LOCAL
GOVERNMENT
NSW

Draft Submission in Response to the Draft Report of the NSW Review of Federal Financial Relations

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Introduction

Local Government NSW (LGNSW) is the peak body for local government in NSW, representing NSW general purpose councils and related entities. LGNSW facilitates the development of an effective community-based system of local government in the State.

Local government is a major part of the NSW economy being responsible for the provision of a wide range of essential infrastructure and services. NSW local government is responsible for:
- Spending around $12 billion each year
- Managing and maintaining infrastructure and land assets worth $142 billion
- Employing around 60,000 people, with many of these jobs in rural and regional NSW, where councils are often the single largest employer and underpin the local economy

Local government is a partner of the State Government in the stewardship of the NSW economy and is a key stakeholder in fiscal reform.

LGNSW welcomes the opportunity to comment on the draft report of the NSW Review of Federal Financial Relations. We also take the opportunity to present our views on tax reforms relating to local government that have not been addressed in the review.

This is a draft submission and is subject to review and approval of the LGNSW Board. Any changes will be advised at the earliest opportunity.

General Comments

LGNSW commends the NSW Government for elevating tax reform on the economic agenda and commissioning a Review of Federal Financial Relations (the Review). However, we are disappointed that the announced agenda and the draft report of the Review, ignore taxation reforms relating to local government. Local government is part of the taxation system of State through its reliance on rates, a form of land tax, as its primary source of revenue. Local government is also impacted by the taxation and fiscal policies of the NSW and Australian Governments. The latter includes rate pegging, the system of rate exemptions, land valuation methodology and the Emergency Services Levy (ESL) on local government.

While the Independent Pricing and Regulatory Tribunal (IPART) was commissioned to undertake a Review of the NSW Local Government Rating System in 2015, the terms of reference specifically excluded rate pegging – a major omission given that rate pegging is a key element of the NSW rating system. IPART delivered its final report to the State Government in late 2016. The Government released the final report and a further consultation paper in 2019 and released its final response in 2020. LGNSW welcomed the Government’s support of several IPART recommendations to provide greater rating flexibility through additional categorisation options and catch up provisions. However, the Government’s response indefinitely deferred consideration of key recommendations involving rate exemptions and the introduction of Capital Improved Valuations (CIV) methodology.

LGNSW strongly recommends that the NSW Government continue to consider reforms to the rating system in line with IPART’s recommendations. Rating system reform should form part of the overall tax reform agenda. LGNSW also seeks the removal of the ESL on local government and supports road funding reform.

End Rate Pegging

NSW has experienced rate pegging for over 40 years now, having been introduced in 1976/77. Local government has strongly opposed the policy since its inception.

Rates are considered to be an equitable and efficient form of taxation. (e.g. by Productivity Commission and Henry Review of Taxation).

However, LGNSW is strongly of the view that rate pegging is unnecessary, produces undesirable consequences and should be abolished. The primary reasons for this are that:

- Rate pegging has been made redundant/obsolete by the implementation of Integrated Planning & Reporting (Community Strategic Plan, Long Term Financial Plan etc).
- The NSW Treasury Corporation's assessment of the financial sustainability of NSW councils undertaken in 2013 indicates that existing revenue restrictions (including rate pegging), severely hamper councils' ability to fund current, let alone future, levels of service.
- The NSW Independent Local Government Review Panel in its 2013 Final Report found there was mounting evidence that around a third of all NSW councils suffer from weak revenues and infrastructure backlogs and connected this with rate capping. According to the Review Panel, over the period 2001/02 to 2010/11, growth in total revenue of NSW councils was 5.7% per annum, compared to an average of 8.0% for the other mainland states, pointing to "revenue foregone" in rates of well over $1 billion over that period.
- Rate pegging leads councils to impose higher user-pays charges which could result in pricing inequities.
- Rate pegging increases reliance on infrastructure contributions creating property market distortions.
- Rate pegging distorts the operation of a land valuation-based rating system. Valuations do not raise net revenue but merely redistribute the rate burden within a council area.
- Councils are democratically accountable, and this keeps rates in check.
- Historical experience of other jurisdictions without rate pegging has shown that rates did not blow out.
- Rate pegging distorts the operation of the rating system and produces negative consequences, including the direct and indirect suppression of the rating effort.

In the long run, rate pegging in NSW has resulted in:

- Under-provision of community infrastructure and services.
- The deferral of infrastructure maintenance and renewal expenditure resulting in massive infrastructure backlog.
- Undermining the financial sustainability of councils.

More recently, the NSW Productivity Commissioner, Peter Achterstraat, when launching the Issues Paper for the Review of Infrastructure Contributions in NSW, commented that local government rate pegging creates a financial disincentive for councils to accept growth and increases their dependence on other revenue sources such as infrastructure contributions.

Business lobby groups have also been recently calling on the NSW Government to abolish rate pegging as part of the government's post-pandemic recovery plan for the state. The Committee for Sydney and the Sydney and Western Sydney Business chambers say rate pegging should be removed so struggling councils can maintain staff levels, provide essential services and invest in infrastructure.

Reform Rate Exemptions

It is LGNSW's policy position that all land used for commercial or residential purposes should be subject to rates regardless of tenure. This accords with IPART recommendation 14:
Sections 555 and 556 of the Local Government Act 1993 NSW should be amended to:

– *exempt land on the basis of use rather than ownership, and to directly link the exemption to the use of the land, and*
– *ensure land used for residential and commercial purposes is rateable unless explicitly exempted.*

In some cases, rate exemption should simply be abolished (e.g. Forests NSW). In other instances it may be a matter of legislating tighter eligibility criteria and/or introducing a system of partial exemptions as applied in other jurisdictions.

Many current exemptions serve to provide financial benefits to numerous religious organisations, benevolent institutions, private schools, universities and some government business enterprises that are no longer justified in terms of principles of optimal taxation, particularly principles of equity and efficiency.

The distinction between charitable and social activity and commercial activity has blurred progressively over time with community orientated enterprises increasingly engaging in more commercially focused activity. Often it is no longer appropriate for local ratepayers to subsidise activities of exempt institutions where institutions act commercially, benefit from council services, and have capacity to pay.

LGNSW acknowledges that this is a complicated and contentious area. However, there are a number of exemptions where there is a strong case for reform to correct current anomalies and distortions. These include exemptions applying to:

- the commercial forestry operations of Forests NSW;
- leasehold commercial and private commercial operations in national parks; and
- social housing owned/managed by Community Housing Providers (CHPs).

Forestry Corporation of NSW

LGNSW has long argued that the commercial forestry operations of the Forestry Corporation of NSW (FCNSW) should be subject to rates. This view is strongly held in all local government areas that FCNSW operates. Local government strongly supports IPART's recommendation that these operations should be rateable.

The current exemption is a blatant anomaly that should have been addressed in past. The exemption is inconsistent with the treatment of other State-Owned Corporations (SOCs) which are subject to rates on lands used for commercial operations. It also contradicts competitive neutrality principles as its competitors, privately owned commercial forestry operators are subject to rates.

It should be noted that forestry operations have a major impact on local roads, bridges and other infrastructure and it is unfair that FCNSW does not contribute to the costs of maintenance and repair.

The Government's recent announcement that it is reviewing the potential privatisation of FCNSW provides bold confirmation that it is a commercial business operation and should be subject to rates. It is imperative that this anomaly is addressed prior to the sale and local government seeks a guarantee that the State Government will not allow the rate exemption to be carried forward into private ownership.

Commercial Leases in National Parks

Private and commercial leases in National Parks are exempt (such as leases for ski resorts and holiday accommodation), which is inconsistent with the treatment of private and commercial leases on Crown Lands that are subject to rates. This is clearly an anomaly that should be addressed. There is no justification for the difference in treatment.

Social Housing

Rate exemptions for social housing is an emerging problem for councils and growing at a rapid rate. The problem has largely resulted from a change in Government policy on the delivery of social housing and the emergence of new delivery mechanisms.

The Government is increasingly handing over management and ownership of social housing stock formerly controlled by State Government agencies (i.e. Department of Family and Community Services (FACs) and predecessors Housing NSW, Department of Housing, (Housing Commission) to Community Housing Providers (CHPs).

The issue is not the provision of community housing, councils support affordable housing. The issue is that the Government previously paid rates on these properties whereas CHPs are seeking and often achieving rate exemptions as Public Benefit Institutions (PBIs) through the Courts. As a result, councils face large reductions in their rate base. These reductions can be significant, particularly for councils with large stocks of social housing (e.g. Campbelltown City, Blacktown City, Nambucca Shire, and Port Macquarie-Hastings Councils).

It is unfair to burden local communities with the costs of subsidising social housing, particularly as stocks of public housing are not evenly distributed. Councils are not in the position to subsidise welfare measures. Such subsidies should be funded through the broader revenue bases of State or Federal Governments.

As this growing inequitable impost has directly resulted from changes to State Government policy it is incumbent on the State Government to correct it. The problem should not be left to grow. The impacts are potentially very large.

IPART provides the example of Campbelltown which has over 5,500 social housing properties. Campbelltown currently receives around $6.5 million in rates from these properties which would be lost if the properties were transferred to PBIs. This represents a cost of $109 per year to each of the remaining ratepaying households. Canterbury-Bankstown with 4,250 social housing properties stands to lose around $5 million.

Local government strongly IPART's recommendation to make all residential land use rateable.

Introduce Capital Improved Valuations (CIV)

The most important recommendations made in the IPART Review of the NSW Rating System relate to the introduction of CIV to the rating system, both as the basis for determination of ad valorum rates and the basis for growth in the rate base outside the peg.

CIV provides a more accurate reflection of the market value of a property and is therefore more easily understood by ratepayers. It also provides a more accurate indication of the land owner's capacity to pay. Importantly, CIV would help remove the rating discrepancies and inequities associated with high density development in urban areas.

CIV would enable councils to equitably and efficiently raise rate revenue from higher density development and help remove the discrepancies and inequities associated with apartment rating.

LGNSW does not support the mandating of CIV for all metropolitan and large regional councils as the underlying needs and circumstances vary. The introduction of CIV is most relevant to councils with a high proportion of high-density development. All councils should be given the option of using CIV or UV as proposed for non-metropolitan councils.

LGNSW also supports the IPART recommendation that growth in rates revenue outside the rate peg be calculated on changes in CIV. This would enable growth in the rate base to keep pace with real growth and the associated increase in demand for council infrastructure and services. LGNSW agrees with IPART's findings that application of CIV would be more equitable and efficient than the current UV based methodology, in that current ratepayers would not subsidise future ratepayers and it would better capture the costs of new developments.

This change has the potential to significantly improve the financial sustainability of growing councils and as such represents one of the most important recommendations that the Government has left open for consultation. CIV would also enhance the equity and efficiency of State land taxes.

Replace the Emergency Services Levy (ESL)

The bushfire disaster renews the focus on the funding model for emergency services in NSW (RFS, FRNSW and the SES). It highlights the need for the emergency services to have a strong funding base, but it has also highlighted the need for the funding model to be equitable, transparent and accountable.

LGNSW welcomes the Review's recommendation that the ESL on insurance policies be removed and replaced with a broad-based land tax. LGNSW has long advocated for this. We endorse the arguments that it is inequitable, lacks transparency and distorts the operation of the NSW insurance market. When combined with the cascading effect of the additional taxes - Stamp Duty and GST - that are applied on top of the combined value of the insurance premium and the ESL, insurance can become prohibitively expensive. This has no doubt contributed to higher incidences of underinsurance and non-insurance in NSW. It also distorts the taxation system as these are literally taxes on top of taxes which challenge taxation principles and clouds transparency.

LGNSW is disappointed however that the Review has failed to identify and address the ESL that applies to local government. Local government is required to fund 11.7% of the combined budgets of the RFS, FRNSW and the SES. LGNSW maintains that this is also a distortionary tax that lacks equity and transparency.

The ESL on local councils is inequitable as it does not apply consistently/evenly across all councils. While the levy is now collected centrally through Revenue NSW, each of the services have different budgetary structures and cost allocation mechanisms. There are different regional structures and allocations are variously based on land valuation and/or population. This complex budgetary process is largely incomprehensible to councils and the general public. Apart from the obvious lack of transparency in the budgetary process one of the consequences is that that the cost burden occurs disproportionately across councils and therefore ratepayers. The cost burden on councils is greatest on rural and regional councils with small rate bases and a relatively large RFS component.

For example, the 2.6% rate peg will provide an additional $120,000 in revenue to Tenterfield Shire Council in 2020/21 but $81,000 of the increase will be consumed by the increase in ESL. Leaving little to offset increases in other expenses. This is a common result, particularly among rural and regional councils with small rate bases and high RFS costs.

The ESL on local government also lacks transparency as it is invisible to ratepayers. The levy is not calculated for individual properties but like other council costs, is embedded in general rates. Ratepayers are not able to identify their contribution to the funding of the emergency services and are generally not aware. Given that the majority of ratepayers are insured they are effectively being double taxed.

The ESL on councils, like the ESL and associated GST and stamp duty on insurance policies, are part of the same hidden tax regime. Ratepayers and the insured are largely unaware of the levies they are paying. There is also a concern that the lack of transparency combined with the fact that the ESL on both insurance and local government funds 85.4% of the emergency services budget, may have enabled the emergency services to avoid the same budgetary scrutiny and accountability that other agencies are subject to.

These views have been supported by numerous inquiries and reviews of fire and emergency services funding over decades. Most notably this includes 2009 Victorian Bushfires Royal Commission which concluded that the lack of equity and transparency in the current arrangements (the Victorian model was similar to the current NSW model) amounts to a good reason for moving to another system and consequently made the recommendation that: *The State replace the Fire Services Levy with a property-based levy and introduce concessions for low-income earners. (Recommendation 64).*

Victoria has since introduced a broad-based property tax to fund their fire services. NSW is now the only mainland state that does not fund its fire services by a broad-based property levy. Other states had already introduced variations on this model - Queensland (1985), South Australia (1999), Western Australia (2003) and the ACT (2006–07).

All these States removed levies on local government when introducing the new funding models.

A property-based levy would ensure that all property owners finance the services in an equitable manner; not only owners that are insured. The levy should be based on the rateable value of each property and, for reasons of administrative simplicity, collected by Revenue NSW.

NSW was heading in this direction with the proposed introduction of the Fire and Emergency Services Levy (FESL) in 2017. However, the NSW Government made a last-minute decision to defer the implementation FESL indefinitely. This was despite the new system being fully operational.

LGNSW recommends that the NSW Government end the FESL deferral and move quickly towards implementation of a revised FESL. However, the revised model must include removal of the ESL on councils in addition to that on insurance companies. Ideally the revised FESL would be based on the Capital Improved Value (CIV) of properties as this better reflects the value of the property being protected and is therefore more equitable. Properties are currently valued at Unimproved Capital Value (UCV-land value) for rating and land tax purposes in NSW.

Develop Equitable Road Pricing Mechanisms

From a local government perspective, it is concerning that fuel excise revenues are in structural decline as highlighted in the Draft Report. Local government has long been advocating for a sustainable road funding model that recognises it has oversight of 75% of the total road length in Australia representing 662,000 km nationally and councils manages 90% of the total length of the NSW road network, representing around 165,000 km. Yet, nationally, local government has the lowest revenue base raising just 3.3% of total tax revenues and is unable to levy any road taxes directly to address the road infrastructure backlog.

As a result, LGNSW supports the Draft Report's recommendation that a road user pricing and charging system needs to be developed that better reflects the costs to society of road use, including pollution and congestion. This could be achieved by implementing a distance-based charging scheme, but it must, as the Draft Report highlights, not unfairly penalize those on lower incomes or those who live in remote and regional areas who may have to undertake longer commutes as a result. It must also fairly reflect the costs of that road use, reflecting for example, the wear and tear inflicted on the road network by high mass vehicles.

Ultimately, local government seeks a sustainable road funding model that will address the road infrastructure backlog and maintenance issues that plague the local road networks in Australia as this is compromising road user safety and putting a handbrake on national productivity.

Conclusion

LGNSW calls on the NSW Government to broaden its tax reform agenda to include local government taxation mechanisms and NSW taxes impacting on local government. A comprehensive tax reform initiative should include consideration of the impacts of:

- Rate Pegging
- Rate Exemptions
- Land valuation methodology (used by councils and the State Government for rating and land tax purposes).
- The Emergency Services Levy (ESL) on local government

LGNSW also seeks to engage with the NSW Government in the development of new road funding mechanisms including road pricing.

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