in NSW is the city of Sydney where businesses pay 8.5 times the rate in the dollar paid by the residential category. This disparity is unacceptable and should be address through a robust framework to avoid the majority of the burden being borne by businesses.

[4] NSW Council Rate Modelling Analysis (2016) M3 Property.
[5] NSW Council Rate Modelling and Analysis (2016) M3 Property.

More targeted exemptions and differential rates

Recommendation 4: **More targeted exemptions should be implemented.**

IPART is recommending a more targeted exemptions framework for council rates. The most significant change is that rate exemptions will no longer be based on the ownership of the land but rather its use.

While the Property Council does support this recommendation in principle, we would caution against any changes that would lead to an increase in administrative burden for organisations that are currently exempt. Currently organisations receive a blanket exemption once they are registered with the Australian Charities and Not-for-profits Commission. If charitable organisations have to make a case-by-case application for every property in which they operate there will be a significant increase in administrative burden. This would be a poor outcome and should not be a consequence of any change that is recommended.

The recommendation by IPART on removing exemptions for land used for commercial or residential purposes regardless of ownership requires further clarification. There are many situations where commercial activities are conducted on land that is also providing a public benefit (e.g. coffee shops, convenience stores located within retirement villages). It would not be equitable to remove exemptions for charitable organisations in these circumstances and rates exemptions should be retained for these 'mixed-use' circumstances.

Recommendation 5: **Differential rates across a local government area should not be implemented.**

IPART recommends giving metropolitan councils greater flexibility when setting rates within their local area. Under the proposed system which is focused mainly on residential land use, councils would be able to move away from a single ad valorem rate for properties in the same categories. Currently councils may set different rates based on separate 'centres of population'. The IPART report rejects this system as it is a vague term: and is open to interpretation/uncertainty. The report states:

"The meaning of the current requirement for setting differential residential rates by 'centre of population' is not clear. In their submission, several councils indicated they were confused about its application in urban areas."

Instead IPART suggests that councils should be allowed to determine a residential subcategory, and set a residential rate, for an area by:

- a separate town or village, or
- a community of interest.

The term 'community of interest' is as problematic as 'centre of population' - it is open to interpretation and could lead to some very subjective outcomes. Should this policy be implemented, the Property Council would seek more robust foundations for the establishment of different zones within a local council.

Depending on the jurisdiction, state government legislation allows councils to set a different rate for specific properties (such as shopping centres, business high-rise). There is no justification for these provisions and we would strongly suggest that this policy should be modified to prohibit these occurrences.

Contacts

If you would like to discuss any element of this submission, please contact:

Jane Fitzgerald
NSW Executive Director
Property Council of Australia
Phone: 02 9033 1906
Email: jfitzgerald@propertycouncil.com.au

Tim Wheeler
NSW Senior Policy Advisor
Property Council of Australia
Phone: 02 9033 1909
Email: twheeler@propertycouncil.com.au