



Response to Productivity Commissions' Draft Research Report:

Assessing Local Government Revenue Raising Capacity

1. The Productivity Commission has examined the capacity of local government to raise own-source revenue. Local councils are currently funded mainly by property rates, and revenue from fees and charges.
2. Local government suffers from an inadequate organisational base, and many rural municipalities are small and depend on grants from other levels of government.
3. The Commonwealth Constitution does not recognise local government, but local government is an arm of State Government (it exists by virtue of s74A Victoria Constitution Act 1975), which is recognised in the Constitution.
4. In attempting to respond to increasingly demanding community expectations, local government now provides an expanding range of community services and infrastructure to support local communities, but lacks appropriate funding.
5. Local government is thus disadvantaged, as communities expect an expanding range of services beyond traditional roads and rubbish, but local government capacity to raise monies does not increase proportionately.
6. The resulting expansion in roles and service levels, coupled with rising input prices generally exceeding the average rate of revenue growth, (land values reflect neither income nor capacity to pay nor growth of community wealth) has seen a significant number of councils develop financial operating deficits. In an effort to control the size of these deficits, some councils have deferred or reduced expenditure on infrastructure maintenance.
7. Councils are investing limited resources in an attempt to address service and infrastructure gaps which are more appropriately federal or state responsibilities. It may be timely for the Productivity Commission to examine which tier of government is best situated to provide and / or fund any given service. Each government level should liaise more effectively with the others to ascertain where and when such issues are inappropriate for, or beyond the capacity or responsibility of councils.
8. The Productivity Commission has not identified any process to ensure that the financial implications of new Government legislation on Local Government are identified, and councils financed adequately.
9. The Productivity Commission was requested to assess the 'impacts on individuals, organisations and businesses of the various taxes, user charges and other revenue sources available to local government'. The VFF asserts that this has not been done thoroughly, and thus the report is flawed.

10. Local government relies currently, for a substantial part of its income, on property based taxes. Property based rating disadvantages farmers relative to other groups in the community, since land is the farmers' primary income producing asset, whereas land is merely the site where non-farm businesses' assets operate. Australian property taxation thus subsidises the non-farm sector at the expense of the farm sector.
11. Since the predominant factor of production in farming is land, farm businesses must invest a large proportion of their total assets in land. This would be uneconomic in non-farm businesses. Farms are generally located some distance away from main population centres, and farmers do not have equal access to the services provided by Councils. Consequently, farmers pay a disproportionate share of the costs of local government both in incidence and distribution of taxes.
12. In Victoria, rates are levied on a hypothetical highest and best use to which the land might reasonably be expected to be put, not on the actual productive capacity of the land. (Valuation of Land Act 1960 (Vic) section 5A).
13. Local Government funding, if based on *ad valorem* property taxation, should be based on the value of a ratepayer's house and curtilage. Rates on farm land should be abolished as in the UK because farmland is a factor of production, and its value bears little relationship to farmers' wealth or capacity to pay. Victorian farm rating disadvantages Victorian farmers against interstate farmers (cf. Queensland), and Australian farm rating disadvantages Australian farmers internationally.

Under the present system, farming pays an annual tax on its income producing assets, while other businesses pay only on the valuation of the site from which they operate. For example, a bank does not pay rates on the capital it has lent, on which it earns its income. The Productivity Commission, moreover, recognises that "*ability to pay does not increase proportionately with increases in property values.*" (Draft Research Report page 48). The VFF suggests this statement should have been adopted as a 'finding' by the Productivity Commission. Other factors such as drought, fire, flood and recovery periods— reduced or zero production levels - do affect ability to pay.

14. The concept of property-based taxes was arguably appropriate when the main function of Local Government was provision of property-based services, particularly the construction and maintenance of roads. The emphasis of local government activity is shifting more and more from property-based services to human services, however this change in activity has not been matched by an appropriate change in how local government is funded.

Land valuations as a basis for taxation is an inappropriate concept in 21st century Australia. Land value is both a poor indicator of an individual ratepayer's capacity to pay and the level of service required. Land ownership has no regard to the owners' income or debt position. Its origins date back to a period when land ownership was a good proxy for both wealth and income, and when the majority of services provided by local government were property related, for example roads, bridges and drainage.

Simply, the value of land doesn't produce income. Ratepayers' ability to pay does not increase proportionally with increases in property values. In the broadacre farm sector, land is both the income earning asset and the major business asset.

15. The present system, where Local Government imposes a charge on property owners in the form of rates which are based on property value, discriminates against farm property owners. Residents who do not own property do not contribute to shire funding, and the cost burden of the maintenance and

improvement of shire facilities is the sole responsibility of property owners, despite these facilities being used by other residents, tenants, tourists and visitors. Farmers need road access, and have the use of footpaths, streetlights, drainage and other services which support urban development. But the farmers use less of these available facilities than their urban counterparts and thus receive lesser value for rates paid, despite their individual greater proportional contribution through heavier incidence of taxes per person.

16. Victoria's local government revenue system is too narrow. It is based on asset value, not on income generation and unfairly prioritizes asset value ahead of income generation.
17. On page xxv, lines 11 and 12, drought is recognised as a random factor affecting revenue raised, however, rates do not vary with drought.
18. While other industries can adjust land use in response to increases in land taxes, generally farmers cannot make such adjustments. Land value can be a poor indicator of an individual taxpayer's capacity to pay. Land ownership is only one form of wealth and does not include the owner's income or debt position. Income and consumption taxes are reduced when the taxpayer is less well off.

The Productivity Commission recognises that *"in principle, the indicator of ability to pay by a local community should be based on disposable income, net of taxes and charges"* (Draft Research Report page 48). Again, the VFF believes that this statement should have been adopted as a 'finding' by the Productivity Commission.

19. The VFF finds it difficult to reconcile the following statements:

- Page xxiv – 'An examination of fiscal capacity does not reveal the extent to which local governments might practicably be able to raise additional revenue.'
- Page xxv – 'it needs to be stated that the purpose of this analysis is not to justify or recommend that councils raise additional revenue. Its purpose is to investigate whether there is some potential to raise additional revenue, if a council and its community wished (and were allowed) to do so'. This would seem to be an almost hypocritical statement given that the point of this exercise is to assess how much more revenue local government could raise.
- Page 5: 'The Commission has set out a framework that can guide local governments towards raising the revenue that maximises the net well-being of their communities'.
- Page 82: 'As a generalisation, all councils have some potential to raise further revenue'.

20. Re: Table 2.7 on page 29. The council rate per \$ per person is irrelevant to farmers.

21. Finding 6.2 states that 'differential rating provisions generally do not constrain the capacity of councils to raise revenue from property rates'. It must be remembered, however, that differentials can be a discount as well as an increase.

22. Finding 7.2 which addresses the distributional impacts of rates neglects to mention that rates are a regressive tax. For many years now, the purchasing power of incomes have been rising faster than land values.

23. Re: Finding 7.3 'In a large number of councils, the average rates incidence is about 2.5-3.5 per cent' This does not apply to farmers.
24. Re: Finding 7.5 'For the majority of households, the rates incidence is less than 3 per cent of disposable income. Farmers are not in the majority.'
25. Re: Finding 7.6 ' For the majority of councils, the average incidence of local government fees and charges is between 2 and 3 per cent of the income of their community'. That the Productivity Commission has not examined the distribution between urban and non-urban ratepayers is a gross deficiency of this study.
26. The Commission was asked to examine the capacity of different types of council to raise revenue and the factors contributing to capacity and variability in capacity over time, the impacts on individuals, organisations and businesses of the various taxes, user charges and other revenue sources available to local government.
27. Since the significant income producing farm capital is taxed, the impact therefore, is significant. Thus the statement on page 7, that 'at a national level, rates revenue is a small share of total taxation revenue collected by all levels of government. The ratio of own-source revenue, including rates, to gross domestic product is also small', is irrelevant, if not misleading. The incidence and distribution is also skewed against farming.
28. Also on page 7, the statement is made that 'the evidence suggests that if the ratio of rates revenue to GDP, at a national level, had been maintained at its 1990-91 level, local government rates revenue would have been 20 per cent, or around \$1.7 billion, higher than the actual level in 2005-06. The VFF reiterates that rates are paid 'out of income', even when there is no income due to inclement weather conditions. Non-farm businesses do not pay income taxes if no income is generated.
29. The VFF strongly agrees with the discussion of cost shifting on page 16 (iii), and notes that the broadacre farm sector contributes disproportionately because of the higher ratio of capital invested in land as between farm sector and urban enterprises. An example is the council responsibility for maintaining trees clear of powerlines belonging to overseas-owned corporations in built-up areas.
30. The taxation incidence implied in figure 2.5 on page 26 does not reflect broadacre enterprise rates ratio to other taxes. Disposable income ratio to rates is very different.
31. Page 38 contains the statement 'rural local governments are also collecting significantly more than the other groups, with a median per person revenue of \$587'. Since this report fails to split rural Shire results into farm and non-farm sectors, the results are skewed.
32. Page 42 says 'remote local governments are spending far more per person, with a median of \$5986, compared with all the other classes of councils, especially the urban fringe, which spend a median of \$720 per person. Given that no split is provided between the farm and non-farm sectors, this figure is a furphy for farmers.
33. On page 45, one of the key points states 'the willingness of the community to pay for local government services determines the revenue actually raised'. The VFF seeks an explanation of how this principle actually works in practice?

34. Page 48 contains the statement 'property values reflect both the wealth and income of residents, and are therefore a better indicator of ability to pay'. The VFF disputes that this statement is true for farmers. It may apply in European countries, where rainfall is assured, however, in Australia the 11-year drought renders this a nonsense.
35. The next statement on page 48 'using property values to assess ability to pay overcomes some of the practical difficulties in obtaining suitable measures of income', is also false in the case of farmers. Lifestyle buyers throughout Victoria have distorted the market, and this has affected the value of farmland. House and curtilage would allow local government to retain property taxation on a fair and equitable basis, without creating a distorting burden on farmland.
36. Fiscal capacity includes net aggregate income from all factors of production. The VFF notes that fiscal capacity as a measure of capacity to pay is irrelevant, unless the Commission finds that income would be a better indicator of capacity to pay. Local Government has no direct access to taxing residents' fiscal capacity. The draft findings utilise fiscal capacity as measured by after-tax aggregate income. This basis distorts the picture for farmers.
37. Among the key points on page 85, are that 'the legislative and regulatory restrictions will have implications for the distribution of revenue burdens within the community' The Commission needs to consider the distribution of the revenue burden between the farm and non-farm sectors, and suggest how this problem could be addressed.
38. In Chapter 7 dealing with impacts on individuals and businesses (p 119), the analysis of the study suggests that rates incidence is about 2.5-3.5 per cent, of income for most income deciles. Fees and charges incidence is 2-3 per cent for most income deciles. Once again, there is no attempt to separate farm and non-farm sectors where the factors of production are distributed differently.
39. Box 7.1 on page 123 contains a rates incidence example. These percentages are simply random assumptions with no relevance to farm enterprises. Again, there is no attempt to split the example in farms and non-farm sectors and hence the assessment of the impacts on business is flawed.
40. The statement on p 135 that 'the tax deductibility of rates enables the rates expense incurred by a business to be shifted, on part, to taxpayers more generally', is a rather meaningless statement. All taxes are eventually borne by the end purchaser of services. The question is why is it subjected to the land invested in and not the total capital invested?
41. Despite the statement that 'caution should be exercised in interpreting the evidence drawn from international studies' in Section 7.2, the U.S. and U.K. examples are discussed. We wonder why overseas evidence is noted when local farm data would have been more beneficial.

We note that the Jones Report, commissioned jointly by the MAV and VFF is not mentioned. Professor Jones pointed out that 'circuit breakers' apply in every State. Surf Coast Councillor Rechenberg-Dupe's study of the subject in the USA revealed various method of offset.

In the U.K. discussion on page 128, no mention is made of the fact that there has been no property tax levied on broadacres in England and the Netherlands since 1928-29, recognising the critical difference between the farm and non-farm sectors. There is minimal farm land taxation in the other EU-member states, since they harmonise intra-member imposts affecting competition.

42. It is noted on page 130 that the incidence of rural rates has not been estimated separately due to income data deficiencies, and difficulties in estimating shares of personal and business income sourced from farming. Unfortunately, it is vital for farmers that such estimates were made, and their absence detracts from the credibility of the study. The Draft Report therefore lacks logically probative evidence to support some findings.
43. On page 228, mention is made of rural effective property rates used as an indicator to compare rural effective property rates across councils. This appears contradictory, given the statements made previously regarding lack of income data on page 130.
44. The VFF agrees that ad valorem property taxation does not significantly distort economic activity and resource allocation in the non-farm sector (p 155). However, the VFF does not concur with this submission re broadacre farm land and notes the resulting inappropriate land use. For example, market garden land is too valuable for farming, so rates force subdivision and buildings.
45. The Commission has taken irrelevant matters into consideration. On page 199, it states that a flat rate of 8 per cent was applied to the CIV of property, to obtain the post-tax income. NAV is defined as 5 per cent of CIV in Victoria. The Johnston Report revealed that the actual rate of return on broadacres averages 1.7 per cent, including notional rental from the farm (house and cartilage).
46. Section C4 on page 201 discusses the relative potential to increase revenue. In order to increase revenue on farmland, there must be a separation of the farm and non-farm sectors for equity reasons. Similarly on 213, the suggestion that own-source revenue may be able to be increased by about 10 per cent, on average requires a split between farm and non-farm sectors to achieve an equitable distribution.
47. On page 231, 'annual rural effective property rates were substantially less than 1 per cent across all deciles'. The VFF expected the Productivity Commission to analyse the impact on individual businesses. This has not been done.
48. The VFF urges the Productivity Commission to:
- consider reducing the dependency of local government on property based taxes;
 - examine what services should be provided by which level of government; and
 - Take into account capital resource allocation in the broadacre farm sector which differs significantly from non-farm capital resource allocation.