PRODUCTIVITY COMMISSION

CAPACITY OF LOCAL GOVERNMENTS TO RAISE THEIR OWN REVENUE
EFFECTS OF THEIR REVENUE RAISING ON THE COMMUNITY

I am aware that local government taxation is a State, not a federal matter. Mr Reith, in 1999, addressed the VFF Annual Conference and said (rhetorically) that the Federal govt was interested in hearing about anything that obstructed business. Further back, Ian Sinclair wrote that he could not regard rates as a tax. The High Court held that rates are a tax in 1904. The Australian Constitution s 51 (ii) would allow the Commonwealth to cover the field.

Rates were meant to be a notional income tax. This does not make sense in a country where farm income may be zero (or less) in year one due to drought. Year two - bushfire. Year three - drought. Year four - flood. Year five re-sow and year six re-stock. Farm rating as notional income tax made some sense (in a country where rain was assured), at least until income tax was introduced (Pitt Government 1799 - Napoleonic wars)

Local Government Act 1989 s7(h) postulates "equitable imposition of rates and charges".

The Farm Differential Rate is not a concession to "wealthy" land owners, but is recognition of a lower earning capacity per unit area of land and hence a proportionate taxation regime:

Hansard [Assembly] 10 November 1949 at 3811 per Brigadier Tovell ... "Clause 14 provides that in municipalities rating on unimproved values, farm lands shall be rated at a lesser amount in the £1 than other lands. Members will realize that persons engaged in farming pursuits need much more land for a given return than those engaged in other branches of industry. They are undoubtedly carrying a heavy burden under a system which rates on land values."

See Hansard [Assembly] 30 April 1949 at 4520. And again in 1951 (See Hansard).

Rating started in England (Poor Relief Act 1601). 327 years of rating revealed that it was counter-productive to levy an annual capital tax on farmers' income producing assets and the English de-rated broad acres under the Rating and Valuation (Apportionment) Act 1928 in conjunction with the Local Government Act 1929. Other businesses paid rates on the site where their assets were located (factories, shops et c.), or where the accounts were kept (*e.g.* banks), but NOT on the actual income producing assets.

The European Union (Articles 39° and 43°) subsidizes its farmers.
The United States has "circuit breakers" in every State of the Union to counter the unholy alliance of rating authorities and real estate developers; in addition, they subsidize farm produce through the Export Enhancement Program, et.c.:

Being paid not to farm: The evolution of US farm subsidies.
Australian farmers goggle with envy about the billions of dollars governments of other countries hand out to their "producers".
The US farm subsidy system was set up in the 1930s to assist farmers during the depression. The system is expanding as Congress fears ballot box retribution in subsidized states if the system were cut back.
A 9 month Washington Post investigation found:

- US$1,300,000,000 paid to individuals as part of the US Farm Payment Program who do no farming at all. Landowners are eligible for farm payments even if only part of their land was once used for growing crops, regardless of if they still grow anything or not.

- Government assistance can also take the form of of Property Tax Reductions and Loan Deficiency Payments (LDPs). LDPs are cash payments to farmers when the market price of a commodity dips below the Government set minimum (or floor) even if only for a single day. The LDP Program can be (and is) easily manipulated by some. Farmers do not have to sell at the lower price to collect the money - they can bank the Government payment and sell their grain when prices are higher.

- The current LDP bears little resemblance to the original support system created by the Government to purchase grain when prices dipped below a price determined by the Government. The current system means US farmers can make as much money by picking the bottom of a market as they can by picking the top.

- In 2006, when pre-tax farm profits were a near record $72,000,000,000, the US Government handed out more than $25,000,000,000 in payments ($250,000 per 100,000 farms), almost 50% more than the amount it pays to families receiving welfare.

- Farm payments have altered the landscape and culture of the Farm Belt, pushed up land prices, favoring some large,wealthy operators. The effect of some farm subsidies has been contrary to their stated aim of ensuring the 'freedom to farm'. Farm subsidies to rice growers in Texas has actually led to the drop in rice acreage (from 600,000 acres in 1981 to 202,000 acres in 2005).

Who gets the money?
According to the OECD report, in 2004 the EU paid agricultural subsidies to its farmers to the tune of US$133,000,000,000. Japan came in second at US$49,000,000,000, with the US running third at $47,000,000,000.

The OECD also report that in the 2003 / 2004 season, the EU paid 80% of subsidies to its wealthiest 20% of farmers. In 1999, 45% of agricultural subsidies in the US went to the largest 7% of farms.
But not all farmers receive subsidies. According to research conducted by the Cato Institute, 58% of farmers, (mostly vegetable, beef cattle and chicken producers operate without subsidies. But the producers of of five crops - wheat, corn,soybeans, rice and cotton - receive more than 90% of government payments.

The big gripe is that this system hurts world commodity prices by encouraging overproduction. They can also be accused of clouding market signals as farmers plant crops which they think have the most attractive government farm payments.

Property taxation in primary production - farming in Victoria

The case for change in rural rating has been made out in:

Prof. Michael Jones, *The Victorian Local Government Property Tax System and its effect on farmers - The case for change.* 1990

David Johnson, (Senior Research Fellow, Institute of Applied Economic and Social Research), *Alternative systems of local government rating of farm land.* 1991

The English rating system had its foundation in the Poor Relief Act of 1601.
This system taxed net property income, measured by actual (or notional) annual rent, net of all expenses necessary to maintain that rent.

Our rating system is based on the English rating system, but "net annual value" (NAV) is deemed to be 5% of capital improved value. This unrealistic 5% is never achieved on farms.

After three and a quarter centuries, the English examined the rating system, found it counter-productive (a tax on income producing assets not borne by other businesses), and de-rated farm land: Rating and Valuation (Apportionment) Act 1928 in conjunction with the Local Government Act 1929.

Farm rates in other European Union countries are nominal.
Typical Case: Farm rates on farm land of equivalent value:

Vic are some $16,000 p.a.; (down from $20,000 - Kennett reforms)

UK, nil;

France, $150 - 300;

Germany $200.

In the USA, "circuit breakers" stop hypothetical values being applied to prime productive land.

If it is the will of Parliament, that Victorian farmers should be disadvantaged compared with their competitors, and Parliament wishes to continue a taxation system long since abandoned as counter-productive by our competitors, and since rates must be derived from income, we propose that rating (taxing) actual or notional net rent would be fairer, and would satisfy better the criteria of the Land Valuation Act.

Planning and Land use.

Rates furnish about half local government income. Rate income depends on valuations. Local government seeks to maximize rate income. Studies have shown that planning is *de facto* dependent on valuation. (Sue Halstead-Lyons: Bass study). Sub divisible land is valued higher. Planning therefore promotes subdivision, not management of land resources in the national interest.

One result is that prime agricultural land which is valuable for production, becomes so valuable, it is put to its "highest and best use", *i.e.* is covered with buildings, because this use returns higher rates to local government; hence local government interests - only - are served by promoting urban sprawl. This is "built into the system." *e.g.* Werribee South market garden land being subdivided.

Consequently we grow our food on productive land, until it becomes too valuable ... gradually, we are covering our best soil with buildings, and farming by default on the poorer and more fragile.

Some problems seem to be:

1. 1. A presumption that there is an infinite acreage of high quality arable and grazing land in Australia (see National Anthem);

2. An Australian misconception that land is a commodity, not a resource; (Professor Thiel, Faculty of Economics University of Munich, 1964)

3. That a hypothetical land value represents a capacity to pay, whereas monies lent by a bank, perhaps to buy that land, do not! The farmer is taxed on his investment, but the bank is not, only on its income.

   England scrapped rates on agricultural land in 1929, because the mediæval system was counterproductive; we Australians continue this obsolete system while our competitors have either scrapped or modified it.

4. The *"ad valorem"* system of annual capital tax which is discriminatory because:
   4.1. Farming is the only profession which pays an annual capital tax on its income producing asset - land; other businesses pay rates on the land where their income producing assets are located: *e.g.* a bank;
   4.2. Rates discriminate grossly between States and parts of States: *e.g.* Queensland's rating system on farm land explicitly recognizes that rates must be proportional to farm income (Valuation of Land Act (Qld)); Victoria's councils are notorious for arbitrary variations in both valuations and rates in different municipalities (See "Side by Side);
   4.3. Although called an *"ad valorem* capital tax", rate money obviously has to come from income - *i.e.* from production from the soil; and farmers watch grass not growing on dry, non producing soil during a drought, or not growing under floods, or not growing after a bushfire, but the rates have to be paid

5. Our overseas competitors do NOT pay such high rates. All US States have "circuit breakers" or rate capping systems and the Europeans have either abolished agricultural rates or reduced them to a token figure. World agricultural commodity prices are not tilted in our favour by our competitors' subsidies; worse, our own system of funding local government tilts the playing field against us!

6. A consequence of taxing the means of production is that the farm sector contributes disproportionally more to local government than the non-farm sector.

Municipal rates are a tax: *Municipal Council of Sydney* v *Commonwealth* (1904) 1 CLR 208, confirmed in *Essendon Corporation* v *Criterion Theatres Ltd and The Commonwealth* (1947) 74 CLR 1:17 per Dixon J.

Reform is long overdue to rectify:

1. Discrimination against farmers as a minority group singled out for special tax treatment by historical accident;

2. Discrimination between States and parts of States;

3. Money being sucked out of primary industry by an antiquated regressive tax based on the Poor Relief Act 1601 of mediæval England. This is Australia 2007!

4. Reduced rural employment opportunities (consider also multiplier effect).

5. Competitive commodity disadvantage built into our system (our competitors continue to build advantages into theirs);

6. A planning system warped by a system of funding local government which distorts land resource management and promotes urban sprawl; interface councils have serious problems with land banking, farms and rates and green wedges face planning blight and therefore subsequent rezoning and subdivision to the advantage of land bankers and speculators but not to the advantage of the affected farmers in the green wedge, who find themselves between the anvil of State Government limitations on subdivision and the hammer of local government ambitions to utilize high rates to force subdivision.

7. An inadequate system of funding local government which mismatches demands and funding;

8. The Municipal Association of Victoria notes that some 10% of rural or remote councils are not financially viable.

CONSEQUENCES OF REFORM:

- a more level "playing field" vis-à-vis our competitors
- fairer nationwide taxation;
- higher rural employment plus consequent higher urban employment due to multiplier effect;
- higher returns to Australian and State governments;
- planning based on long term land capability:
- reduced local government income, which would require a grants commission type funding to roll out inequalities *or* a share of income or goods and services taxes.

• REMEDY

Preferred: De-rate broadacres.

Fall back: Abolish Net Annual Value @ 5% of Capital Improved Value and replace it with Net Annual Rental, actual or based on a Valuer's estimation.

Rates in the $1 on (Unimproved) Capital Value should be at econometrically justified differentials. Differentiated or undifferentiated (uniform) rates must be justified by logically probative evidence adduced to justify Council decisions. Subordinate legislation containing Guidelines for Councils to strike differential rates should be enacted by State Governments. The State Governments should request Productivity Commission to get input from academic studies, Municipal Association of Victoria and Victorian Farmers Federation and to compare our and our competitors' taxation systems. Farm rates should not fluctuate from council to council, area to area.

Despair: If the State governments will not, our Australian Government has taxation powers under s 51(ii) of the Australian Constitution to remedy this economic (and therefore environmental / ecological) mess;

The Commonwealth parliament has power under Constitution section 52 placitum (ii) with respect to: "taxation, but not so as to discriminate between States or parts of States;"

"MUNICIPAL CHARGE"

Victorian councils can set a "municipal charge" to share overhead costs evenly across their municipality. Most councils are unwilling to set this charge at a reasonable level, because they argue it would raise non farm rates. One downside of democracies is once a majority has become parasitic on a minority, it tends to vote so as to maintain that economic advantage. The municipal charge should be mandatory and set at a econometrically justified level.

Econometric studies carried out by Dr David Johnson at Melbourne University 1991 show that average returns on capital in farm enterprises is 1.7% (disregarding the notional return on a dwelling, if present).

This contrasts sharply with the hypothetical 5% return on capital improved value (CIV) posited by Net Annual Value (NAV);

i.e. by somebody's unsubstantiated guess, NAV = 5% of CIV

Dr Johnson's study blew this guess out of the water.

Intuitively, coalition members recognized that this guess was not justifiable by experience at least as far back as 1949. Perhaps some members had farm and non farm investments and recognized that the return on capital invested in farm operations was and is factually lower than non farm. Members recognized that tariff protected secondary industry returns were on average better than on unprotected farming.

This view was re-iterated in 1951 (See Hansard).
Today, this is still recognized in s 7(h) Local government Act 1989 "equitable imposition of rates and charges".

The operation of LGA s 161 is supposed to give Local Government the ability to impose taxation equitable, but flexibly, in accord with local conditions. This is why s 161 also imposes a statutory duty on local councils to explain why differential rates apply - (but an anomaly is that the council does not have to explain why no differential should apply). Under the current Act, a farm differential rate may be higher than other rates.

No council, I believe, has ever justified either differential or uniform rates, econometrically.

Dr Michael Jones' study showed that our competitor the USA employs "circuit breakers" to lower farm rates. The US EEP subsidizes farm exports to Australian farmers' detriment.

The EU, under Articles 39° and 43°, subsidizes their farm production and farm rates vary from zero in England to nugatory in other EU States.

You will appreciate that LG has not collapsed in the USA nor EU.

Some believe that the farm differential is a concession or a subsidy, which the non-farm sector *e.g.* commercial and residential, has to make good through excess inequitable rates.

This argument fails in three ways:

1. Differential rates are intended to achieve fair and equitable taxation;

2. Council outgoings are elastic; *i.e.* discretionary - every responsible council buttons its coat to the wind. No council should live beyond its community's means.

3. The conceptual difference between farm and non-farm property *ad valorem* taxation is that a farm, as a work place, is taxed on its income producing asset, *viz.* land, <u>*and*</u> on the site where its income producing asset is located - the land.

   Other commercial enterprises, *e.g.* a bank, pay property *ad valorem* taxes on the site where the business operates, but pays no *ad valorem* taxes on the money it lends.

Some Councils view the farm differential rate as a subsidy and seek to get a *quid pro quo* to recoup what they see as an unjustified concession, to recover the general rate.

One such *quid pro quo* is a rate rebate under LGA s 169 for weed control and land management. Arguably, weed control is properly a function of DS &E under the CaLP Act and councils cannot derive powers from an Act which does not authorize the exercise of such powers. Section 169 is inapt for weed control.

Confusing the purposes of LGA ss 7(h), 161 and 169 defeats those purposes, imposes inequitable taxation and leads to a distorting economic burden.

<u>Borrowings</u>

Interest on loans to local government should be income tax free. At an appropriate rate, interest payments by local government to lenders would be reduced and nett return to lenders slightly advantageous.

CONCLUSION

It is submitted that the current system of funding local government based on *ad valorem* property taxation does not enable local government to carry out its statutory and "voluntarily assumed" duties, and constitutes material detriment for farmers both within the Australian tax system <u>and</u> vis-à-vis our competitors. Municipalities should receive a share of growth taxes.
A municipal charge should be mandatory. Farms should be de-rated, house and curtilage rated.