Submission to the Victorian Local Government Rating System Review

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About Prosper

Prosper Australia is a research institute holding up a light to the dusty corners of an economic system no longer working for the common good. In particular, we believe the missing piece in the analysis of economics and taxation is land.

Summary of Key Recommendations

Recommendation 1

- Choice of valuation and rating base: **Site Value**
- Facilitate transitions from rating on Capital Improved Value to Site Value

Recommendation 2

- The choice of valuation base should not affect flexibility provided for differentials.

Recommendation 3

- Further restrict differential rating e.g. the lowest relative to the highest from 25% to e.g. 50%.
- Cap the number of differential rating categories (for all valuation bases) e.g. to 10.
- Exempt vacant land and vacancy type categories from maximum differential rating limits.

Recommendation 4

- Reconceive deferment as revenue-generating for government and convenient for ratepayers, rather than a costly financial hardship concession.
- Expand deferment eligibility to all individual (non-incorporated) ratepayers until sale/transfer, and potentially farm businesses for time-limited durations.
- Establish a state government Public Financial Corporation (PFC) to administer a deferment system.
- Reinvest deferment net interest revenue into the Victorian Grants Commission for Local Government.

Recommendation 5

- Maintain highest and best use for valuation purposes, using deferment to offset hardship for owners maintaining a lower current use.
- If current use valuations are considered, adopt the ACT "change of use charge" (Lease Variation Charge) to collect 75% of the uplift in site value upon change of use.

Recommendation 6

- Make all non-government land rateable. Council support should not discriminate on tenure type, but instead use grants to transparently reimburse beneficiaries of existing rating exemptions. Council support should not discriminate on tenure type.
- Transition non-rateable land to rateable land by enabling temporary differential rates below the existing minimum differential. Alternatively, require alternative rating agreements as currently available for cultural and recreational land.

Recommendation 7

- Grandfather rates concessions and pensioner rebates in favour of deferment (see Recommendation 4). Retain them only in instances where deferrals exceed a significant proportion of Site Value e.g. 50%

Recommendation 8
- Facilitate the use and interaction of special rates and charges with Land Value Capture for infrastructure projects.

Recommendation 9
- Constrain regressive municipal and service charges in favour of revenue collected from general rates.
- Service charges e.g. waste charges, should be optional only where opt out reduces council costs by an equal or greater amount.

Recommendation 10
- Allow rates to be paid in fortnightly and monthly installments statewide.

Recommendation 11
- Adopt a "change of use charge" to use as an alternative revenue source for local government.
- Resist industry pressure to curtail Infrastructure Charges, and expand their use.

Recommendation 12
- Require councillors to declare their property interests in their LGA, and also demonstrate how any changes made to the rating system will affect councillors' own rates burden.

General comments on Terms of Reference

1. Choice of valuation base for rates

Rates should be calculated on the **site value** (SV) of properties. Currently most councils levy rates on Capital Improved Value (CIV), and in a few exceptions Net Annual Value (NAV). There is strong evidence that the site value base is more progressive, better reflects capacity to pay, lowers the rating burden for most properties and is economically more efficient.

1.1 SV is more aligned with capacity to pay (incomes) than CIV

Contrary to conventional wisdom, SV is most closely correlated with household incomes (and thus capacity to pay) than CIV. Prosper Australia has undertaken new research[1] using VIC valuation data, household income data and other index measures.

Our results show that a 1% increase in income is associated with a 0.10 to 0.57% increase in the SV/CIV ratio[2]. This indicates that as incomes increase, higher income households spend a larger proportion of income on SV than they do on improvements. A 1% increase in income is associated with an increase in rates paid of 1.9% under CIV, and 2.3% under SV. Therefore shifting the rates base to SV would improve the progressiveness of the rating system and also better align it with household capacity to pay.

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[1] Attached below in the appendix for reference.

[2] This is important, because past studies have erroneously used to separate linear regression comparisons of SV and CIV to incomes, which assumes a constant SV/CIV ratio across the income distribution.

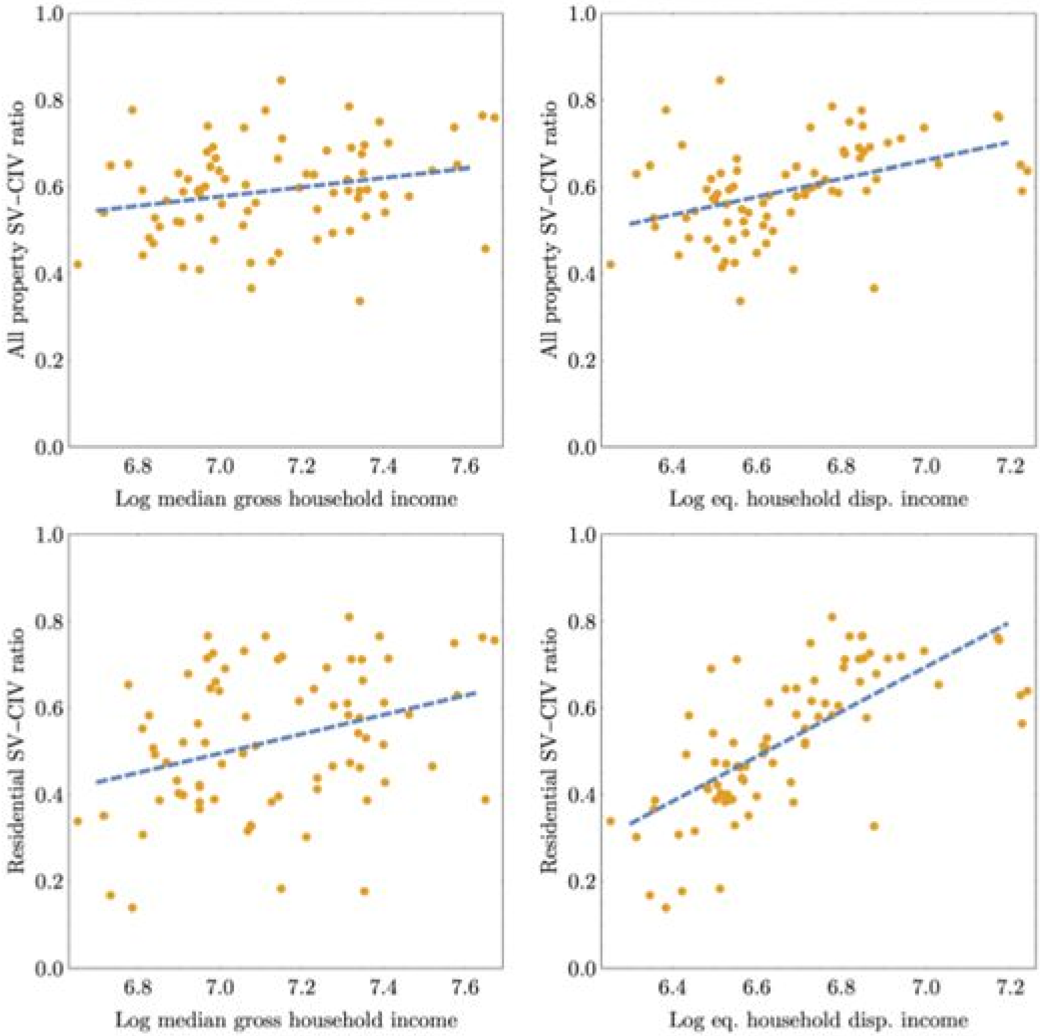

Figure A.1: Relationship between LGA-level SV-CIV ratio and income metrics (incl. best fit).

1.2 SV is more aligned with the beneficiary principle than CIV

Public goods provided by councils can directly influence SV.[3] Properties with access to well maintained and graded roads, libraries, swimming pools etc. all benefit from increases in SV - irrespective if property owners use the service. Tenants pay higher rents for well-serviced locations , while owner-occupiers receive the benefits as imputed rent.

Capital improvements (CIV net of SV) on the other hand bear little relationship to value provided by council services. While it is true that more intense land use can result in a higher demand for council services, this does not account for the efficiencies of scale found at higher density, or duplications of service provision due to vacant and underutilised sites. SV taxes sites as if they were already built to highest and best use (implying the potential

[3] (2013) In Our Hands Strengthening Local Government Revenue For The 21st Century p.32
https://opus.lib.uts.edu.au/bitstream/10453/42057/3/Strengthening-LG-Revenues.pdf

services from which the site benefits and could consume), and so incentivises faster development and redevelopment of properties.

1.3 The efficiency difference of SV and CIV is underestimated

While theory suggests that the impact of rates on improvements is low, empirical evidence from Victoria seems to indicate otherwise.

Prosper analysed data from the Melbourne Metropolitan Board of Works for 26 predominantly rural Victorian local councils between 1952-1984. We tracked the number and value of dwellings constructed for at least two years prior and three years following (7.5 years of data on average for each council) from their year of transition from CIV to SV..

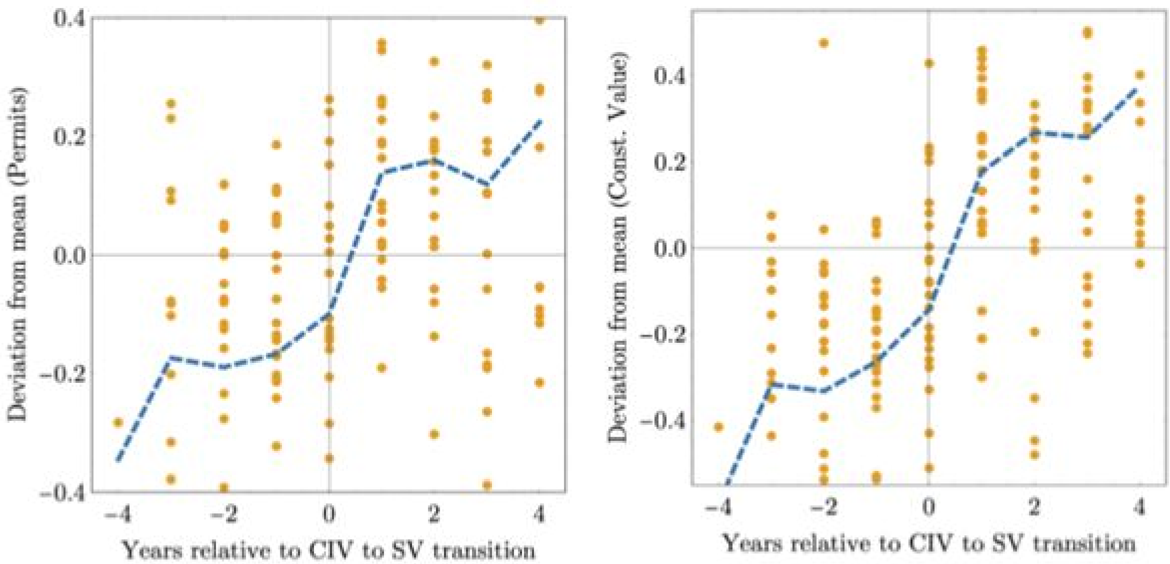

Figure 2: Deviation from sample mean. Left is permits. Right is construction value.

We found that for at least the 3-5 year window following the tax change, dwelling construction investment increase between 20-50%. This is consistent with past studies such as Lusht 1992, which concluded LGAs which rated on site value experienced significant stimulus to development, and that this was sustained in the long run although somewhat eroded. It also highlights that the rating effort is high enough to influence behaviour.

Higher differential rates on vacant land are not sufficient to achieve this result. Under CIV, underutilised property (with little to no improvement value but not vacant) is still heavily subsidised. Additionally the penalty to investment in improvements is not removed, instead minimal investment is incentivised.

1.4 Areas most negatively impacted by CIV can least afford it

The detrimental effects of rating on CIV are most stark in rural and regional councils which are more likely to be in financial stress and socio-economically disadvantaged. In these councils, the rates effort is generally the highest.

For example, Buloke Shire is a highly disadvantaged council, and it was noted in 2017 its rating effort is 0.96%.[4] Consequently the penalty to investment due to CIV is much higher in these LGAs due to higher rates in the dollar. It is notable that many of these LGAs are also located in agricultural areas, which means the penalty to investing in farm improvements is significant.

1.5 SV is more concentrated than CIV, lowering median rates

Additionally, we find that the distribution of SV and CIV among properties differs significantly. Measuring the Gini Coefficient for each valuation base, we find that SV is significantly more concentrated in fewer properties/locations.

This is consistent with past findings, and suggests that switching to a SV base will reduce median rates and lower rates for most properties even if the distribution of rates between different categories of land does not change.

Instead, rates would be concentrated towards a few properties with higher SV/CIV ratios - properties which would consist of vacant and underutilised land. This concentration of the rating burden also accelerates investment in improvements.

Table 1: Gini coefficients of different value bases

	SV	**CIV**
LGA Residential (2016)	0.45	0.33
LGA All types (2016)	0.33	0.26
SA1 All types (2011)	0.41	0.37

2. Differential Rating

2.1 Differential rating flexibility should not differ between valuation bases

Currently councils can only use limited differential rates for SV (and NAV), whereas can use full differential rating for CIV. Councils should be incentivised to rate on SV, whereas currently they are penalised with this inflexibility. This has been a major contributor in councils moving away from SV to take advantage of differential rating flexibility under CIV. Prosper believes valuation bases (especially SV) should receive equal treatment with regards to differentials.

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[4] *Inquiry into the sustainability and operational challenges of Victoria's rural and regional councils — Final Report* p.105

2.2 Differential rating should be constrained

Differential rating should be restricted in the number of differential rating categories and the level of differentials. Prosper notes that while differentials can enable councils to increase their capacity to rate on classes of land with higher political tolerance and willingness to pay (which could increase overall rates effort if not for the rate cap), they can also be abused by councillors to subsidise some landholders to the detriment of the community.

Differential rating has little economic basis and largely involves the political power of different classes of ratepayers. There may be some grounds for allowing councils the autonomy to adjust differentials to promote or discourage certain types of land use e.g. vacant land, vacant property. However differentials tend to be set arbitrarily, and distort the ratings base.

Capacity to pay issues may be used to argue for differentials, however some of these issues could be addressed through other means e.g. deferment in the case of a heterogeneous farming sector.

Differentials are not the best mechanism to address capacity to pay issues. Understanding the economic incidence of rates is important in this respect. Retirement village differentials are a case in point. While it may seem a socially useful to advantage the elderly, the real beneficiary will invariably prove to be a property developer, who capitalises the concession into the land price and thereby extracts its value. As land is a monopoly, reductions in rates do not actually reduce cost pressures for new residents who buy into a community. Although they can provide incumbent ratepayers with more imputed rent.

Other reasons cited for differentials are misleading. Some stakeholders argue that as they don't personally use certain services, facilities, libraries and kindergartens, they need not contribute to these civic facilities. This ignores the fact that many urban land holders don't use them either, yet the facilities add to the locational amenity for all and are capitalised into their land values. In the instance of farmers, small towns still benefit them and service their needs even if they don't live there.

Prosper supports constraining differential rating further. The existing maximum and minimum differentials should be further narrowed e.g. to a factor of 2x instead of the existing 4x. However certain rating categories should not be subject to these constraints (see sections 2.3 and 4.1). We also believe too many differentials can also make the rating system arbitrary. We note in QLD some councils have over 100 differentials.

2.3 Enable higher differentials on vacant land and vacant property

Vacant land and vacant property are economically detrimental to communities by forcing co-location and duplication of services, allocation inefficiencies and constraints on agglomeration. It is not surprising that councils generally choose to rate higher rates on vacant land. Although part of this is attributable to using CIV.

In addition to vacant land, there is also the potential for councils to rate on a vacant property base if the State Government provides the assessments. Prosper notes that the state government now levies a vacancy tax, and that councils could potentially levy their own higher differentials on the same tax base. This could also be expanded to non-residential vacancies, which are a growing issue in some LGAs.[5]

These sort of economically useful differentials should not be restricted by the maximum differential rating cap, or have much higher limits e.g. a factor of 10x. Councils should be able rate on these categories in accordance to the cost they believe these types of land uses impose on the community.[6]

3. Deferment

Prosper's work on tax deferment builds on our recently published report by Dr Tim Helm *Stamp Duty To Land Tax - Designing The Transition (2019)*.[7] Deferment should be the primary tool to assist with rates relief.

3.1 Deferment is a profitable "win-win", not a costly concession

Tax deferment is effectively risk free lending by the state against secure property, since the lien is the first charge against the property. 40 years of deferred rates under very punitive conditions only manages to reach 30% of a property's value.[8] Charging commercial interest rates helps prevent the "lock-in effect" - the perverse incentive to delay sale to avoid triggering tax obligations.

Additionally the State Government could earn an interest rate spread of 1.5-1.75% minimum while still providing more attractive option of deferment than typical mortgage rates. Net interest revenue has been previously estimated at $10.4bn over 20 years with an average SV rate of 0.5% across the state. This revenue could potentially be used for the Victorian Grants Commission to assist financially stressed councils.

Note that tax deferment and realisation of deferred tax could be exploited if extended to tradeable incorporated entities i.e. transferring the entity holding the land rather than the land itself. So deferment should be restricted to individuals.

3.2 Deferment addresses issues with highest and best use valuation

One of the issues with highest and best use valuations occurs when sudden revaluations lead to rate shock. This is not a capacity to pay problem, as the ratepayer has usually also

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[5] https://www.abc.net.au/news/2019-06-06/ghost-shops-haunting-new-developments/11184644
[6] Prosper notes in practice there does not appear to be many councils that approach the existing maximum differential limit for vacant land currently
[7] *Section 5.3 Tax deferral*, p.35-40 https://www.prosper.org.au/wp-content/uploads/2019/07/Designing-the-Transition_Final_Helm.pdf
[8] Coates (2017), *State property tax reform: balancing economic principle and political realism*, Grattan Institute presentation, Adelaide, https://grattan.edu.au/wp-content/uploads/2017/10/SA-Federalism-and-Tax-Future-Directions-for-Property-Tax-Reform-for-web-28-August-2017.pdf

experienced a significant, unrealised capital gain. The issue of cash flow and the gap between income and wealth can be addressed via deferment. This way the excess rates are only paid when the property is transferred and the highest and best use value is realised.

Currently in NSW, increases in rates that arise from rezoning can be deferred.[9] However a loophole in the legislation forces councils to write them off. In principle deferred rates could be retained until sale. Alternatively deferment could be restricted to a duration, or a cap on property value before repayments must be made.

A related issue is gentrification and the nature of how rates are struck. This is particularly apparent in Maribyrnong, which is compounded by a below average number of assessments. The initial decreases in rates in ungentrified areas relative to gentrified, is subsequently offset by the sharp jump in rates once gentrification occurs. These fluctuations in values over time again can be resolved through deferrals. Even allowing ratepayers to defer the *increase in rates* (as opposed to all) would help ratepayers with cashflow issues.

Prosper notes that alongside a deferment statement, communications which include statements of valuation changes overtime can help ratepayers evaluate the growth in their tax debt relative to their asset value. For example, as in this mock Land Tax notice (fig. 3)

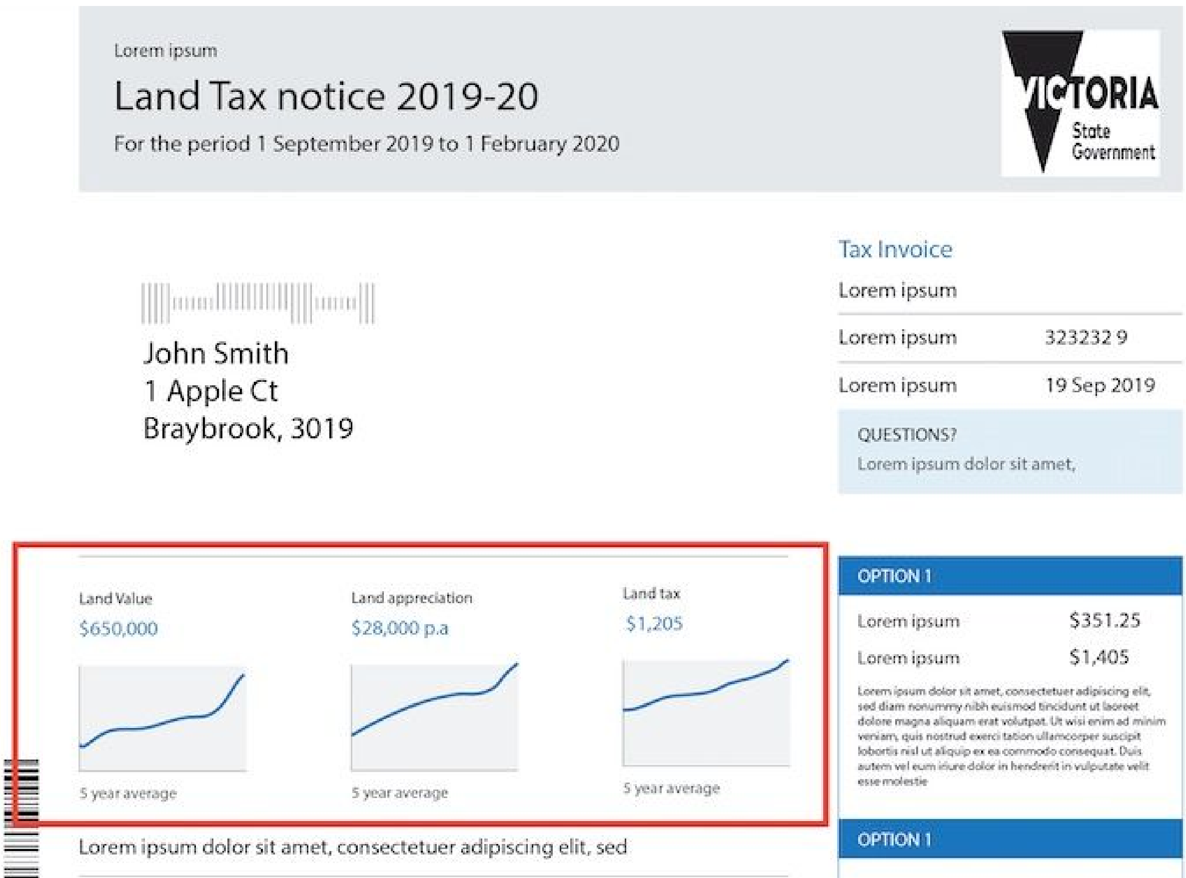

Figure. 3: Mock Land Tax notice

[9] Sections 585 and 595 of the NSW Local Government Act allow for this extra rates burden from rezoning of detached housing lots to be deferred, but forces councils to write-off these obligations after 5 years.

3.3 Deferment could help farmers manage income fluctuations

Farm incomes are not regular or predictable, either across time or within the sector itself. Deferment would allow farmers to pay as they can, similar to HECS type system.

Additionally since farm rates are generally constrained by farms with the least present capacity to pay (usually a cash flow issue), promotion of deferment should increase the capacity to rate the heterogeneous farming sector. Farms currently experiencing low incomes due to drought, low commodity prices etc. can defer, while farms doing well can pay down their deferred rates.

Due to the aforementioned issues with deferment for tradable legal entities, it may however be necessary to restrict deferment for farm businesses to a limited duration e.g. 10 years.

3.4 Deferment should be administered by the state at scale to exploit lower borrowing costs

Deferment is best established and administered by the state government through a single entity to achieve scale. A Public Financial Corporation (PFC) could use the state's lower borrowing cost to maximise returns and provide equity across councils. The PFC could pay rates to councils on a ratepayers behalf, while holding the deferred tax asset. Cash could be raised through bond issuance, and the PFC could be initially capitalised by the state government through an equity investment.

Rates deferment should be as convenient as HECS debt deferment. Ratepayers should be able to easily access deferment, perhaps even by default with minimal eligibility constraints.

4. Who should pay rates or receive rates relief?

In principle, the ratings system should have minimal or no direct special reductions for certain ratepayers etc. Rather rates should be levied, and then grants and financial support provided, without reference to tenure type. If councils wish to support certain ratepayers, it should do so explicitly with grants or disbursements from consolidated revenue so the scale and nature of the subsidy is transparent to all.

4.1 Rateable land

In principle all non-government land should be rateable. At a minimum, owners of non-rateable land should be required to strike alternative rating agreements similar to cultural and recreational land to cover council costs.

In order to transition non-rateable land to rateable, Prosper supports using unrestricted differential rates. Councils should then be able to decide what differentials are sufficient and form a transition plan towards the existing differential limits.

Prosper notes that currently various types of land owned for religious purposes is not rateable. We believe that if councils wish to support religious organisations, it should not be through the rating system (which favours religious organisations that choose to own property). These organisations still benefit from council services and should contribute accordingly.

Prosper also acknowledges and respects our war veterans. However, we see no reason to subsidise their activities through the rates system and warn against the economic distortions this introduces. A clear example of the anomalies this can create is the very wealthy NSW RSL clubs which have become significant business and trading organisations based on poker machine revenues. This major activity has little or nothing to do with veterans' welfare. Local government remains obligated to provide their full range of services to veterans' clubs.

Mining land should be rateable. Mining involves significant human activity and material movement and can create considerable obligations on LGAs. Councils are invariably drawn into the conflicts with adjoining land holders and have an enduring interest in final site rehabilitation. They provide and maintain the roads outside the mine site, to be trafficked by the heaviest permissible vehicles.

4.2 Reduce concessions and rebates in favour of deferment

Deferment should be the default rates relief tool, unless perhaps deferment reaches a high level of site value. It is highly inequitable to provide tax concessions to ratepayers who are asset rich. Other ratepayers with less wealth are forced to subsidise them. Additionally rates concessions are a significant cost to the State Government budget, at ~$100m per year.

Existing concessions could be potentially grandfathered for existing beneficiaries. In future eligibility for rates concessions should be restricted to ratepayers who have accrued significant deferred rates e.g. 50% of land value.

5. Rates and charges excluding general rates

5.1 Regressive municipal and service charges should be further limited in favour of general rates

Municipal charges are effectively regressive poll taxes on property that subsidise higher value properties. In principle, flat charges should be phased out in favour of general rates on SV. Benefits received are directly reflected in SV and rates are paid proportionally on that basis.

Prosper notes however that direct benefits to SV (or CIV) do not come from council services alone, and that some direct property services have clear measurable costs (and value delivered) to each property e.g. waste collection. In these instances charging a flat rate to each property is justifiable.

5.3 Service charges should not necessarily be optional

Opting out from waste charges should only be permitted if doing so directly reduces council costs to provide the service by an equal or greater amount and saves the council money. In the instance of waste collection, it is not clear this is the case. The garbage truck still drives past properties that could choose to opt out. If made optional, owners of vacant properties are subsidised by opting out.

5.4 Special rates and charges could be utilised for land value capture

Special rates and charges could be a useful tool to facilitate land value capture for infrastructure projects by or in partnership with local government. We note that in some instances this is more appropriate than general rates. In the case of the Gold Coast light rail, a fixed charge was levied across the whole municipality even though only properties within an 800m radius directly benefited in land value uplift.[10]

Prosper believes increasing public transparency and engagement with all ratepayers more generally in this process will ensure that beneficiaries contribute more toward the benefits they receive rather than being subsidised by other ratepayers.

6. Miscellaneous

6.1 Infrastructure Contributions or a Change of Use Charge should supplement rate revenue

Infrastructure Contributions (ICs) are an alternative source of revenue which could be more heavily exploited by councils (with legislation change). Despite perceptions they have detrimental impacts on housing affordability and development, there is strong evidence to suggest that developer charges are purely a tax on land rent (similar to the Growth Areas Infrastructure Contribution), and instead capitalise into lower land prices.[11] They are not a tax or cost on development.

Another alternative is a “change of use charge”. Currently the ACT levies a 75% Lease Variation Charge (previously Change of Use Charge) on the land value uplift from land use change.[12] In Victoria this could raise over $3.2bn p.a.[13] We note this is outside the terms of reference.

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[10] https://www.propertyobserver.com.au/forward-planning/advice-and-hot-topics/70945-why-gold-coast-light-rail-was-worth-it-matthew-burke.html

[11] Murray, C. K. (2018). Developers pay developer charges. *Cities*, *74*, 1-6.

[12] https://www.prosper.org.au/wp-content/uploads/2016/09/The-First-interval-Evaluating-ACTs-Land-Valur-Tax-Transition.pdf

[13] Murray, C., & Frijters, P. (2017). *Game of Mates: How favours bleed the nation*. p.20 Cameron Murray.

6.2 Current use and the “change of use charge”

Some have suggested to abandon highest and best use valuation and value on current use. The ACT currently does this, but couples every change in land use with its Lease Variation Charge. Prosper supports highest and best use first and foremost. However should current use valuation be considered (be it for some classes of land or all land), it must be modeled on the ACT system to prevent disincentives to delay development and private capture of rezoning windfalls.

6.3 Rates installments

Prosper supports mandating councils to offer rates installments in monthly and fortnightly payments. We believe this will better align with other utility bills and payroll cycles, making it more manageable for some ratepayers and putting rates into perspective with other household bills.

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