Local Government
Better Practice Guide
2014

Revenue and Rating Strategy

State Government Victoria

Local Government Victoria

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ISBN 978-1-922250-27-8

Authorised and published by the
Victorian Government
1 Treasury Place, Melbourne

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1 Introduction

This guide is a revised version of Local Government Victoria's 2004 *Developing a Rating Strategy*. It has been developed by the Department of Transport, Planning and Local Infrastructure (DTPLI) to support councils to take an integrated approach to developing a revenue and rating strategy which takes into account all council revenue components.

The guide provides a discussion of the major issues in revenue and rating and a method for supporting councils to take up this integrated approach, along with some technical appendices. The guide is focussed upon presenting a higher level perspective on municipal revenue and rating but not a specialist one. Future iterations of the guide will address more technical and detailed aspects of revenue, rating, costing and pricing with a view to expanding the contents and scope of the brief technical appendices presented in this version. This future expansion material may be of specific interest to council officers and specialists. The main points of this guide are the following:

- Rates are just one part of the revenue picture, which includes other revenue components such as fees, charges and grants. All must be considered in conjunction with each other
- A key influence of the overall revenue picture is a council's pricing policy that determines what type and proportion of each revenue source pays for different services
- Knowing the full cost of council services is important when setting their prices
- Rates are an important source of funding for infrastructure
- The rating system chosen by a council should take into account a number of factors including equity, efficiency, capacity to pay and the benefit derived.

2 Revenue and Rating in Local Government – An Overview

2.1 Local government service provision

Local governments provide many public services and no two councils are identical in the mix of services they provide to their community. The Annual Budget describes the services that a council is deciding to provide, along with the funds to provide them. Most importantly, the budget is a statement by the council as to what they consider important for their community. Service decisions are the result of a variety of factors such as history, community demand, identified need and previous decisions. Regardless of the mix of services, providing the revenue stream to meet their cost is a basic requirement of council planning and decision making. The two critical areas for a council to consider are first, the mix and cost of services (expenditure) including what is appropriate, desirable and feasible, and second, the mix of revenue required to pay for the services.

2.2 Revenue and rating mix

In an annual budget cycle, councillors often focus on rates and their impact with less attention given to other elements of the revenue pie. Rates and other sources of revenue such as fees, charges and grants should be determined together, noting their different characteristics and impact on the community. A balance needs to be struck between rating to fund *public* services and benefits (for example, footpaths) versus *private* services to specific groups or individuals (for example, leisure centres), which are often better funded through user fees and charges. Many goods and services fall between these two extremes – they have both public and private good characteristics. In these cases, decisions regarding how best they are funded becomes challenging.

Councils generally do not provide pure public goods (though many have public good characteristics) rather, they provide a variety of 'mixed goods' (part public, part private) and private goods. Examples of services provided by local governments that are more closely defined as public goods include local roads, footpaths, public parks and community libraries. Examples that are more closely defined as private goods include waste collection, parking and planning permits.

Directly charging users for services with mostly public good characteristics is usually impractical (such as charging people a fee for walking on footpaths). Councils should therefore recognise that it is more appropriate to recover the cost of services that have predominantly private good characteristics through user-pays charges and use property rates to offset the cost of public goods. Striking a balance between these two revenue sources forms an important element of a revenue and rating strategy – a pricing policy.

The pricing policy is an expression of a council's desired mix of property rates and other revenue sources. It is an acknowledgement that the chosen mix is a policy decision by council and takes into account a range of often competing and conflicting considerations. A pricing policy thus includes making considered choices about discretionary revenue such as fees and charges paid by service users and residual service costs borne by ratepayers. In each case the pricing policy should be driven by service objectives.

The pricing policy can directly affect who obtains access to services (affordability) and the level and frequency of that access. These aims are commonly addressed by the introduction of subsidies. Cross-subsidisation implies that one group may pay higher/lower prices than another group. Cross-subsidisation exists in a number of forms:

- cross-subsidisation between the fees and charges paid by different users for a specific service – a cross subsidy between users (for example concession prices)
- cross-subsidisation between fees, charges and rates – a cross subsidy between users and ratepayers or from one service to another service
- cross-subsidisation between the amounts of rates paid by various classes of ratepayers.

To be effective a more holistic approach than that traditionally taken by councils is required. More often than not user fees and charges are based on historic levels rather than any ongoing review of objectives, rationales and levels set against the cost of the service.

2.3 Brief history of local government rates

The taxation of land as a source of revenue for local government extends several centuries back – well before the colonisation of Australia and to the early part of the 16th century in England via the 1531 *Statute of Sewers*.[1,2]

Its appeal is attributed to its close alignment with municipal government services – which among other things directly influenced the value of land. The taxation of land was also held to have administrative appeal – both in simplicity and transparency – as title records were maintained and readily available for the estimation of tax liabilities.

There are many benefits to the use of land taxes to raise revenue, notably their efficiency and the low level of distortion they impose on economic decisions when compared to many other forms of taxation. If administered well, land taxes are also stable and predictable, in that they are typically less volatile than revenue drawn from consumption or transaction taxes.

Land taxation has been an important source of revenue for governments in Australia – all three levels of government have utilised land as a basis for raising revenue at different times. From 1910 to 1952 the federal government taxed land values, while state and local government have taxed land for over a century.[3]

The application of rates by local government has changed along with the mix of goods and services provided. Over time how property is taxed has also been subject to change – for example the use of alternative valuation bases and the ability to combine service charges with *ad valorem* rates. Rates continue to provide an important revenue source for councils accounting for $4.30 billion (or 52 per cent) of own source revenue for Victorian councils in 2012/13.[4]

1 The (Elizabethan) Poor Relief Act 1601 – An Acte for the better Releife of the Poore of this Kingdom

2 The Report of the Committee of Inquiry into Local Government Finance (the Layfield Committee); as cited in Oakes, The Report of Committee of Inquiry into Local Government Rating and Other Revenue Powers and Resources, 1990.

3 Groenewegen, *Public Finance in Australia (Theory & Practice)*, Prentice-Hall of Australia, 1979

4 Victorian Auditor General's Office, *Local Government: Results of the 2012-13 Audits*, December 2013

In addition to property rates, local governments raise revenue through the levying of fees and charges for services, along with other revenue sources. The primary principle behind a user fee or charge is that of 'user-pays'. The basic concept argues that the beneficiary or user of a service pays an amount directly for its use. Many public services attract a fee or a charge. The extent to which such fees and charges are used are important decisions of a council. The revenue mix is different for each council and rates, despite attracting a great deal of attention compared with other council revenue sources, are only one part of the picture.

Council Revenue Composition, 2012-13

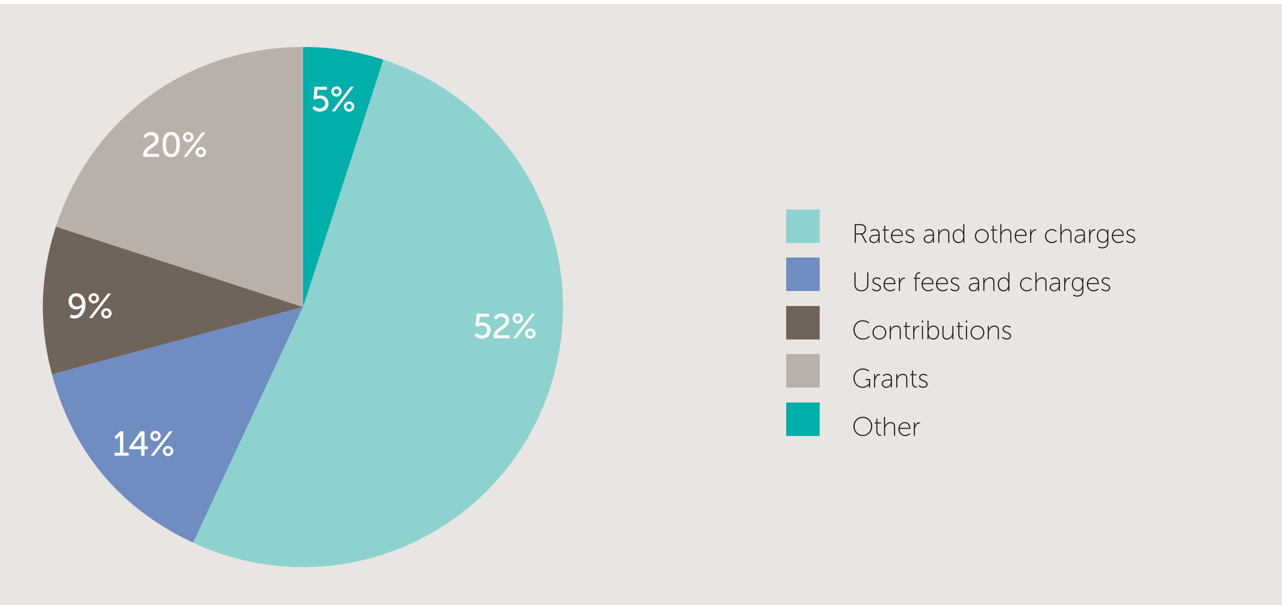


Diagram reproduced from the Victorian Auditor General's Report - Local Government: Results of the 2012-13 Audits

3 A Better Practice Revenue and Rating Strategy – Step by Step Outline

What does a better practice revenue and rating strategy look like?

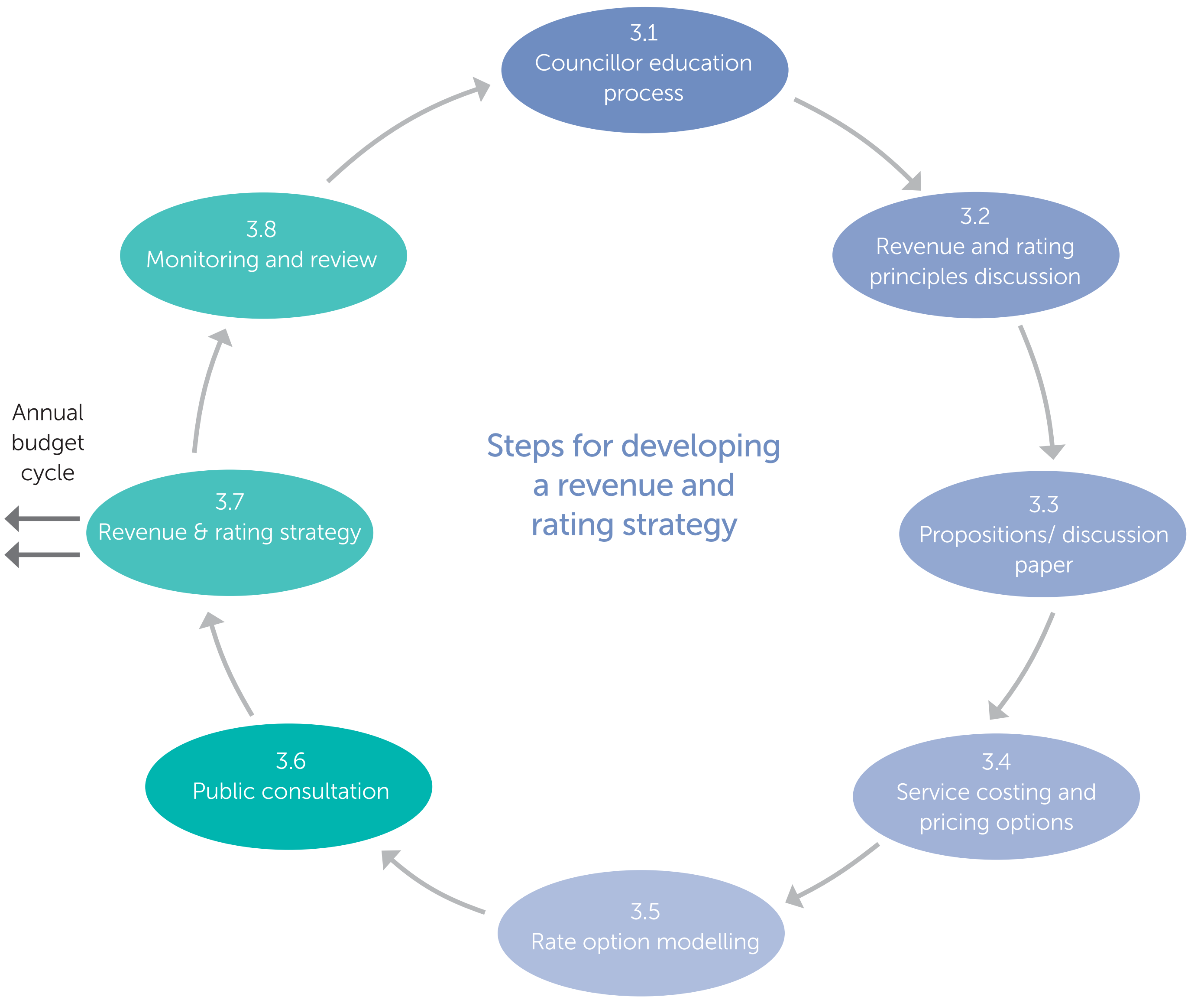
Councils can take a range of approaches to devising a revenue and rating strategy. The key message of this guide is that template approaches have limitations and are only a starting point and a way to assist a process that supports considered decision-making and the transparent expression of a council's views. It is the fulsome consideration of the whole revenue picture by council that matters most. A revenue and rating strategy ideally comprises a number of components and may include documents on:

- a council rationale and objectives discussion including its pricing policy and core components of its rating structure
- related research and background discussion on the municipality and past practices
- comprehensive rates, fees and charges impact modelling on the municipality
- explanatory material
- opportunity for public review/consultation.

Above all of these steps is the need for time. A revenue and rating strategy is unlikely to take less than six months and could take up to 12 months depending on the level of community engagement. A revenue and rating strategy should cover at least a four-year period, consistent with the strategic resource plan and be updated each time a general revaluation takes place. Service area reviews are likely to be periodic and will feed into the overall strategy.

Steps for developing a revenue and rating strategy	Result
1. Education process for councillors	Informed council that understands the underlying principles and the process for preparing a revenue and rating strategy
2. Discussion of the major revenue and rating principles	Formulation of a council view based around councillors' response to some common propositions
3. Proposition/discussion paper	Distillation of the views expressed by councillors and a statement of preferred principles (and priorities) to apply to the setting of rates, fees and charges and the basis of a council's pricing policy for its services
4. Costing of services and pricing options	Striking of the revenue balance between rates and other sources of revenue for funding the delivery services
5. Modelling of rating options	Proposed rating structure for the consideration of the council and community
6. Public consultation process	Expression of a council's rationale for the different options and a preferred approach
7. Preparation of the revenue and rating strategy	Strategy that informs the preparation of the budget
8. Monitoring and review	Review of the revenue and rating strategy at least every two years in line with the general revaluation of properties within the municipal district

Each of the above steps is shown in the following process diagram and discussed further in the following sections.



Department of Transport, Planning and Local Infrastructure

3.1 Councillor education process

An important aspect of developing a revenue and rating strategy includes understanding what charging approaches are available and how the revenue and rating system works. With respect to the latter this should cover councillor education on:

- the concepts of revenue neutrality and zero sum – how the rating system determines only the share of revenue contributed by each property and does not influence the total amount of money that will be raised and how a reduction provided to any group of ratepayers through the use of differential rates must be borne by increases to other ratepayers
- the arithmetic around how rates are calculated – the revenue target, property values and rate in the dollar
- fundamentals around property valuation – the valuation bases available, revaluation cycle, factors taken into account by valuers when valuing property and the valuation profile/s of the municipality
- relevant legislation and guidelines – the rating instruments that may be used by councils including municipal charge, differential rates, service rates and charges, rate rebates, concessions, waivers and payment of rates
- the basic statistical knowledge required for data interpretation and decision-making.

3.2 Revenue and rating principles

The rating system is one of the most sensitive issues on which council make decisions. A coherent and well-presented revenue and rating strategy can help everyone involved – councillors, council staff and ratepayers – better understand the issues involved and the choices and trade-offs that have to be made. In getting to this point it is important to have an understanding of the following key principles involved.

3.2.1 Wealth tax principle

Wealth can be defined as the total value reflected in property and investments and income directed to day-to-day living. Local government is limited to taxing one component of wealth – real property. Council rates tax the stored "wealth" or unrealised capital gains inherent in land and buildings.

The "wealth tax" principle implies that the rates paid are dependent upon the value of a ratepayer's real property and have no correlation to the individual ratepayer's consumption of services or the perceived benefits derived by individual ratepayers from the expenditures funded from rates.

3.2.2 Equity

Equity is a subjective concept that is difficult to define. What is considered fair for one person may be considered unfair for another. There are two main equity concepts used to guide the development of rating strategies (and taxation more generally):

horizontal equity – ratepayers in similar situations should pay similar amounts (ensured mainly by accurate property valuations, undertaken in a consistent manner, their classification into homogenous property classes and the right of appeal against valuation)

vertical equity – those who are better off should pay more than those worse off (the rationale applies for the use of progressive and proportional income taxation. It implies a "relativity" dimension to the fairness of the tax burden).

Rates are essentially a wealth tax, determined on the value of property. A pure "wealth tax" approach implies that the rates paid relate directly to the value of a ratepayer's real property. The tests of horizontal and vertical equity are solely based on a property's value. There is frequent debate surrounding the characteristics of property owners that may impinge on the application of an equity principle. The three main ways in which positions can vary are:

- the benefit or user pays principle – some ratepayers have more access to, make more use of, and benefit more from the council services paid for by rates
- the capacity to pay principle – some ratepayers have more ability to pay rates than do others with similarly valued properties
- the incentive or encouragement principle – some ratepayers may be doing more towards achieving council goals than others in areas such as environmental or heritage protection.

Concepts such as "user pays" and "capacity to pay" often conflict. Depending on your viewpoint the equitable outcome may be the one where individuals pay more, or less, or exactly in proportion to, their level of consumption of services.

A difficulty arises where services are fully or partially public goods and it is either difficult or impossible to quantify use or access. For practical reasons equity considerations become focused on how the costs of some universally available basket of services should be shared between ratepayers.

3.2.3 Efficiency

Economic efficiency is measured by the extent to which production and consumption decisions by people are affected by a tax. Setting aside taxes explicitly intended to change behaviour (such as high taxes on cigarettes), a perfectly efficient tax would be one, which did not distort behaviour. Of course, there is no such tax – all taxes affect behaviour to some extent. However, economic *efficiency* in revenue collection is maximised when the degree of this distortion is minimised.[5]

Price is the major mechanism through which taxation efficiency may be achieved and for services where users are price sensitive, direct charging can influence demand and thus lead to greater efficiency. Conversely, the funding of services through rates (or via subsidies from other services) may result in an inflated demand for services and additional costs for councils to meet this demand. As a result, a mix of user charges and rates revenue funds a variety of council services.

The efficiency of a tax is also related to the cost of administration. Administration costs include the issuing of assessments, collection of rates (including maintaining and improving collection systems), monitoring outcomes, educating and informing ratepayers, and enforcement and debt recovery.

3.2.4 Simplicity

The taxation principle of simplicity revolves around how easily a system can be understood by the public namely ratepayers. This can conflict with the principles of equity and efficiency.

A simple rating scheme would have a limited number of rating classifications, even using a uniform rate. Other features of a simple rating scheme may be practicality and ease of administration. Rates in general are quite simple to administer in that they rely on a clear information source (property values) and they place a levy on something that is impossible to conceal (land). Public understanding is another consideration for a council in striving for simplicity. A simple system should be easier for the public to understand as should the explanation of it by a council.

The efficacy of using rates to provide incentive or encouragement for ratepayers to act in a certain way to achieve corporate goals (e.g. environmental) should be evaluated critically against other approaches in terms of likely effectiveness.

5 Access Economics, Analysis of state tax reform, Report for the Financial Industry Council of Australia, 2011

3.2.5 Benefit principle

A popular complaint levelled at councils is that "the rates I pay have no correlation with the services I consume or the benefits I receive". This argument is based on the benefit principle (the opposite of the wealth tax principle) that argues there should be a clear nexus between consumption/benefit and the rate burden. A user pays system is closely reflective of the benefit principle.

Application of the benefit principle to rates is difficult in practice because of the impossibility of measuring the relative levels of access and consumption across the full range of council services. While it might be quite obvious that certain geographic areas may not get access to specific services, for example street lighting, it is the level of benefit across the full range of rates-funded services that is important in determining the amount of rates that should be paid. Clearly, the exercise is not clear cut – for example, it might be argued that rural ratepayers derive less benefit from library services than their town counterparts but the reverse argument can apply to the costs of repairing local roads in rural areas where there are mostly rural users.

The analysis of benefit is often reduced to arguments of what services are consumed by town v. country, businesses v. residences and between different towns and suburbs. Such a simplistic determination of rates based on where services are located ignores the facts that:

- many services are not location specific
- access is not synonymous with consumption
- residents can travel or use technology to access some services
- (perhaps more significantly for many councils) services provided in different locations within a municipality have different costs. For example, the actual cost of providing the same or a lesser level of service to a more remote or less central location may be higher due to economies of scale or logistical reasons.

In some ways the arguing of the benefit principle with respect to council rates is like trying to do the same for Commonwealth income tax that is used to fund a wide range of universally accessed services.

It is likely to be quite costly to regularly undertake in-depth analyses on service access, consumption patterns and costs in order to attempt to review the level of benefit. In any event many subjective assumptions will have to be introduced that is unlikely to produce a fair result.

Other pricing instruments such as user charges, special rates and charges, and service rates and charges better lend themselves to dealing with the issue of benefit.

3.2.6 Capacity to pay

Councils may decide that capacity to pay is fundamentally reflected by property value or that the application of the wealth tax and benefit principles should be moderated for groups of ratepayers because of capacity to pay considerations.

As rates are levied on unrealised wealth in the form of property, their nexus with ratepayers' capacity to pay may be tenuous – ratepayers may be asset rich but cash poor or vice versa. Councils have been provided with a number of rating instruments that allow them to address the capacity to pay issue to varying degrees, including differential rates, waivers and deferrals.

One of the major issues councils face in assessing "capacity to pay" relates to the landlord-tenant relationship and the fundamental distinction between who is legally liable to pay rates and the economic incidence of rates. The economic incidence of rates reflects who ultimately bears the cost of rates through higher prices, lower wages or lower returns on assets. Liability for rates typically rests with property owners. Hence a council is required to assess fundamentally the capacity to pay of the property owner and not the tenant, although council may legitimately have concerns for the latter. Property owners are not just individuals but individual investors represented by firms, superannuation funds, insurance companies, property trusts and banks.

Two issues are pertinent here. First, changes to property taxes have marginal effects on the rents (return) that properties can earn because rent is determined by the demand of actual and potential users against a fixed land supply. The theory goes that even if taxes are passed on to the renters the increase in rents will cause rents to fall as demand for rental premises declines. In response to this it could be argued that there are a number of reasons to think that rate rises maybe passed onto tenants. For example rental markets may be tight or slow to adjust and there are often logistic and other factors why businesses are committed to particular premises. In some commercial arrangements, a tenant can be liable for the rates as a result of a contractual agreement.

Councils therefore need to determine whether they should have regard to, and how best to address, the issue of the economic incidence of rates. Given the assumption that landlords will generally (but not always) have a greater capacity to pay rates than tenants, councils may wish to consider whether they can discriminate between properties on this basis. In practice, there is no simple means of identifying the properties that are rentals and therefore additional council resources would be required to do this.

Historically, councils have used the capacity to pay principle as a primary argument in the setting of differential rates. There has, however, been a lack of transparency concerning the basis for the views held about capacity to pay and their translation into a hierarchy of rates. More often than not substantive and evidence-based reasons are not provided why the rate in the dollar on one type of property is higher/lower than another (or for that matter why a uniform rate system exists) or to explain the basis for the difference.

On equity and good public policy grounds, it is appropriate that the meaning and assessment of capacity to pay is agreed, at least from a practical point of view, and that decisions are influenced by a strong understanding of the factors relevant to particular property classes in order to make informed, albeit, generalised observations about their capacity to pay rates.

Knowledge and/or consideration of the following might be useful:

- Who are the poor and disadvantaged in a community (single renting pensioners and unemployed as well as home owning pensioners)?
- Is a council making assumptions about the relative capacities of different type of property owners e.g. pensioners versus single income families with little home equity?
- When devising rates, fees and charges, do you map income and wealth across your municipality?
- What is the breadth of businesses within your community, and what council services do they use and consume?
- Is it reasonable to treat a range of very different property types as very large blocks?
- What proportion of the economy within your local government area is small / large / heavy / light / rural business?
- Who are the farmers – small family businesses or large multi-nationals or a mix?
- Do you compare similar rates; for example a small business with a house versus family farm?
- Do you understand the property profiles in your local government area? For instance:
  - Who owns vacant land in your municipality?
  - Are they speculators, investment holders or superannuation organisations?
  - Which type own large blocks, small blocks?
  - Does a vacant land differential rate affect the behaviour change you are seeking or does it only make for a symbolic rate?
- Have you considered the appropriateness of rebates for addressing environmental problems?
- Have you considered the rating of specific uses such as charities and not for profit organisations?

- Should you benchmark your rates against adjoining councils?
  - Now?
  - Over time?
  - What are the reasons for differences between adjoining councils?
- By funding an extra program in your budget which property owners are you pressuring?
  - Are these property owners benefitting from this and like programs?

Understanding these things can help you develop a series of rationales, which will underpin decisions about the rating system.

3.2.7 Diversity

There is no way of getting around the fact that despite the "likeness" of members of property classes, there will also be considerable diversity with each class. There is considerable diversity in the economic circumstances of households related to household income, the number of breadwinners and members, expenditure patterns and debt levels.

Similarly, enormous business diversity exists – businesses range from small businesses with owner operators and few employees to corporations employing many thousands of people. They may take a variety of forms – sole operators, companies, partnerships, cooperatives and trusts. Production may cover a diverse range of goods and services for local, national or overseas markets. They may vary considerably in terms of turnover, net worth, profitability and gearing – just to name a few characteristics. Businesses may be "price takers" with little market power or "price makers" operating in oligopolistic markets.

Council rate setting for different groups may need to have regard to the general capacity of those classes of property to pay rates. There are practical limits to the extent that classes may be differentiated because of impacts on efficiency and simplicity – and the broader a property class, the more general are the assumptions about capacity to pay. Clearly, there is an issue of how well the assumptions made about a large class of ratepayers accurately reflect the circumstances of most of its members.

3.3 Propositions / discussion paper

The propositions/discussion paper should express the importance a council places on the various revenue and rating principles with a view to this shaping the formation of the revenue and rating strategy. This need not be a lengthy document, rather, it must strive for clarity in expressing what a council is seeking to emphasise.

Such a paper should be the basis of a pricing policy covering all revenue sources. As noted previously, it is impossible to devise a revenue and rating strategy in isolation from other revenue sources.

3.4 Service costing and pricing options

Costing and pricing are two essentials in building the revenue and rating strategy. The pricing step is critical to establishing the revenue balance struck between rates and other sources of revenue such as user fees and charges. Pricing of services is typically undertaken over a rolling, multi year cycle as the work can be complex. Appendix B and C provide additional information on this step in the process. The revenue generated from user fees and charges can be estimated and inform the next step in the process.

3.5 Rate option modelling

The revenue and rating strategy should include a presentation of the different options for rating and their effect on the municipal valuation base. The analysis of the valuation base discussed earlier should form the subject of the analysis. In this way, the impact of the proposed options on the lowest valued properties, the median and different property categories (among others) can be ascertained.

It is important that modelling include the use of different instruments available under the *Local Government Act 1989*. Analysis of the effects of different instruments and their appropriateness can continue work that started in the previous step: that assesses the range of instruments available to a council and their utility for achieving the council's aims.

The rationale is the explanation for why a council chose one option (or set of options) over another. It is the culmination of the council's discussion of various principles and objectives subsequently illustrated by modelling of options and their community impact. By electing or preferring one option to another, a council is able to make a statement to the community as to why their preferred course of action aligns with their policy aims. Critically, a rationale provides for community transparency as to why a council chose to do what it chose to do. It also allows a council to defend its course of action and explain why it is desirable or preferable to other options.

In addressing the above considerations, a council has an information challenge arising from privacy considerations, the cost in obtaining and analysing relevant information, as well as the local relevance, quality and currency of available data.

The most obvious information source for a council and one that is most accurate is the certified municipal property value data. There are however a range of data that may assist councils in their considerations of the key principles. This may include socio-economic, business and agricultural data from sources such as the ABS. Data held in other areas of council or purpose developed for informing the process should also be considered.

A sometimes neglected part of the rating structure is the policy on the application of waivers, rebates and concessions.[6] The criteria for the application of such instruments should strive for clarity and consistency to ensure that the public can easily understand their use. They are important to consider carefully as their use allows targeting of individuals or groups, thereby concentrating their beneficial effect.

3.6 Public consultation

A public consultation is an important part of the revenue and rating strategy. Such an undertaking and its importance warrants a council engaging with their community about the revenue picture, its aims and its impact upon the municipality. If done in an effective way, it also offers a council an opportunity to inform the community about the revenue and rating system and how it is applied.

Options for public consultation range from a process such as that prescribed in section 223 of the Local Government Act 1989 to appointing a community based committee or panel to advise on the development of a revenue and rating strategy. Given the great deal of misinformation about rates, as well as the complexity of the system, the utility of a better informed community should not be underestimated.

3.7 Revenue and rating strategy

The outcome of steps 3.1 to 3.6 above will be the revenue and rating strategy which will inform the preparation of the annual budget. This last step in this strategic process of development is one that the council undertakes in order that it makes what it considers to be the most appropriate decisions. The process of discovery it applies is in many respects as important as the end result of the strategy itself.

The final consideration for the revenue and rating strategy is for it to be published in or alongside the council's adopted annual budget. As a result, the process for developing the strategy should fit into the annual budget preparation process. Nevertheless, if a council decides to broadly

6 Noting that concessions on rates are provided by the Victorian Government under the *State Concessions Act 2004*. The Municipal Rates Concession provides a 50 per cent discount off council rates up to a yearly maximum of $202.90 in 2013-2014. The concession is available to homeowners and must be for their principal place of residency.

change the way in which they approach their revenue and rating strategy and seek to clearly communicate to and ask for feedback from their residents, the public process for a revenue strategy can practically exceed that of the budget.

3.8 Monitoring and review

Monitoring of the revenue and rating strategy once implemented can involve a mix of feedback from the community and active attempts by the council to understand the effects of its decision making. Further modelling following new information, especially the use of updated census data or property revaluations can be invaluable here.

A review period may also be considered by a council to make possible changes to the strategy. Given the longer term perspective of a revenue and rating strategy, a review should be undertaken after each general revaluation cycle. Nevertheless, a council may determine a review is warranted at any time, and advice from its officers and a community's needs is the best position to consider the timing and scope of a review.

Appendices

The appendices in this guide provide general overviews of the major considerations in developing of a rating strategy. They are not intended to constitute sophisticated technical guides for council officers and specialists at this stage. Future versions of this guide will expand upon these appendices and will complement exiting material and manuals on pricing and costing.

4 Appendix A - Revenue and Rating Strategy – Sample Template Outline

Purpose

To determine the most appropriate, affordable revenue and revenue strategy which, in conjunction with other income sources, will adequately finance the objectives proposed in the council plan.

Council's pricing policy

[INSERT COUNCIL NAME] requires sufficient revenue to satisfy its service delivery needs and fund its infrastructure needs. The most important sources of these funds are:

- general rates
- government grants
- fees and charges.

All avenues have been pursued to obtain external grant funds for prioritised works. Similarly, the council has reviewed all fees and charges over the past [INSERT NUMBER] years and increased/decreased the levels consistent with application of the user pays principle – that is, so far as is possible, the cost of providing a direct service will be met by the fees charged.

Council has determined that an annual assessment of all fees and charges is excessively costly and unnecessary. A rolling review process for all service areas is to be undertaken that ensures all service areas are subject to review at least once every four years.

A schedule of the current user fees and charges is presented in the annual budget. Also included is a selection of council services and their costs compared to the fees charged for their provision.

Council has resolved to utilise a band of plus or minus [INSERT NUMBER] per cent with regard to the cost/price ratio of services. In instances where this is not the case, a rationale is included to explain the variance and the basis for the subsidy.

Income from these sources represents [INSERT NUMBER] per cent of revenue required. The balance of [INSERT NUMBER] per cent must be obtained from general rate income.

The rating system is based on property valuations, these being carried out at two-year intervals. Rates are based on these valuations. The council has several means by which it can vary the amounts which are levied, including:

- a general rate
- a municipal charge
- differential rates
- service rates and charges
- special rates and charges
- rebates, waivers, deferments, concessions and exemptions.

Several propositions were put through a rate modelling process to develop the most suitable rating system. This entailed the council giving consideration to a number of factors, such as:

- equity of the system
- efficiency of application
- capacity to pay
- the link between rate levied and benefit to be derived.

An extensive discussion of these principles in the context of the municipality is found in the discussion paper published in [INSERT DATE].
In the paper, council considered and modelled the effects of the following options:

- the valuation base of rates, being site value (SV), capital improved value (CIV) and net annual value (NAV)
- the use of a uniform rate
- a uniform rate combined with a municipal charge set at [INSERT RATE & CHARGE]
- A differential rating system with and without a municipal charge
- The use of rebates and deferment schemes
- Policy approaches for exemptions and concessions
- Rating of cultural and recreational land.

Proposed rating system

Table A1

				Existing		New Strategy			
Rate Type	No.	Capital Improved Value	Share of Capital Improved Value	20xx-xx Municipal Charge & Rate Revenue	Share of Revenue	20xx-xx Municipal Charge & Rate Revenue	Share of Revenue	$ Change	% Change
Rate 1									
Rate 2									
Rate 3									
Rate 4									
Rate 5									
Total									

The main features of the new rating system are as follows:

- The municipal charge will be based on covering some of the administrative costs of the council, including property valuations, rates administration and cashiering, councillor support and office of the chief executive. This will result in an increase in the unit level of the municipal charge from [INSERT $] in 2013-14 to [INSERT $] in 2014-15. Council has noted the regressive element of a fixed property charge, but has determined that it is appropriate for the recovery of certain and identified costs specific to property
- There will no longer be a commercial / industrial rate. A commercial / industrial rate set at [INSERT %] of the general rate has been used over recent years. Council has determined that it is unable to determine that commercial property uses a greater or lesser proportion of council services than other property types. Where there is direct benefit of council services for commercial properties, council has resolved to examine the use of additional user charges or special charge schemes
- The agricultural land rate (previously farm rate) has been abolished in favour of a primary producer rate deferral scheme. Council has resolved that with the wide variety of farming in the municipality, it is not equitable to levy a general 'farm rate'. A primary producer deferral scheme allows council greater consideration of issues of equity and permit a more targeted approach that takes account of the specific circumstances of the primary production business *(in order to qualify for the primary producer deferral scheme, evidence of Australian Taxation Office primary producer status will be required)*

- A three-tiered approach to cultural and recreational properties will be implemented which will result in:
  - rates being waived or fully rebated for recreational facilities which provide broad public access for no charge
  - rates at the level of [INSERT %] of the general rate being applied to private recreational facilities which have significant local membership
  - The general rate being levied on recreational facilities which are considered to have a substantial commercial focus that exceeds their primary and original outdoor recreational purpose.
- A differential rate equal to [INSERT %] of the general rate will apply to low income residential housing owned and / or managed by volunteer, charitable, not-for-profit organisations *(in order to qualify for this discount, evidence of charitable or not for profit status will be required)*
- A waiver or rebate equivalent to the full value of rates will be provided to areas of high environmental significance that are registered by the Trust for Nature. These changes will result in some shifts in the rating burden, as shown in the Table A1 above.

Past and proposed rate levels

Table A2

Year	Total Levied	% Increase	Average % Increase Large Rural Shires	% of Total Revenue	Rates per Assessment
2001-02					
2002-03					
2003-04					
2004-05					
2005-06					
2006-07					
2007-08					

Summary

In council's view the proposed revenue and rating strategy puts due emphasis on equity and capacity to pay. The proposed increases of [INSERT %] for [INSERT FINANCIAL YEAR] and [INSERT %] thereafter are relatively moderate but necessary to help address identified service deficiencies.

It is noted that the first quintile of the valuation band will pay rates between [INSERT $] and [INSERT $]. This has been compared with the income profile of the area indicated by the most recent census. The average income for the municipality is [INSERT $]. This is [INSERT "higher" or "lower"] than the national average. More significantly, the municipality has areas in which significant numbers of people are low-income earners. This has been taken into consideration by council for this year's budget.

5 Appendix B – Full Service Costing

Cost recovery

Setting fees and charges is often determined by a notion that the fee charged for a service should correspond with the cost of providing the service – that is the costs borne by the council are fully recovered.

Council operations attracting fees and charges

All council services can be reviewed to assess whether they are appropriate to attract user fees and charges. Attributes of a service that can affect the ability for a council to place a fee or charge include whether the operation is a public or private good in nature and if there is any state & federal government legislation or funding conditions prohibiting or setting ceilings for pricing. Examples of such charges are found below:

Table B1: Examples of council fees and charges

Area	Significant or typical fee or charge	Examples of Constraints
Business and Economic	Planning application fees	Many fee levels set by Victorian Government
Traffic and Streets	Parking fees and fines	Nil
Recreation and Culture	Leisure centre entrance fees	Competition (if any) from other centres
	Library fees	Basic services free as condition of State Government funding
Family and Community	Child care centres	Constraints from funding agreements Competition from private providers
	Maternal and child health	Basic services free as part of State Government funding
Waste Management	Kerbside collection fees	Nil
	Tip disposal fees	Influenced by Environment Protection Act 1970 provisions
Aged and Disabled	HACC services fees	Maximums set by State Government
Governance	Local Laws fees or fines	Some related to penalty units set annually by State Government

Full cost

The full cost of delivering a service or providing a facility include both:

- direct costs – those costs that can be readily and unequivocally attributed to a service or activity because they are incurred exclusively for that particular product/activity
- indirect Costs (often referred to as overheads) – those costs that are not directly attributable to an activity, but support a range of activities across the council.

As discussed above, an important goal of this guideline is to achieve the benefits outlined, while minimising costs for councils. Most of the direct costing methodologies discussed here are part of "business as usual" sound financial management for any service. However, compared with current practice for many councils the allocation of indirect costs may involve some additional time and effort.

Direct Costs

Most councils have good systems for calculating the direct costs of providing services. These include:

- labour – the wages and salaries of all staff directly working on that service. These costs include staff overheads such as allowing for annual leave, sick leave, workers' compensation payments, and long service leave
- materials and supplies – supplies used in providing the service. This may include car operating expenses
- administrative expenses – the office support for a service. Typically an operational unit provides a number of services, so the administrative costs of that unit will need to be allocated across the different services
- capital equipment and assets used in providing the service – this may include plant hire or, where a council owns the equipment and assets, allowance for asset replacement and depreciation.

Indirect Costs

Every council has a range of "back office" operations that are not directly tied to any service delivery. Nonetheless, these involve real costs that are incurred in supporting the delivery of direct services. For examples, direct services would soon grind to a halt without the support of IT services, or the work of the human resources unit selecting and paying staff. Two widely used methods to allocate indirect costs are:

- activity-based costing – links an organisation's outputs or goods and services to the activities used to produce them, and then assigns a cost to each output based on the rate of consumption of associated activities
- the pro-rata approach – allocates indirect costs on a proportionate basis by using measures that are easily available, such as staff involved in the activity as a percentage of total staff, or the service unit's share of total office space.

Activity-based costing

The activity-based costing method is the most accurate way of allocating indirect costs. It works by examining the activities undertaken, determining what drives or causes the activities to be used in the production process, and then allocates costs on the basis of the resource consumption of each activity.

Table B2 below, based on examples in the Auditor General and DTF reports, illustrates the application of activity-based costing in allocating $300,000 of human resource costs between two areas: recreational services and child care.

The allocation of costs takes two steps:

1. Establishing the cost parameters of the human resources department:
    - Identify the main functions of the department (one of which is recruitment)
    - Estimate the proportion of time the department spends on each function (with recruitment estimated to be 30% of the total human resources workload)

- Calculate the cost of each function from the overall cost of the department and the proportion spent on each function (as recruitment is 30% of the overall cost of $300,000, recruitment's cost is $90,000)
- Identify what is the most important activity driving cost in each function (referred to as the cost driver). For recruitment, the most appropriate cost driver is the number of positions advertised.

2. Allocating the costs between the operational units. For illustrative purposes, Table 3 uses just two units; recreational services and child care:

- Establish the number of cost driver units for each operational area. For example, each year recreational services has five positions advertised (25%), and child care, 15 positions (75%)
- Apply the proportion of cost driver units to the cost of that function. Recreational services has 25% of the positions advertised, so generates 25% of the $90,000 total cost of the recruitment function
- Sum the costs of each functional area for each operational unit
- Ensure that the total costs allocated to all operational units equal the overall costs of the department.

Adopting these steps, the table below gives the full allocation of the costs of the human resources department across the two operational units.

Table B2: Example of activity-based costing

Step 1: Analyse costs of human resources function

Main human resources functions	% of time spent on these functions	Cost of each function (=% x total cost)	Most appropriate cost driver
Recruitment	30	$90,000	No of positions advertised
Selection	20	$60,000	No of interviews
Payroll	50	$150,000	No of employees
Total	100	$300,000	

Table B3: Example of Activity-Based Costing

Step 2: Allocate indirect costs to operational units

Function	Number and proportion of cost drivers		Allocation of indirect costs	
	Recreational services	Child care services	Recreational services	Child care services
Recruitment	5 (25%)	15 (75%)	$22,500	$67,500
Selection	20 (40%)	30 (60%)	$24,000	$36,000
Payroll	40 (40%)	60 (60%)	$60,000	$90,000
Total			$106,500	$193,500

Source: Auditor General Fees and Charges Figure A1, p30. The report notes this table is based on material in Department of Treasury and Finance *Cost Recovery Guidelines.*

Using the activity-based costing method, the allocation of the council's total human resource (indirect) costs between these two services are $106,500 for recreation services and $193,500 for child care services.

While activity based costing gives a comprehensive approach, an alternative pro rata approach, may be preferable. This is so for two reasons:

- It is not always practical to use the activity-based costing method. This process can be too labour intensive and costly to identify actual resource usage of different activities within a service
- A pro rata approach often delivers similar results with less effort.

An example of overhead allocation – that of the Municipal Association of Victoria's overheads model is covered in MAV's 2009 *Overheads Model – A Manual for Councils*. This provides a comprehensive overview and should be used as a guide for undertaking a review of indirect costs on a pro rata basis.

6 Appendix C – Pricing Policy

After a council has calculated the full costs of a service, another series of questions require answers before prices are decided. Presented as a sequence, these include:

- Do any external constraints apply? Possibilities include:
  - either the State or Commonwealth Government sets a statutory price for that service; and if the service has private sector competitors AND is a "significant business activity", the council needs to check competitive neutrality conditions (discussed in section 5.2 above). How would the service users respond to any price changes?
- Is a price based on the full cost of the service competitive with other suppliers (nearby councils and/or private competitors)?
- Does the council have a specific policy either:
  - to subsidise this service (setting prices below full costs)?
  - to use the service as a taxation mechanism (setting prices above the full cost level)?

If a competitive neutrality assessment is required, the following steps are recommended by the Victorian Government's National Competition Policy and Local Government Statement:

- Determine whether the operation is a "significant business activity" and, therefore, subject to the policy
- Assess the full costs of providing the services, including all overheads
- Identify any aspect whereby the operation gains a net commercial benefit from being government owned.

If this analysis shows that a significant business does enjoy a net competitive benefit, the council is expected to set prices that include competitive neutral adjustments. However, under the policy this is not required if the council:

- decides that the costs of applying competitive neutrality outweigh the benefits
- conducts and documents a "public interest test", which involves public consultation on costed options, and identifies clear public policy objectives for providing the service at below competitive neutral prices.

As well as ensuring a level playing field for private sector competitors, the policy aims to identify subsidies, make them transparent to the community, and explain why the council is providing cross-subsidisation. Cross-subsidisation implies that one group may pay higher/lower prices than another group. Cross-subsidisation exists in a number of forms:

- cross-subsidisation between the fees and charges paid by different users for a specific service – a cross subsidy between users
- cross-subsidisation between fees & charges and rates – a cross subsidy between users and ratepayers or from one service to another service
- cross-subsidisation between the amounts of rates paid by various classes of ratepayers.

The final step in a pricing policy is identifying what council services or service areas are "public goods" and therefore most appropriate for funding via general rate revenue. This need not be an exacting exercise, and as often noted, few council services fall exclusively into the public or private goods category. But it is important for a council to make recommendations that as far as possible allow judgements to be made and a rationale for pricing decisions to be expressed in the rating and revenue strategy.

A hypothetical example of pricing issues – aquatic centre

Parrot Park Recreation Centre in Beachville is operated by the Wombat Shire Council. Parrot Park, like many council aquatic centres, offers a range of activities and services, including:

- general recreational aquatic activities
- learn to swim classes
- group fitness
- gym
- occasional child care
- a small sales outlet (with a range of swimwear and accessories, snack foods, etc.).

Setting prices for these different activities requires consideration of a number of issues, including:

- council's policies for the centre
- the operational costs, and how these are allocated across the above activities
- responses to prices from both users and any competitors.

The council's 2004-2007 Community Plan included goals to:

- facilitate optimal health and wellbeing outcomes for all ages
- nurture and support young people and families
- facilitate an improved level of access to recreation and leisure opportunities to provide better health and wellbeing outcomes.

The council identified Beachville as a particularly high need area due to local areas of socio-economic disadvantage. In consequence, the council was prepared to subsidise the centre.

A key issue for allocating costs to the different activities is the high capital cost of the centre. Reports by both the Victorian Competition and Efficiency Commission (VCEC) and the State Government Department of Treasury and Finance's (DTF) July 2003 guidance on the application of competitive neutrality policy to council-owned aquatic and leisure centres looked at this issue.

Some of the centre's activities are commercial, and compete with other gyms and fitness centres. However, as DTF noted, the "recreational aquatic component" of the leisure centre is not viewed as a commercial operation but as a public amenity or community infrastructure:

> *"... gym fitness and aerobics programs . . . are often incorporated in such facilities because they make an operational profit that can cross-subsidise the overall centre. These integrated centres are more economically viable and offer a broader range of services to the community."*

In such a case, the VCEC report suggested that the avoidable cost methodology may be appropriate. This approach recognises that the basic capital costs of the aquatic centre – related to the non-commercial recreational aquatic component – would occur in any case, whether or not a fitness centre/gym is included. Therefore, the commercial activities should be costed based on their full direct costs plus only those capital costs which are related to that activity (fit-out of the gym for example, and an appropriate rental for the specific floor space).

As outlined above, this cost base provides a starting point for setting prices. As the DTF guide suggests:

> *"The overall 'commercial operation' of the council leisure centre should achieve full cost recovery. Full cost recovery is not required for each activity or output produced i.e. commercial activities can cross subsidise one another."*

Within this overall objective, DTF acknowledges that "generally, admission prices are set consistently with 'going rates' in the market".

The centre sets a range of prices:

- single visit prices for access to the gym or fitness classes
- discounts for concession card holders (about one third of the centre's users have concession cards, and the council offers a 30% discount)
- periodic memberships, for three, six and 12 months, with different levels of access (the centre offers silver, gold and platinum categories)
- corporate memberships, where a group of users from one company can access a discounted rate (30% off).

In addition, other possibilities include off-peak prices where the centre could try to encourage additional usage during quieter times.

Setting such prices requires a balancing and iterative process between achieving council's policy goals, covering costs, and being aware of competitive pressures for particular activities. Table C1 below compares rates for several council leisure centres in 2007.

Table C1: Examples of premium full access membership fees

	3 month		12 month	
	Full	Concession	Full	Concession
Parrot Park (Platinum)	$240	$168	$720	$504
		30%		30%
Maryland Aquatic Centre	$430	$366	$850	$723
		15%		15%
Bunyip Council Leisure Centres	$224	$108	$729	N/A
		52%		
City of Wetherby Recreational Centre	$228	$194	$603	$512
		15%		15%
Jack McEwen Olympic Pool (Rural City of Murray)	$300	N/A	$700	N/A

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