



Valuation and local government rating in Tasmania: a robust framework for the future

October 2010

Report by Access Economics Pty Limited for

Local Government Division, Department of
Premier and Cabinet (Tasmania)

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Acknowledgements

Access Economics would like to acknowledge the contribution and input provided by a range of organisations throughout the course of this project.

- The four councils who agreed to act as case studies for the project and who provided data and supporting information to enable this to occur:
 - Hobart City Council
 - Kingborough Council
 - Latrobe Council
 - Northern Midlands Council.
- The two councils who made premises available to host Discussion Forums:
 - Glenorchy City Council
 - West Tamar Council.
- The Discussion Forum attendees and those who made written submissions in response to the Discussion Paper.
- The organisations, and the individuals within these organisations, who made time available to meet with Access Economics and discuss Tasmania's property valuation and rating system:
 - Office of the Valuer-General
 - Property Council of Australia
 - Australian Property Institute
 - LG Valuation Services
 - Valuelit.
- The agencies in other jurisdictions who made time available to discuss property valuation and local government rating in their respective jurisdictions:
 - Adelaide City Council
 - Queensland Office of Local Government (Department of Infrastructure and Planning)
 - Local Government Victoria and Valuer-General Victoria
 - Western Australia Department of Local Government and Landgate.

Glossary

<i>Ad valorem</i>	Proportion of value (i.e. a rate in the dollar)
AAV	Assessed annual value (Tasmania)
Government valuations	Valuations undertaken for government clients for purposes such as land acquisition, government financial asset reporting or government property transactions
GRV	Gross rental value (WA)
NAV	Net annual value (Victoria)
OVG	Office of the Valuer-General
Statutory valuations	Valuations undertaken for government clients for rating, rental or land tax purposes
Supplementary valuations	Valuations conducted between general valuations e.g. where building or planning changes have been made to a property

Executive Summary

Consistent with trends observed across much of the nation, Tasmania's property market has experienced strong growth over the last decade. However, this growth has not been uniform – trends have varied across both geographic areas and market segments. In addition, there has been a disconnect between property prices and rents – with property prices growing at a more rapid rate (in some cases considerably so) – resulting in falling property yields.

Conditions of this nature invariably create challenges for the users of property valuations, in particular for councils who rely on this information for the administration of local government rates. Rapid and inconsistent growth in property valuations amplifies the challenges associated with ensuring that the desired distribution of rates is achieved and that property market volatility does not manifest in rating instability.

In Tasmania, these market-driven challenges have been compounded by the characteristics of the state's property valuation and rating system.

- Properties are re-valued every six years (the least frequent valuation cycle of any state or territory), meaning that significant increases in property value can occur following revaluation, particularly during periods of property market buoyancy.
- All 29 Tasmanian councils employ assessed annual value (AAV) as the basis for rating, however legislation stipulates that AAV must not be less than 4% of capital value ('the 4% minimum rule'). Falling yields have resulted in the proportion of properties on the 4% minimum rule increasing dramatically, to the point where the majority of properties are now subject to the rule and are hence effectively rated against capital value.
- While indexation (known as 'adjustment factors') has been employed to smooth property prices between revaluations, the efficacy of this mechanism has been limited, as properties subject to the 4% minimum rule have been indexed against AAV (despite being effectively rated against capital value).
- Limitations on the rating tools available to councils under current legislation, coupled with ambiguity in relation to key legislative provisions, has constrained councils' ability to respond to changing property market conditions and created uncertainty in relation to their legal capacity to implement certain measures.

Combined, these factors have increased the challenges faced by councils in the administration of local government rates and have generated instability in rating outcomes. Rates have fluctuated significantly for some groups of ratepayers and concerns have emerged among policymakers and the community regarding the robustness of the system.

However, the purpose of this review is not merely to ensure Tasmania's valuation and rating framework is one capable of withstanding buoyant and/or variable property market conditions such as those witnessed over the last decade. Rather, its aim is to comprehensively assess the extent to which the current model is consistent with best practice and the degree to which it provides all councils with a robust framework for navigating the future challenges that may emerge, given the markedly variable circumstances they face.

Evaluating the current system and the reform options

In undertaking an analysis of the current valuation and rating framework and its alternatives, a robust assessment framework is required – a set of criteria against which comparisons can systematically be undertaken. Local government rates are a form of taxation and hence this assessment framework is one consistent with the principles applied to tax policy analyses more broadly. The key criteria are outlined below. Given the nature of the issues pertinent to local government rating, particular emphasis is placed on the first four of these principles.

- Economic efficiency
- Simplicity (for both administrators and ratepayers)
- Equity (including capacity to pay and benefit principle)
- Sustainability (including stability)
- Cross border competitiveness
- Competitive neutrality

Of course, simultaneously optimising each of these criteria is not feasible; there are tradeoffs among them. For example, the most efficient system may place an excessive burden on segments of the community where, from an equity point of view, this is not desirable. Hence, the design challenge is one of balancing often competing considerations in an economically appropriate fashion. While some options will quite clearly be superior to others, the preferred design of the rating and valuation system ultimately hinges on the weight that policymakers assign to different criteria.

In assessing the scope to implement a best-practice framework, consideration must be given to those factors which have the potential to constrain the system going forward. In the Tasmanian context, several such constraints are relevant.

- While the current legislation permits councils to employ AAV, capital value or land value as the basis for local government rates, the range of rating tools that can be utilised by councils is limited.
- A shortage of qualified valuers in Tasmania and a small market for the provision of valuation services currently constrains the volume of valuation work which can be undertaken.
- Councils in many cases lack the technical expertise and resources necessary to effectively administer rates under complex circumstances.

While these constraints need not limit the scope or type of reform options canvassed, they must nonetheless be taken into account in the analysis and its resulting recommendations.

In identifying and evaluating potential reform options, Access Economics has drawn on the outcomes of discussions involving representatives from all of the state's councils; from consultations with local and interstate stakeholders; and from detailed modelling, where the recent rating outcomes of four case study councils with differing circumstances – and therefore broadly representative of all councils – were simulated and compared against a variety of reform options.

Findings and recommendations

Based on the outcomes of the consultations and modelling process, and in light of the assessment criteria articulated above, the review finds that there are a range of areas where reform is warranted.

Rating

Economic modelling suggests that the case study councils analysed as part of this review could have achieved marginally more stable rating outcomes following their most recent revaluation, through the utilisation of the rating tools currently available – principally fixed charges and differential rates.

More significantly, the analysis finds that irrespective of the valuation base/s utilised going forward, there is a case for:

- refining the *Local Government Act* to provide councils with greater certainty and clarity in relation to the existing provisions;
- explicitly introducing legislative capacity for councils to employ change caps and to utilise fixed charges more extensively (i.e. to raise up to 50% of total general rate revenue);
- encouraging councils to reduce reliance on measures such as maximums and minimums, in favour of transparent remissions (in exceptional cases), multi-tiered rates and fixed charges; and
- limiting the proportion of properties that can be ‘on the minimum’, thereby ensuring that the general rate cannot be structured as a flat rate.

Of course it must be borne in mind that the design of an optimal rating model, including the extent to which various rating tools are appropriate, will hinge on local circumstances and will therefore vary from council to council.

Valuation base

The review finds that there is not a strong case for retaining AAV as the valuation base for local government rates – against no criteria is it superior to either land value or capital value and against several it is inferior. The Tasmanian State Grants Commission and State Fire Commission, which also use AAV, could readily employ alternative valuation data (i.e. capital value or land value). Nevertheless, in the event that retention of AAV is preferred by policymakers, the 4% minimum rule should be removed for all properties other than those where practical valuation of AAV is not feasible. Valuation frequency should also be increased, ideally to a four-yearly cycle with biennial indexation. However, there would be additional costs associated with this.

Capital value and land value are both deemed superior to AAV, however which of these is preferred ultimately rests with policymakers and the weight placed on alternative design criteria; both valuation bases have their strengths.

- **Land value** is the most economically efficient and the best equipped to address benefit principle considerations. It is also the least resource-intensive and hence least costly to administer. Indicative estimates suggest that a 50% saving in total valuation costs could be achieved under a land value only model and that valuation frequency could be increased from every six years to every two years in a broadly cost-neutral fashion. It is

also consistent with the recommendation of the recently released Henry Review that state land tax and local government taxation be more closely aligned.

While a wholesale shift to land value – whereby capital valuations were no longer undertaken – would require changes to the administration of stamp duty, it is believed that these are manageable and indeed that they would bring Tasmania into line with other jurisdictions.

- **Capital value** has one distinct advantage over land value: it is better equipped to address capacity to pay considerations. Capital values more closely reflect income/wealth and, as a tax base, it better allows policymakers to target equity. It is also well understood by ratepayers and would generate administrative cost savings relative to a system which included AAV. However, these cost savings are estimated at around 15% and would hence be considerably less than the overall gains achievable under a 'land value only' model. As a result, increasing the frequency of revaluations would be more challenging. While it could not be achieved in a cost-neutral manner, four-yearly revaluation subject to biennial adjustment factors is recommended if capital value is employed.

Economic modelling indicates that the transition to an alternative base would be manageable under both land value and particularly capital value, provided the abovementioned rating strategies were in place and councils were supported with adequate resources to facilitate the change. While the transition would create a level of short term instability, this would be outweighed, over the longer term, by the benefits of a more robust system.

While councils could be given the option of selecting either capital value *or* land value, cost savings would only be realised if capital value data was not maintained for those councils which opted for land value, in which case reversion to capital value in future would be effectively precluded by its cost.

Valuation process

Access Economics' review has also revealed scope to improve the valuation process and to generate an environment conducive to competition among service providers – the benefits of which would materialise in a more efficient model of delivery and a higher quality valuation service. Key conclusions in relation to valuation processes include:

- Maintenance of the current synchronicity which exists with Victoria's biennial valuation cycle is critical to the system's capacity to continue to create a commercial proposition which is attractive to interstate contractors.
- Increased revaluation frequency would increase commercial attractiveness to contractors and therefore the competitiveness of the tender process.
- This could be further enhanced through changes to the way valuation contracts are administered, in particular, through bundling additional lines of work such as supplementary valuations and adjustment factors and offering contracts for multiple valuation cycles.

Implementation and transition

Given that legislative reform will be required to facilitate many of the measures outlined above, it will be extremely challenging – quite likely infeasible – for changes to be introduced for the 2011-12 rating year. However, it is anticipated that a number of the less fundamental recommendations could be implemented ahead of a more fundamental reform package to

assist councils in managing their rating administration – in particular, clarity regarding minimums and differentials and provisions for change caps and higher fixed charges. Critically, it will be essential that any changes are accompanied by a process of council education and support (see discussion below). Legislative change will be ineffectual if councils lack the capacity to determine the most appropriate and effective rating strategy given their local circumstances.

Importantly, the recommended rating tools – change caps in particular – will also form part of the strategy to successfully manage the transition associated with any more fundamental reform process. A range of other complementary measures also will be required to support the transition process and to underwrite councils' capacity to manage the implementation of any changes:

- Execution of an education campaign.
- Provision of guidelines and other reference material.
- Access to on-call expert support.
- Additional modelling, especially if land value is adopted.

Conclusions

The conditions which have prevailed in Tasmania's property market over the last decade have created challenges for, and uncovered limitations in, the state's framework of property valuation and local government rating. Looking ahead, it is unlikely that these circumstances will be repeated over the short to medium term. Indeed, some of the pressures which have built up may in fact abate of their own accord.

Irrespective, it is evident from this review that the current valuation and rating model has limitations in its structure and application – as revealed through an assessment against best-practice design principles – which warrant consideration of reform. The system's instability is inherent and is partially a function of valuation practices and processes – including the 4% minimum rule and its relationship with the estimation and application of adjustment factors – but is also symptomatic of a rating framework which requires refinement if it is to give councils the maximum ability to effectively manage their revenue raising.

The findings of this report suggest that, combined with reform to the rating framework, there is a strong case for shifting the valuation base employed for local government rating to either capital value or land value. Ultimately, the choice between these two valuation bases rests with policymakers, as it hinges on the significance placed on, primarily, capacity to pay considerations.

Regardless of which valuation base is preferred by policymakers, the specific design of an optimal rating strategy will vary between councils based on their local characteristics. The key to ensuring a robust rating system at a local level will therefore lie in providing councils with the resources and support necessary to implement and maintain the best practice measures required to effectively manage the diverse local circumstances they face.

Access Economics

1 Introduction

Access Economics has been engaged by the Local Government Division of the Department of Premier and Cabinet to provide technical advice as part of a review of valuation and local government rating in Tasmania. The review has been initiated in response to concerns by ratepayers and councils regarding the system's performance over recent years. Its terms of reference include:

- assessment of the effectiveness of current valuation and local government rating practices;
- evaluation of alternative models for valuation and rating, including their applicability within the Tasmanian context; and
- recommendation of preferred valuation and rating models for Tasmania, including any legislative amendments required to give effect to the preferred models.

The review must also consider the impact of any preferred valuation models on other government users of valuation information and provide advice on transitional issues for any recommended valuation and rating models (with reference to the capacity of councils to implement any changes). A steering committee has been appointed to undertake the review and comprises representatives from a range of State Government agencies and local government stakeholders, including the Local Government Association of Tasmania.

The review is focused on rates and charges levied by local governments – therefore, charges levied by other entities are not included in the analysis (such as water and sewerage charges, following the shift in responsibility for the provision of water and sewerage services to three regional water corporations in July 2009).

Access Economics' technical advice forms one component of the overall review process. Following delivery of Access Economics' final report in October 2010, the steering committee will consult with councils and the broader community throughout the remainder of the year, before making its recommendations to Government in early 2011. The Government has stated that any major changes arising from the review would not be implemented until the 2012-13 rating year.

Access Economics is also cognisant of the 2010 State Tax Review which has been announced by the Treasurer (with findings due to be published by the end of 2011). There is likely to be interplay between the two reviews, with the State Tax Review's terms of reference noting that the review of local government rating will be taken into account by the Taxation Review Panel.

Overview of the approach

Access Economics' approach to this assignment has involved a combination of the following methods:

- **Desktop research and analysis**

A review of rating and valuation practices employed in other states and territories was undertaken. Relevant sources included state/territory legislation, and state/territory government websites and publications.

- **Consultation with major stakeholders**

Two discussion forums were convened (one in Hobart, one in Launceston) to procure direct input from councils, especially in relation to concerns with the current valuation and rating system and views toward a range of potential reform options. A Discussion Paper was prepared and distributed to all councils prior to the forums and written feedback was invited.

Consultations were also held with a range of stakeholders, including the Office of the Valuer-General, private valuation firms, the Australian Property Institute, the Property Council of Australia and representatives from local government departments in other states/territories.

- **Detailed economic modelling**

Four case study councils – Hobart City, Kingborough, Latrobe and Northern Midlands - were selected by the steering committee to form the basis of detailed economic modelling to assess the impact of a range of alternative rating and valuation scenarios. The selected councils represent a cross-section of circumstances and characteristics (e.g. a mix of land use, property types and industry base).

Report structure

The remainder of the report is structured as follows:

Section 2 provides an overview of Tasmania's local governments and describes the current valuation and local government rating system, including the practices permitted under legislation and the actual practices used by councils. It also outlines the valuation methods and rating tools used by other jurisdictions in Australia.

Section 3 identifies and analyses key concerns with the current valuation and rating system. These concerns relate to the impact of Tasmanian property market trends on ratepayers and councils in terms of volatility and the redistribution of rates following revaluations, and legislative uncertainty for councils when making rating decisions. Interstate experiences are also canvassed to highlight how other jurisdictions manage similar concerns.

Section 4 outlines the principles of a best practice valuation and rating system. It describes the types of services provided by local government and implications for revenue-raising, and then considers the principles of optimal taxation design and how these relate to local government rating in general and in the Tasmanian context.

Section 5 draws on these best practice principles to assess the options for improving Tasmania's valuation and rating system. It analyses the options based on their potential to mitigate the systems' identified shortcomings and deliver a robust framework that allows

councils to effectively respond to changing circumstances. It cites modelling results for the four case study councils to demonstrate the likely impacts of various reform options.

Section 6 presents the conclusions and recommendations for reform. It notes the advantages of the recommended options, including their suitability for Tasmania given the priorities and concerns identified through consultations.

Section 7 explores legislative steps involved and the strategies that can be used to manage the transition process should a decision be made to reform the current system. It describes how rating tools, support to councils and stakeholder education can be used to ease the adjustment to a new valuation and rating framework.

Appendix A includes an outline of Tasmanian council rating structures in 2009-10; and Appendix B provides a description of interstate valuation methods and rating systems.

The Technical Appendix (separate to this report) includes detailed modelling for the four case study councils (Appendix C through to Appendix F).

2 Background

This section provides an overview of Tasmania's local governments, with a focus on property characteristics across councils, and then details the current system of valuation and local government rating employed in Tasmania. Interstate valuation and rating practices are also canvassed to enable comparisons with the current Tasmanian system.

2.1 Tasmania's local governments

There are 29 councils in Tasmania. Councils range in geographic size from West Coast Council which covers about 9,570 square kilometres (and has a population of approximately 5,500) to Devonport City Council which has an area of about 116 square kilometres (and a population of approximately 26,000).¹

Across Tasmania, residential use is the predominant land use purpose in terms of both number of properties (76.6%) and value (62.1%), as shown in Table 2.1. Residential land use represents the greatest share of property values in all councils except Central Highlands, Circular Head, Flinders and King Island, where primary production dominates.

Vacant land is the second most common land use, comprising just over 10% of the total number of properties. However, primary production is the predominant land use in terms of area (although it only comprises 5.5% of the total number of properties).

Table 2.1: Distribution of Tasmanian properties by land use, 2010

Land use	Distributions of properties	Distribution of values
Commercial	3.3%	14.6%
Industrial	1.1%	4.1%
Primary Production	5.5%	8.8%
Public Purposes	1.5%	6.2%
Quarries	0.1%	0.2%
Residential	76.6%	62.1%
Sport & Public Recreation	1.5%	1.0%
Vacant Land	10.4%	3.0%

Note: Values related to assessed annual value (AAV).

Source: OVG

The land classification mix and the characteristics of the property market varies markedly across Tasmania. For example, over 90% of land is classified as residential in Brighton, Clarence, Devonport, Glenorchy, Kingborough and West Tamar. In contrast, less than 60% of land is classified as residential in Flinders and King Island. Municipal areas that have a relatively high proportion of commercial land are Hobart, Launceston and West Coast. Over 20% of land is classified as primary production in Circular Head, Dorset, Flinders, Kentish, King

¹ Information from council websites.

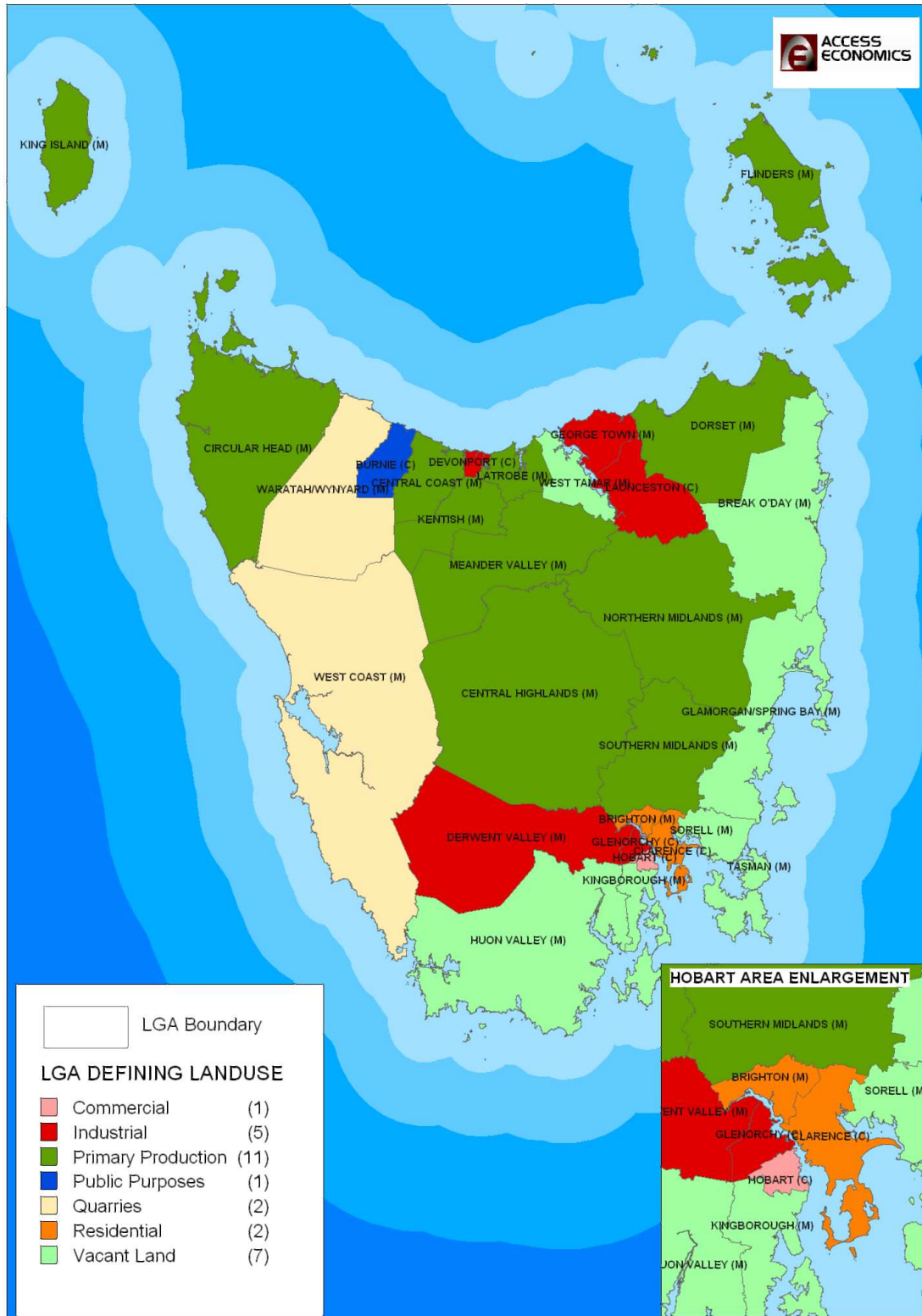
Island and Southern Midlands.² Variations also occur within municipal areas – for example, Clarence City Council contains both high value beachfront residential properties and low value housing commission properties.

Assessing land use in a different light, Figure 2.1 shows the *defining* land use for each council, where the defining land use is determined relative to the state average. For each council, it represents the land use which has the highest share to total land value relative to the state average (listed in Table 2.1 above). For example, for a given municipality, residential may be the prominent land use in absolute terms (e.g. 60% of total), but the defining land use may be commercial (e.g. four times the state average).

Eleven councils have primary production as their defining land use, whereas only two councils are defined by residential land use (Brighton and Clarence City Councils). Not surprisingly, Hobart City Council is the only local government where the defining land use is commercial.

² As at 1 July 2010 (data provided by OVG).

Figure 2.1: Defining land use for Tasmania's local government areas



2.2 The current system of valuation and rating

In Tasmania, valuation is governed by the *Valuation of Land Act 2001* and local government rating is subject to the *Local Government Act 1993*.

2.2.1 Valuation

Under section 11 of Tasmania's *Valuation of Land Act*, the Valuer-General must determine three different values for each property:

- land value – value of the property excluding all visible improvements (e.g. buildings, structures) but including invisible improvements (e.g. draining, excavation);
- capital value – total value of the property, excluding plant and machinery; and
- assessed annual value (AAV) – gross annual rental value of the property, excluding GST, council rates and land tax.

Section 11(3)(e) of the *Valuation of Land Act* states that AAV must not be less than 4% of the capital value of the land (the 4% minimum rule).

Under section 20 of the *Valuation of Land Act*, revaluations ('fresh valuations') must be made within a seven-year period. In practice, all properties in Tasmania are revalued within a six-year cycle, with three biennial revaluations which apply to one-third of the 29 councils in each revaluation round. These statutory valuations are outsourced by the Office of the Valuer-General (OVG) to private valuation firms, with quality assurance of this work undertaken by the OVG.

In 2004, when the six-year cycle was formalised, adjustment factors were introduced as a mechanism to index property values and reduce the fluctuation that would otherwise occur between revaluations. This system was further refined in 2007 and is now undertaken on a locality-by-locality basis rather than broad municipal basis.

Under section 50A of the *Valuation of Land Act*, adjustment factors may be determined for land value, capital value and AAV. Currently, adjustment factors are determined annually for land value and every two years for AAV, but are not determined for capital value. The OVG determines these adjustment factors in-house. It also undertakes government and non-revaluation supplementary valuations in-house.

Councils are required to pay for the cost of valuation services under section 46 of the *Valuation of Land Act*. The cost is recovered from councils by the Valuer-General (and subsequently used to fund services provided by the valuation contractors). Costs of the valuation service contracts for the 2011 revaluation round are outlined in Table 2.2 below.

Table 2.2: Costs of 2011 revaluation round

Valuation district	Valuation services contractor	Cost
Derwent Valley	ValueIt Pty Ltd	\$145,000
Dorset	LG Valuation Services Pty Ltd	\$126,000
Flinders Island	LG Valuation Services Pty Ltd	\$54,000
Glamorgan-Spring Bay	LG Valuation Services Pty Ltd	\$126,000
Glenorchy	ValueIt Pty Ltd	\$339,000
King Island	ValueIt Pty Ltd	\$75,000
Launceston	LG Valuation Services Pty Ltd	\$542,000
Sorell	ValueIt Pty Ltd	\$160,000
Tasman	ValueIt Pty Ltd	\$95,000
Waratah-Wynyard	ValueIt Pty Ltd	\$173,000

Source: OVG website

In effect, councils are responsible for meeting the direct costs of producing the valuation information (but not the OVG's contract management and quality assurance work). However, councils are not the sole users of this information: other government departments and agencies also use this information for a number of purposes (highlighted in Box 1 below). The fact that councils fully fund the direct costs of producing valuation information is offset, to some extent, by the fact that the costs incurred by the OVG in providing supplementary valuations exceed the charges levied on councils for these services (that is, they are cross subsidised). In addition, the OVG does not charge councils for determination and provision of adjustment factors or contract management and quality assurance.

Box 1: Other users of valuation information

Property value information is used by councils to determine rates. However, they are not the only users of valuation information:

- AAV is used by the Tasmanian State Grants Commission to determine local government grants and the State Fire Commission (to calculate fire levies).
- Capital value is used by the State Government to determine stamp duty.
- Land value is used by the State Government to determine land tax and by the Commonwealth Grants Commission.

Practical constraints

There are several practical constraints within the valuation system which impact on the provision of valuation services and, by extension, affect local government rating. These constraints relate to OVG staffing and funding and the small valuation services market in Tasmania.

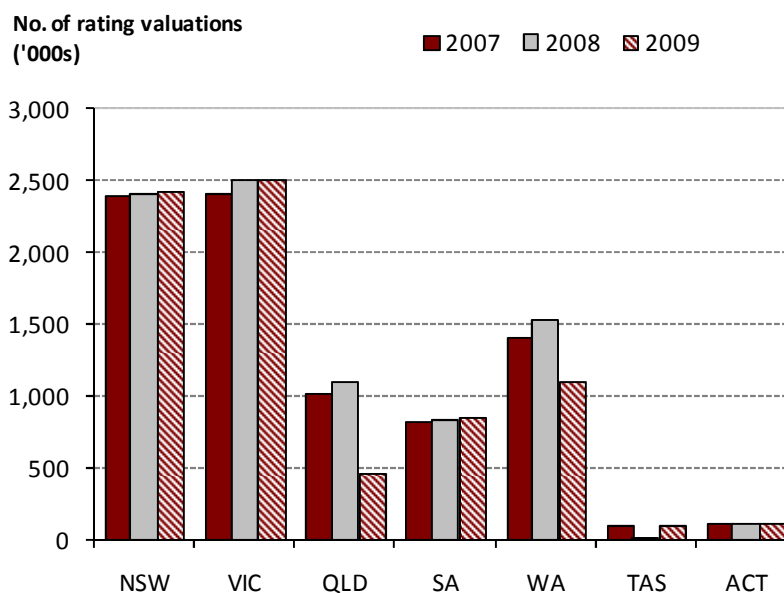
Staff resourcing issues limit the OVG's present and future internal capacity. The OVG currently has 32 staff, including 13 qualified valuers and 10 graduate/assistant valuers. However, most of the experienced senior valuers are due to retire over the next three years. The OVG has also experienced difficulty in attracting appropriately qualified staff to Tasmania, with some positions remaining unfilled over a period of time. Compounding this problem, no valuation university courses are offered in Tasmania.

In terms of funding, the OVG has traditionally been dependent on funding from commercial services to meet some of its fixed costs. Under the 2008-09 funding model, for example, approximately 70% of funding came from commercial sources (predominantly local governments) and 30% from recurrent consolidated appropriation (i.e. State Government sources). As alluded to above, this funding model did not accurately reflect the distribution of work undertaken by the OVG, effectively leading to the cross-subsidisation of non-commercial work (such as government valuations for land tax and stamp duty purposes) through commercial work (such as statutory valuations for local government rating purposes).

The Tasmanian Government recently announced additional funding for the OVG of \$1.5 million per annum in 2010-11 and 2011-12, increasing to \$4 million per annum in 2012-13. The funding may enable the OVG to move towards a shorter revaluation cycle, by shifting the funding model and providing the OVG with a more sustainable operating base.³ It may also increase the OVG's aggregate resourcing levels, especially through the employment of additional staff (although the abovementioned challenges in recruiting qualified staff will have a bearing on this).

The size of the Tasmanian market also has implications for the valuation and rating system. Chart 2.1 below provides an indication of market size in terms of the number of 'rating' valuations undertaken each year. Although the number of valuations undertaken in a given year depends on a jurisdiction's valuation program, it is nevertheless evident that overall the Tasmanian market is significantly smaller than any other jurisdiction besides the ACT.

Chart 2.1: Number of statutory valuations per year by jurisdiction



Note: Data for NT not available.
 Source: Queensland Public Service Commission (2009)

Correspondingly, the private market for valuation services in Tasmania is small. There is only one Tasmanian-based valuation firm that is large enough to tender for the revaluations, and

³ For example, the 2010-11 funding model for the OVG has moved to approximately 60% from State Government sources and 40% from commercial sources.

the other valuation firms that undertake contract work in Tasmania have head offices in Victoria. The current volume of valuation work and its sporadic nature (i.e. nine/ten councils every two years) generates only limited incentives for new firms to enter the market.

Tasmania must also compete with other states for the services of Victorian-based valuation contractors. Revaluations occur biennially in Victoria and the relative size of the Victorian and Tasmanian markets means that firms are usually only prepared to tender for Tasmanian revaluations in the Victorian 'off-year' (e.g. for the 2010-11 revaluation round, only two valuation firms tendered for all 10 municipalities).

An historical constraint within the valuation system was the reliance on paper-based systems within the OVG. However, electronic systems are currently being implemented, which are likely to provide efficiency gains for the OVG and other users of valuation information. In effect, this constraint is already being addressed and is unlikely to be a future source of concern.

2.2.2 Local government rating

The provisions concerning local government rating are contained in Part 9 of the *Local Government Act*.

Under section 89A(2), councils may base their rates on any of the three property values determined by the Valuer-General – land value, capital value or AAV. In practice, however, all Tasmanian councils use AAV for local government rating.

Section 90 of the *Local Government Act* permits councils to set one general rate and a minimum (but a minimum may only be set where the general rate does not include a fixed charge).

The composition of the general rate is outlined in section 91. It may comprise both an *ad valorem* component and a fixed charge. A fixed charge must apply equally to each property that is being rated and total revenue from the fixed charge must not be more than either the council's total recurrent administrative expenditure in the previous financial year, or 20% of the council's general rate revenue for that particular year (whichever is the least amount).

Under section 107, councils may vary the general rate within different parts of the municipal area according to one or more of the following factors: the use (or predominant use) of the land; non-use of the land; locality of the land; and planning zones. 'Use' of land is divided into several categories:

- residential purposes;
- commercial purposes;
- industrial purposes;
- public purposes;
- primary production;
- sporting or recreation facilities; and
- quarrying or mining.

In addition to general rates, councils are able to set service rates and charges for items such as waste management, stormwater removal and fire protection (although revenue generated

from fire protection charges is not retained by councils). Councils are also entitled to set construction rates and charges and separate rates and charges in certain circumstances.

Under section 129, councils may grant a remission of rates (by class of ratepayer).

Tasmanian council rating practices for 2009-10 are summarised in Table 2.3. Minimums are used relatively consistently, with all but three councils setting a minimum in 2009-10. However, the minimums for general rates ranged from \$105 to \$749. 14 councils had differential rates (i.e. variations to the general rate), with 10 of these councils having four or less differentials. All councils set waste management charges, with minimums and variations incorporated into these charges across most councils. Six councils also had a stormwater charge. A table that summarises the 2009-10 rating structures on a council-by-council basis can be found at Appendix A.

Table 2.3: Snapshot of 2009-10 Tasmanian council rates

Minimums	
Number of councils with minimum general rates	26
Average minimum general rate	\$266.05
Number of councils below the average minimum general rate	18
Number of councils above the average minimum general rate	8
Differentials (i.e. variations to the general rate)	
Number of councils with differential rates	14
Number of councils with 4 or less differential rates	10
Highest number of differential rates within one council	43
Service charges	
Number of councils with a stormwater charge	6
Number of councils with a waste management charge	29

Source: Department of Premier and Cabinet, Tasmania.

The *Local Government Act* does not explicitly provide for the use of maximum rates, flat rates or change caps (i.e. upper percentage limits for rates increases). Nevertheless, some councils have attempted to use available rating tools to implement quasi-maximums, quasi-flat rates and quasi-caps. Similarly, the legislation does not explicitly state that differential minimums can be used. These points are further discussed in Section 3.2.

2.3 Interstate comparisons

The methods employed by local government for generating rate revenue vary across Australia. Legislation in several states and territories provides councils with a choice of valuation bases, whereas other states and territories mandate the use of one particular valuation base. Most jurisdictions provide a flexible kit of rating tools to ensure that councils have sufficient capacity to raise revenue and adequate flexibility to generate an appropriate distribution of the rates burden.

Table B.1 at Appendix B provides a detailed description of the valuation methods and rating tools used by each state and territory in Australia. An overview of the valuation and rating practices used across jurisdictions is given below.

2.3.1 Valuation practices

Only three other jurisdictions besides Tasmania - Victoria, South Australia and the Northern Territory - provide councils with the choice of three different valuation bases for local government rating purposes, and most councils in these jurisdictions choose capital value as their rating base. Western Australia requires councils to use either land value or rental value depending on the location of the property. In the remaining jurisdictions – NSW, Queensland and the ACT – councils must use land value for local government rating.

Choice of valuation base – Victoria, SA and NT

In Victoria, almost all councils use capital value ('capital improved value') for local government rating (73 out of 79 councils). This contrasts sharply with Tasmania, where no councils choose to rate based on capital value. Only six Victorian councils use a form of rental value ('net annual value') as their rating base, whereas all councils in Tasmania use rental value (i.e. AAV). Interestingly, Victorian legislation implicitly encourages councils to use capital value rather than land value or rental value, as it only permits the use of differential rates under capital value (although limited differential rates can be used under land value and rental value - discussed below).

All properties in Victoria are revalued on a biennial basis, as opposed to the six-yearly Tasmanian revaluation cycle. Biennial valuations were introduced in 2000, and all properties across Victoria are revalued on the same date (1 January). The frequency of the valuation cycle both reflects and sustains the relatively large market for private valuation services in Victoria.

Despite these notable differences, Victoria and Tasmania also share some commonalities. Significantly, legislation in both jurisdictions requires all three values to be determined for each property, even though councils ultimately use only one valuation base for rating. In both states, the valuation work is contracted out to private valuers (although Victorian councils are currently responsible for managing the contracting out of valuation services, with quality assurance undertaken by the Valuer-General Victoria, whereas in Tasmania the OVG is the responsible managing entity). In addition, councils in both states must pay for the cost of valuation services.

In South Australia, most councils choose to rate based on capital value, rather than land value ('site value') or rental value ('annual value'). In comparison to both Tasmania and Victoria, valuations are undertaken on an annual basis. Councils also have the choice to use property valuations either supplied by the Valuer-General or made by a qualified valuer employed or engaged by the council. In practice, almost all councils use valuations supplied by the Valuer-General.

Although Northern Territory legislation permits councils to use either land value ('unimproved capital value'), capital value ('improved capital value') or rental value ('annual value') for local government rating, in practice only land value is used. However, this does not occur through the deliberate choice of councils – rather, local governments in the Territory are required to use property valuation data supplied by the Australian Valuation Office, which is currently only able to supply land value data.

In summary, where rental value is an option for councils, very few choose to rate using this valuation base – instead, most councils opt for capital value. In all three jurisdictions where it is an option, a ‘percentage rule’ is used in the determination of rental value, although the structure and application of the rule within each state is slightly different to Tasmania’s 4% minimum rule (canvassed in more detail in Section 3.3).

Land value and rental value – WA

Western Australian legislation requires councils to use land value (‘unimproved value’) as the rating base for properties in rural and fringe urban areas, and rental value (‘gross rental value’) for properties in urban areas. Valuations are conducted ‘in-house’ by Landgate (the Valuer-General in WA). The frequency of valuation depends on the valuation base – land values are determined annually whereas rental values are determined every three to five years.

Land value only – NSW, Queensland, ACT

Land value is the ‘compulsory’ valuation base used for local government rating in NSW, Queensland and the ACT (although the names in each jurisdiction vary from ‘site value’ to ‘unimproved value’, they are all a form of land value). All three jurisdictions also have the potential to have an annual valuation cycle, even though this may not occur in practice (i.e. land values for rating purposes are only issued every three or four years in NSW, but are still determined annually for land tax purposes). The use of land value in these jurisdictions demonstrates that this particular valuation base can be a viable option for local government rating.

2.3.2 Rating practices

Rating practices are generally similar across jurisdictions, with most states and territories providing councils with the option to use minimums and fixed charges. All jurisdictions permit the use of some form of differential rating. However, the particular structure of rating tools varies between jurisdictions, and some states and territories provide councils with a more comprehensive range of rating tools than others.

Minimums and fixed charges

All states and territories provide councils with the option to set a minimum, except for Victoria and the ACT. In South Australia, the minimum (which may be used as an alternative to a fixed charge) must not apply to more than 35% of all properties.

Most jurisdictions also allow councils to set a fixed charge as an alternative or in addition to a minimum, although the structure of the fixed charge varies across states and territories. For example, in Victoria the fixed charge is called a ‘municipal charge’, which is used by 34 (out of 79) councils. The total amount raised from the municipal charge cannot be more than 20% of the total raised from the combination of the municipal charge and general rates.

High fixed charges are permitted in South Australia, which enables councils to implement a fixed charge that generates up to 50% of aggregate general rate revenue. Similarly, in New South Wales, the fixed charge (called the ‘base amount’) must not produce more than 50% of the total revenue to be derived from the rate (or the category or sub-category of the rate). The base amount can also vary between categories or sub-categories. The New South Wales

Government notes that the 50% limit acts as an implicit guide for councils that rating is intended to be primarily and predominantly determined upon an *ad valorem* system, whereby the incidence of any rate burden is split differentially according to the value of rateable property (NSW DLG, 2007).

In the ACT, rates are based on a fixed charge component and a valuation-based charge component called a 'rating factor' (with the valuation charge subject to a rate-free threshold). Each year, the ACT Revenue Office sets fixed charges and rating factors for residential, commercial and rural properties. In 2010-11 for example, the fixed charge for residential properties was \$532, commercial was \$1,147 and rural was \$116.⁴

Differential and multi-tiered rates

All jurisdictions have some form of differential rates, with the rules varying between states and territories. For example, Victoria only permits the use of differential rates under capital value. However, limited differential rates may be used under land value or rental value i.e. they may only be applied in relation to farm land, urban farm land or residential use land.

Some states and territories have clear legislative rules about the use of differentials, which helps councils ensure they are complying with the rating legislation. Clarity also offers implicit guidance to councils on 'best practice' use of differentials. In Western Australia, for example, if a differential is 100% greater than any other rate in the dollar, a council must provide justification and obtain Ministerial approval. This provision has been used mainly by rural councils to obtain greater parity from mining tenements.

Victorian legislation also contains specific rules about the application of differential rating. It specifies that the highest differential rate must not be more than four times greater than the lowest differential rate, and requires councils to provide certain information about its differential rates. For example, councils must specify the objectives of the differential rate, and show that they are equitable and efficient. They must also publish information about the amount of rates payable for each category of differential rating and the proportion of the total rates and charges that this amount represents.

In South Australia, councils are able to implement two-tiered rating, whereby a different rate can be applied for that proportion of a property's value above a nominated threshold.

Change caps

Victoria, Queensland and South Australia permit the use of change caps, which are not explicitly included in Tasmanian legislation. In Victoria, the cap specifies the maximum rate increase that will be imposed on an individual ratepayer from year to year.

In Queensland, councils can limit the increase in rates by either no more than the previous year's rates amount or a stated percentage increase on the previous year's rates amount. There can also be different percentage caps for different classes of land or different types of rates. Under the regulations, councils have the discretion to determine the percentage cap.

⁴ http://www.revenue.act.gov.au/rates/rates_calculation

Averaging or phasing

Some jurisdictions allow councils to phase in or average property values over a period of time. This means that the impact on ratepayers is minimised following significant increases in property value following a revaluation.

In Western Australia, rental values for all land that has increased in value can be phased in over a three-year period (although only a very small percentage of councils use this rating tool). In Queensland, councils have the option to average property values over the previous two or three years, again to minimise any impact on ratepayers where property values have increased substantially. In the ACT, the property value used for the calculation of rates is the average of the previous three years' values.

Rate pegging

New South Wales is the only jurisdiction to use state imposed rate pegging. Each year, the Minister for Local Government sets a rate peg percentage which limits the amount by which each council's overall rate revenue can increase. For example, in 2010-11 the rate peg percentage was 2.6%.

Concessions and remissions

Most jurisdictions permit the use of concessions or remissions, although the application varies between states and territories. Generally, concessions may be granted in specific circumstances only. For example, in Victoria, rebates or concessions may be granted to assist proper development of the council area, and to preserve, restore or maintain buildings or places that are of historical or environmental interest. In addition, rebates or concessions may only be applied to no more than one-third of all properties in the council area.

In South Australia, councils have the ability to grant rebates to provide relief against what would otherwise amount to a substantial change in the rates payable by a ratepayer due to: a change in the valuation base used for rating; rapid changes in valuations; or changes to the rating structure.

3 Concerns with the current system

Over recent years, concerns about the performance of Tasmania's valuation and rating system have emerged, both from policymakers and from the public more broadly. This section explores two issues with the current system that were raised by councils during the Discussion Forums held by Access Economics: volatility and legislative uncertainty.

The major source of concern for councils and the broader community relates to property value volatility, and the impact of this volatility on the distribution of rates between classes of ratepayers following revaluations. These problems have surfaced as a result of trends in the Tasmanian property market and the interplay between these and the property valuation system. Legislative uncertainty, due to a perceived lack of clarity in relation to the tools and strategies available under the *Local Government Act*, is also an issue for councils.

This section also examines interstate experiences with rental value and 'percentage rules', to understand how other jurisdictions have managed concerns similar to those that have recently emerged in Tasmania.

3.1 Impact of Tasmania's property market

Over the past seven years, elements of Tasmania's property market – most notably in the residential sector – have experienced rapid growth in prices in many parts of the state. That is, land values, and by extension capital values, have grown strongly. At the same time, rents have grown considerably more slowly and consequently yields (rents as a proportion of prices) have fallen. In other words, the capital value of residential properties has increased significantly but the rental value of these properties has not matched this growth. Similar trends have been observed nation-wide with investors prepared to pay more for residential properties despite low yields, in anticipation of offsetting capital gains.

For example, average residential property prices (capital values) have increased 156% in Hobart since 2001, 159% in the Huon Valley since 2002, 134% in Kingborough since 2002 and 142% in Latrobe since 2002. However, AAVs have increased by 96%, 106%, 82% and 102% respectively over the same period.⁵ It is important to note that the variations between capital value and AAV changes quoted above (and below) would have been even more pronounced if not for the effect of the 4% minimum rule. That is, properties where the yield has fallen below 4% have had AAV artificially inflated up by the minimum.

There have also been significant disparities in the rate of growth across different land use categories. In general, the increases in the capital value and AAV for land with residential and primary production uses have exceeded those for properties with commercial and industrial uses. For example in Hobart, which is defined by commercial land use, capital values for commercial properties have increased by 105% and AAVs by 62% since 2001 (compared to the 156% increase in capital value and 96% increase in AAV for residential properties).

However, trends vary markedly across councils. In Devonport, for example, capital values for residential properties have increased by 44% since 2003, whereas commercial properties have

⁵ Data provided by the OVG.

experienced a 53% increase in capital value and industrial properties have increased by 47%. Nevertheless, the increase in rental values has still lagged the increase in capital values, with AAVs increasing by 41% for residential, 36% for commercial and 31% for industrial properties over the same period.

As the discussion below examines, the impact of these trends has been several fold:

- an increased reliance on the 4% minimum rule;
- limited ability of adjustment factors to smooth fluctuations between revaluations; and
- significant rate increases following revaluations.

3.1.1 Increased reliance on the 4% minimum rule

One of the most pervasive impacts of the property market trends described above has been a significant increase in the number of properties subject to the 4% minimum rule. Indeed, the majority of properties in Tasmania are now on the 4% minimum rule and are therefore in effect being rated on a capital valuation of their property rather than on an AAV basis.

Table 3.1 demonstrates the increasing number of affected properties, showing the proportion of residential properties that shifted to the 4% minimum rule after the 2008-09 revaluation cycle. For all but three of the nine councils that were subject to a revaluation, over 50% of residential properties are now on the 4% minimum rule, with notable increases in Kingborough (67 percentage points), Latrobe (49 percentage points) and Huon Valley (46 percentage points).

Table 3.1: Residential properties on 4% minimum rule after 2008-09 revaluation

Council	Before revaluation (%)	After revaluation (%)	Percentage point increase
Kingborough	9	76	67
Latrobe	20	69	49
Huon Valley	9	55	46
Hobart	8	46	38
Kentish	46	81	35
Devonport	54	81	27
Southern Midlands	11	24	13
Central Highlands	71	76	5
West Coast	8	10	2

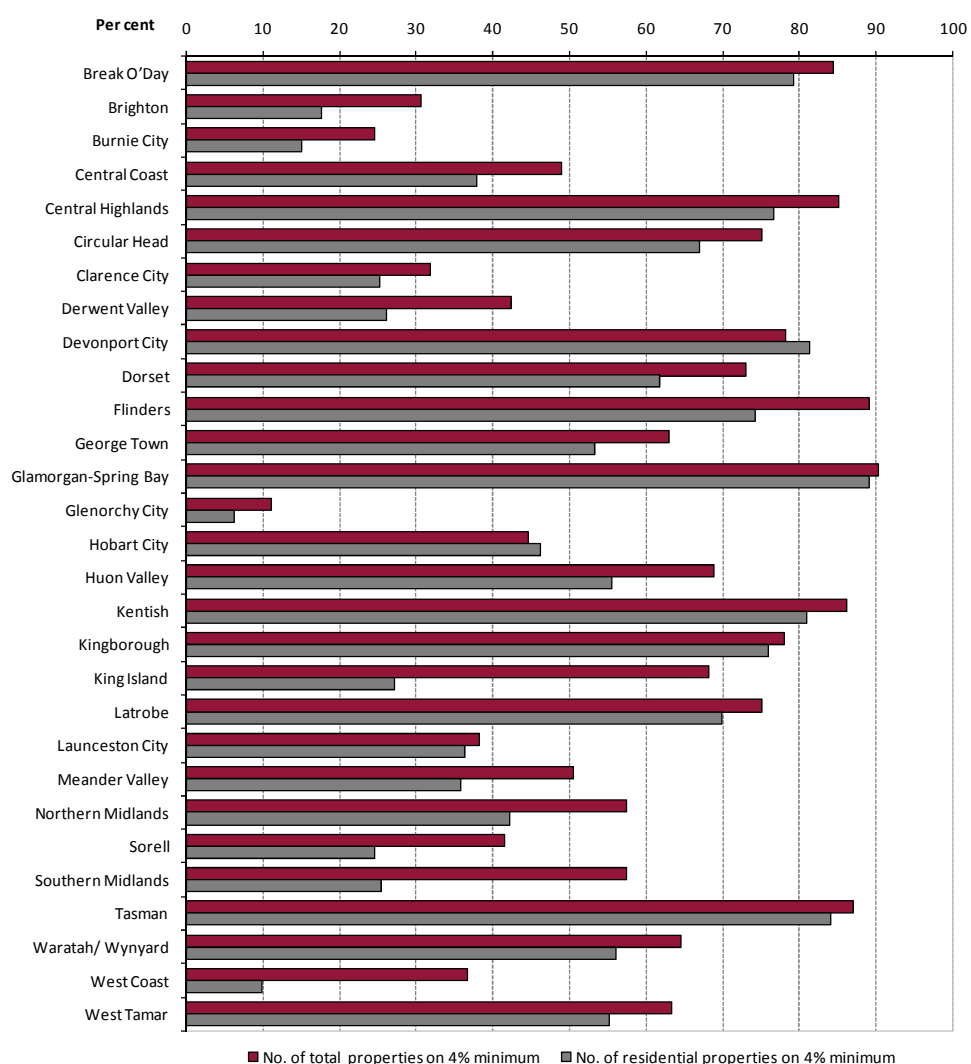
Source: OVG.

Chart 3.1 below further highlights the point that the majority of properties are now subject to the 4% minimum rule, showing the proportion of properties on the 4% minimum rule in each council as at 1 July 2010. For 19 (of the 29) councils, over 50% of properties are on the 4% minimum rule and for 11 councils, over 70% of all properties are on the 4% minimum rule. This chart also shows the number of properties on the 4% minimum rule where the primary land use is residential.

For 15 councils, over 50% of residential properties are on the 4% minimum rule and over 70% of residential properties are on the 4% minimum rule for eight councils. In most – though not

all – cases, it is apparent that the residential sector is driving the heavy application of the 4% minimum rule.

Chart 3.1: Proportion of properties on 4% minimum rule, total and residential



Note: As at 1 July 2010
Source: OVG.

The impact of an increasing number of properties on the 4% minimum rule has, other factors aside, been to shift the distribution of the rates burden away from historical relativities – significant numbers of ratepayers are now paying rates which bear little semblance to their genuine yields (AAV). Discussions with councils also highlighted that increased application of the 4% minimum rule has raised concerns throughout the community, with ratepayers confused and at times frustrated with the seemingly arbitrary impacts it generates.

3.1.2 Limited ability of adjustment factors to smooth fluctuations

The system of adjustment factors has been limited in its ability to smooth fluctuations between revaluations, primarily because adjustments in the intervening years have only taken account of average movements in AAV in each locality and not movements in capital value.

Rate increases in the years between revaluations are driven by average actual movements in AAV. However in the revaluation year, the movement in capital value since the previous revaluation determines the change in AAV and hence rates payable where properties are affected by the 4% minimum rule (provided there is no change to rating formula). That is, in the year of revaluation, affected ratepayers effectively pay an increase based on movements in capital value over the six-year period adjusted for the effect of any average movements in AAV that have already been applied.⁶ The (hypothetical) case study in Box 2 below illustrates this point.

Box 2: Case study - effect of the 4% minimum rule

Assume that a residential property is paying council rates based on the 4% minimum rule following a revaluation, and that over the next six years:

- AAVs typically increased by 2% p.a. but capital values of residential properties in that locality increased in value by 7% p.a.; and
- the council’s rate in the dollar remains unchanged each year (to simplify the analysis).

Over the five years following the first revaluation, the adjustment factor would be applied to result in increased rates for the property of 2% p.a. If the capital value of the property moved in line with the locality average, it would increase by 50% between revaluations. In the year of the second revaluation, the 4% minimum rule would result in an increase in rates payable on that property of 35.9% (compared to the 2% p.a. increase over the preceding five years). This is shown in the table below. Assume for simplicity a property has a capital value of \$100,000.

Year	Capital value	AAV	Basis
Year 0	\$100,000	\$4,000	Based on 4% minimum rule
Year 1		\$4,080	Based on 2% adjustment factor
Year 2		\$4,162	Based on 2% adjustment factor
Year 3		\$4,245	Based on 2% adjustment factor
Year 4		\$4,330	Based on 2% adjustment factor
Year 5		\$4,416	Based on 2% adjustment factor
Year 6	\$150,073	\$6,003	Based on capital value revaluation & 4% min. rule

N.B. Year 6 is the year of the second revaluation.

$$\text{Increase in AAV in Year 6} = \$6,003 / \$4,416 = 35.9\%$$

It does not necessarily follow that the council will generate 35.9% more rate revenue in the year of the revaluation. Instead, there will typically be a shift in the proportion of the overall rate burden paid by properties that have had a relatively significant increase in capital value since the last revaluation and who are ‘caught’ by the 4% minimum rule.

It therefore follows, that if some properties pay a much higher than average increase in rates, others must pay less than the average increase.

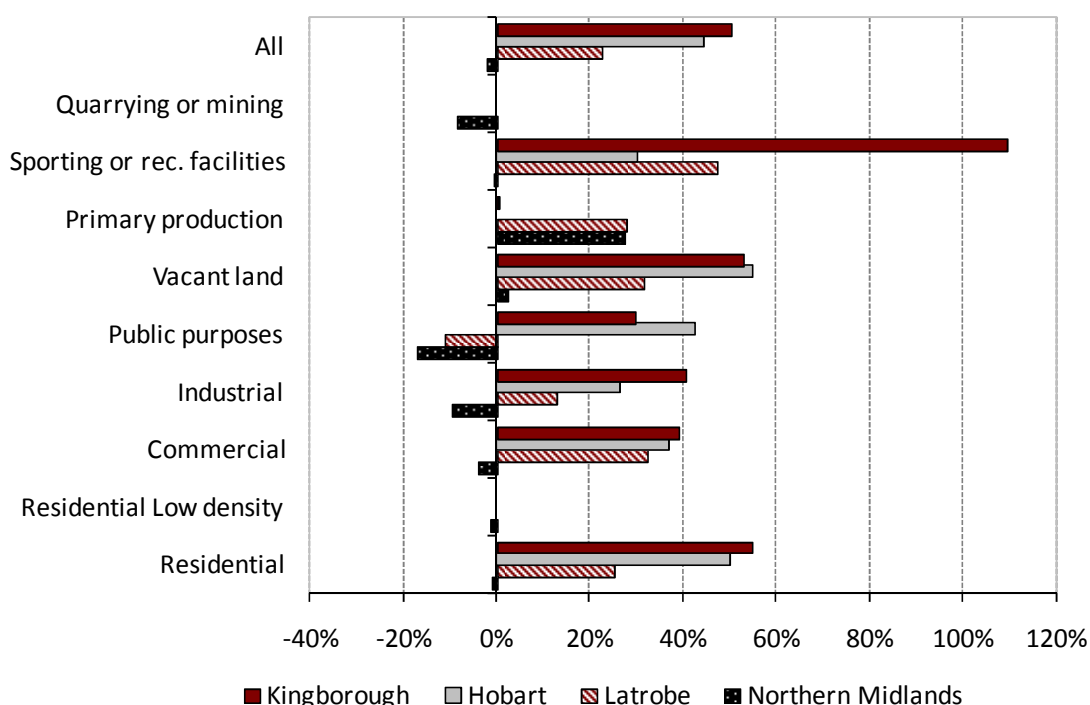
⁶ Note: the actual increase for any individual property will also depend on the actual movement in that property’s AAV & capital value relative to other properties in the council area and the quantum of revenue raised by a council.

3.1.3 Significant rate changes following revaluations

The relative infrequency of revaluations (i.e. every six years), coupled with the effects of increased reliance on the 4% minimum rule and the limitations of the adjustment factor process has meant that some groups of ratepayers have experienced substantial rate increases following the revaluation of their property. In many councils, residential ratepayers have been particularly affected due to the buoyancy of the residential property market over recent years.

Chart 3.2, below, shows the percentage change in the average AAV in each land use category for the four case study councils analysed in this report. Evidently, trends varied markedly between the councils, with all land use categories except primary production and vacant land falling in Northern Midlands, all land use categories except public purposes increasing in Latrobe, and all land use categories increasing in Kingborough and Hobart.

Chart 3.2: Change in AAV by land use category following revaluation, case study councils



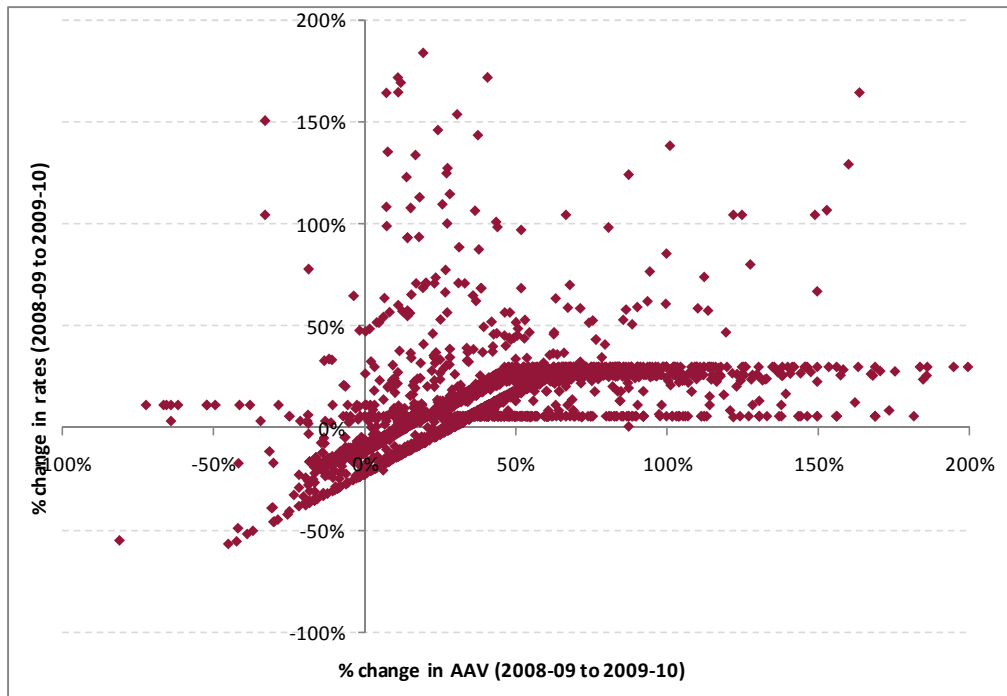
Note: Chart shows 2006-07 and 2007-08 data for Northern Midlands; 2008-09 and 2009-10 data for other councils. 'Quarrying or mining' not shown for Latrobe – growth exceeded 200%. Only Northern Midlands has a 'residential low density' land use category.

The extent to which movements in AAV have translated into movements in rates payable has been heavily influenced by councils' rating strategy. For example, while the average AAV among residential properties in Northern Midlands fell 1.1% following their most recent revaluation, the average rates payable increased by around 8%. Similarly, the average AAV among commercial properties in Latrobe increased by 32%, but average rates payable increased by a relatively more modest 9%.

Chart 3.3 further highlights the volatility in, and relationship between, changes in AAV and changes in rates payable, showing the outcome for each individual property in Latrobe following the 2009-10 revaluation. As can be observed, both changes in AAV and changes in

rates payable have varied considerably across ratepayers, with annual change ranging from -50% to +200% (although some of the cases of extreme change are likely to be data anomalies).

Chart 3.3: Percentage change in AAV and rates payable following revaluation, Latrobe



Note: Although the data includes remissions, some impacts may be overstated as certain properties were ineligible for remissions and other properties that experienced extreme change were affected by factors such as supplementary valuations.

3.2 Legislative uncertainty

The second area of concern with the current system that was raised by councils in the Discussion Forums is legislative uncertainty and a perceived lack of clarity regarding rating provisions within the *Local Government Act*. For example, different councils have received different legal advice about particular rating strategies and whether they are permissible under the *Local Government Act*.

Concerns are largely concentrated around the legislative provision for the use of flat rates, maximum rates, change caps, differential rates and differential minimums in Tasmania.

3.2.1 Flat rates

The legislation does not explicitly provide for the use of flat rates. However, some councils have introduced a quasi-flat rate by setting their general rate to include a very high minimum and a very low *ad valorem* rate.

Brighton Council is one local government that has implemented a ‘flat rate’. In 2010-11, for example, Brighton has a general rate of 2.36670 cents in the dollar and a minimum of \$760. It also sets a range of differential rates to account for different land uses and localities (e.g. land used for commercial purposes has an *ad valorem* rate of 7.446064 cents in the dollar). Most residential properties are subject to the general rate but because of the high minimum relative

to the general rate the minimum also operates as a quasi-maximum (i.e. the 'flat rate'), as very few properties will pay more than the minimum amount.

3.2.2 Maximum rates and change caps

The legislation is also silent on the use of maximum rates or change caps. Nevertheless, remissions are used by some councils as quasi-maximum rates or caps on the amount of rates payable per ratepayer (or certain ratepayers). The *Local Government Act* simply states that remissions may be granted for rates payable by a 'class of ratepayers' (section 129). Some councils use this to 'cap' rates, or set a quasi-maximum rate, by offering remissions to those ratepayers who experience rate increases.

However, there is some uncertainty over the term 'class of ratepayers', and whether all ratepayers who experience a certain rate increase could be classified as a 'class' (as opposed to pensioners, for example, who would presumably fall within the definition).

3.2.3 Differential rates

There is a degree of ambiguity surrounding differential rates. There are no statutory definitions of the factors by which the general rate may be varied under section 107, and some councils are concerned that this does not provide sufficient legal certainty. For example, 'use' of land is defined in section 107(2) as being for a number of purposes - such as residential, commercial or public purposes (amongst others). However, these purposes are not defined within the legislation.

There is also uncertainty surrounding the use of differential minimums. Although section 107 permits councils to vary the general rate, the *Local Government Act* does not explicitly state that differential minimums can be used.

3.3 Interstate experiences

An understanding of the use of rental value and 'percentage rules' in other states and territories provides some lessons that may be useful in the Tasmanian context, particularly in terms of how concerns similar to those that have emerged in Tasmania have been managed by other jurisdictions.

As previously noted, there are three other jurisdictions (besides Tasmania) where councils are permitted to use rental value as a basis for local government rating – Victoria, South Australia and Western Australia (acknowledging that rental value is not used in practice in the Northern Territory). In these states, councils that use rental value also tend to be in inner-city (or at least urban) areas, which have a higher proportion of commercial properties compared to rural or regional areas.

All three jurisdictions employ a 'percentage rule' in the determination of rental value. However, the structure and application of the rule within each state is slightly different to Tasmania's 4% minimum rule.

Victoria

Only six councils in Victoria currently use net annual value (NAV) - Glen Eira, Maribyrnong, Melbourne, Port Phillip, Yarra and Whittlesea. These are all Melbourne inner-city councils, with the exception of Whittlesea (which is still a metropolitan council).

Victoria has a 5% minimum rule, as specified in the *Valuation of Land Act 1960*, whereby NAV must be at least 5% of capital value ('capital improved value'). However, NAV is exactly 5% of capital value for properties used exclusively for residential purposes and farm land. This means that NAV does not have to be estimated for these types of properties – rather, the valuation is simply 5% of capital value.

Western Australia

In WA, gross rental value (GRV) is used for urban areas. In total, approximately 80% of all properties in WA are rated on the basis of GRV.

WA also has a percentage rule, outlined in the *Valuation of Land Act 1978*, which applies only where an annual rental cannot be easily determined. In these cases, the GRV becomes an 'assessed value', which is defined as a percentage applying to the capital value of land within a particular class. For example, the assessed value for vacant residential land is 5% of capital value.

In 2009, the *Valuation of Land Act* was amended to allow multiple percentages to be applied to different classes of land. The Valuer-General's intention is to prescribe that assessed value for vacant residential land is reduced from 5% of capital value to 3% of capital value. This proposal would take effect in mid-2011. The proposed lowering of the percentage rule was motivated by the significant increase in inner-city vacant land values, especially during the boom conditions of the mid-2000s, and subsequent complaints from affected ratepayers.

Importantly, the percentage rule does not apply to residential properties. These properties must be valued on the basis of rental value. This 'exception' rule for residential properties was introduced in 1987 for equity reasons – there was concern that long-standing residents in certain locations were being levied rates based on 5% of a relatively high capital value (based on high land values), even though the houses were quite modest and had correspondingly low rental values. In effect, therefore, residential land-owners always pay rates based on rental value, regardless of the capital value of the land.

The percentage rule is not a 'minimum' rule, thereby avoiding the movement of properties from one type of valuation base to another due to changes in property value. However, under WA's system, this type of movement may still occur where fringe urban land is reclassified as urban. For example, the development of large tracts of land in outer metropolitan areas leads to about 20,000 properties each year moving from land value ('unimproved value') to GRV for rating purposes. Hobby farms are particularly affected by this change in rating base.

In general, however, there is no significant community concern about the performance of the valuation and rating system and any market fluctuations have reportedly been successfully managed by councils.

South Australia

Adelaide City Council is the only council in SA that chooses to rate based on annual value, which is defined in the *Valuation of Land Act 1971* as three-quarters of the gross annual rental of the land.

Similar to WA, a percentage rule only applies where it is not reasonably practicable to determine a gross annual rental. In these circumstances, the annual value for rating purposes is 5% of capital value. Also similar to WA, it is not a 'minimum' rule – in other words, a property will not move from one valuation base to another depending on fluctuations in rental and capital values. In practice, many properties have an assessed annual value of more or less than 5% of capital value.

In addition, the majority of properties in Adelaide City Council's area have a non-residential use and a majority of these are rented out to occupants. Most residential properties are also leased out. Therefore, there is administrative efficiency in the collection of annual value, as yields are readily available, and the concept of annual value as a basis of rating is well understood and accepted by property-owners and ratepayers

4 Principles of a best practice system

The preceding sections of this report have overviewed the current model of rating and valuation in Tasmania, drawn comparison with other jurisdictions and highlighted concerns that have arisen and limitations that have emerged over recent years.

While these issues are ultimately what has motivated this review, they are of course not the sole consideration in assessing its appropriateness for the future. While part of the challenge of creating a robust system for the future lies in addressing current shortcomings, a review of this nature must also evaluate the extent to which the system is consistent with best practice more generally.

In undertaking such an evaluation, a robust assessment framework is required – a set of criteria against which the rating system can be systematically assessed. In light of this, the discussion below briefly outlines the primary functions of local government and their associated implications for revenue raising, before canvassing a range of considerations pertinent to the design of a best-practice rating and valuation system. The principles of an optimal framework are overviewed initially in general terms and subsequently in the context of the current rating system used throughout Tasmania.

4.1 Revenue-raising by local government

The characteristics of the goods and services provided by government have important implications for how revenue should optimally be raised to finance their provision. Broadly, economists draw distinction between two classes of goods (and services): public goods, which are primarily the domain of governments, and private goods, which are generally provided within a ‘free’ market framework (Box 3). Of course many goods and services in the economy fall between these two extremes – they have both public and private good characteristics – and the decision regarding how best they are financed (and delivered) becomes a more challenging one.

Box 3: Public versus private goods

Public goods are those goods where (i) the use of or enjoyment by one person does not diminish their availability to, or enjoyment by, others (that is, they are non-rival); and (ii) it is not practical to exclude access to them (that is, they are non-excludable). These characteristics mean that if left to unregulated private markets, these goods would be provided and consumed at socially suboptimal levels. Hence, their provision generally falls to government and their financing to general tax revenue, with consumers facing no direct charges for their consumption.

Private goods are those goods which are both rival in consumption (that is, one person’s use diminishes the good’s availability to, or enjoyment by others) and excludable. Most goods and services in the economy can be characterised as private goods and their characteristics meant that they are produced and consumed at relatively appropriate levels in unregulated markets. Consumers and producers make market decisions based on the prevailing price signals and the market outcome (absent other distortions) is an efficient one.

The prime historical role of local government was as a road-making authority. Roads have public good characteristics (but are not pure public goods) and road-making authorities were, for example, established in the UK with the power to levy adjoining property-owners to pay for their construction and maintenance. This was considered fair because access to a road network invariably increased a property's value.

Today, the mix of goods and services provided by local government is somewhat nuanced. 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. In many cases the costs of providing goods with private characteristics are funded not through general revenue, but through user-pays charges. For example, all councils in Tasmania levy a charge for waste removal.

The goods and services financed through general rates revenue include local roads, parks and gardens and community facilities such as libraries. These goods and services more closely align with the definition of public goods in that, firstly, their use by one person does not limit their availability to others (although at high levels of usage, congestion may be an issue); and, secondly, it is generally not practical to exclude individuals either from their use, or from access to their indirect benefits. In these cases, directly charging users would be neither practical nor efficient.

Hence, local government rates are a form of taxation. That is, their purpose is to raise revenue for general government purposes, not to recover the cost of a particular service or activity (though some council services are funded through user-pays charges). This distinction has important implications for the architecture of an optimal, or best-practice, system. For example, where charges are employed to recover the costs of providing specific services, identification of individual users and calibration with marginal costs are key issues. In the case of general revenue-raising, other issues are generally more important – efficiency is assessed differently and capacity to pay considerations are more significant.

Furthermore, as Section 4.2.1 describes in greater detail, immobile property (i.e. land) is among the most efficient tax bases in the economy. However the appropriateness of property as a tax base for local government is amplified by the fact that the goods and services councils provide are in many cases directly reflected in property prices. High quality roads, stormwater drainage systems, well maintained parks and gardens and proximate community facilities are all factors which will be capitalised into a property's market value. That is, a property in an area characterised by these features would be higher in value (by a fixed dollar amount), than an equivalent property in an area without them.

4.2 Principles of optimal taxation

In considering the architecture of a best-practice system of taxation, economists generally draw on a number of design criteria. The recently released Henry Review⁷ highlighted five key criteria it deemed most significant in evaluating taxes and tax systems: efficiency, equity, simplicity, sustainability and policy consistency.

Consistent with this, Access Economics deems the following principles to be most significant in the architecture of local government rating and valuation systems:

⁷ *Australia's future tax system: report to the Treasurer*, December 2009.

- **Efficiency:** does the rating methodology significantly distort property ownership and development decisions in a way that results in significant efficiency costs?
- **Simplicity:**
 - Is the system practical and cost-effective to administer and enforce?
 - Is the system simple to understand and comply with?
- **Equity:** does the tax burden fall appropriately across different classes of ratepayers?
 - **Capacity to pay:** are those community groups with greater economic capacity in fact contributing more?
 - **Benefit principle:** where the distribution of benefits is not uniform, should those who benefit more contribute more?
- **Sustainability:** does the system generate sustainable, reliable revenues for councils and is it durable and flexible in changing conditions (i.e. can it adequately withstand volatility)?
- **Cross-border competitiveness:** to what extent does the rating system undermine the competitiveness of the council/state as a place to live and/or own a property or operate a business?
- **Competitive neutrality:** are businesses conducting similar activities treated in similar ways?

Of course, simultaneously optimising each of these criteria is not feasible; there are tradeoffs among them. The most efficient system may place an excessive burden on segments of the community where, from an equity point of view, this is not desirable. Alternatively, it may be overly costly for councils to administer, or for ratepayers to understand and comply with.

Hence, the design challenge is one of balancing often competing considerations in an economically appropriate fashion. That is, the preferred design of the rating and valuation system, and the extent to which it satisfies the criteria below, ultimately hinges on the weight that policymakers assign to different criteria.

Areas of greatest significance

In general, it is the first four of these criteria that attract greatest attention in the context of local government rating. While cross-border competitiveness is an important consideration for all aspects of the taxation system, local government rates are generally modest in comparison with the aggregate costs of obtaining and holding property. Consequently, their direct impact on the allocation of capital across regions is likely to be marginal. For example, the decision of an investor to build or purchase a commercial property in one locality or another will be influenced by their expectations of risks, costs and revenue generating potential in both localities. Any difference in council rates payable is likely to be a relatively minor influence in the ultimate decision.

Furthermore, as Section 3 outlines, the discussion forums revealed the major source of concern among Tasmanian councils and ratepayers to be sustainability – or more precisely stability. Councils are primarily concerned with the system’s performance throughout the recent property market buoyancy, and the instability that volatility in property valuations has generated for rating administration and outcomes.

However, while volatility and its implications for the distribution of rates may be the greatest single motivation for this review, the purpose here is not merely to design a system capable of withstanding volatile property market conditions. Future trends in the property market are uncertain and whether – or even if – the conditions of the last decade are repeated is unknown. Hence, the challenge for this review is to ensure that councils are equipped with a system that is consistent with best practice and allows them to effectively navigate whatever future challenges emerge, given the varied circumstances they face.

Most significant in this context are the principles of economic efficiency, simplicity, equity and sustainability – each of which is discussed in greater detail below.

4.2.1 Economic efficiency

A tax is deemed perfectly efficient if it does not distort production and consumption decision-making. In reality, all general revenue-raising taxes distort such behaviour to some degree, however a key consideration in taxation design should nonetheless be the minimisation of these distortions.

The extent to which behaviour changes in response to the introduction (or variation) of a tax is determined by the price-elasticity of supply and demand in the relevant market. In markets where either demand or supply is invariant with price (perfectly inelastic), the introduction of a tax will have no impact on market outcomes hence impose no efficiency cost to the economy. Conversely, where demand/supply is highly responsive to price (highly elastic), the introduction of a tax will induce relatively large changes in behaviour and therefore result in relatively large efficiency costs. Hence, the more inelastic is the tax base, the more economically efficient is the tax. Indeed, in outlining this contention, a 2008 report into the efficiency of state and local government taxes by Access Economics found that:

This is especially true for land based taxes (including municipal rates) which, in effect, fall on the rental price of immovable land. Empirical studies of markets for land find very low elasticities of demand and, especially, supply. Consequently, these are attractive markets from the perspective of efficient taxation arrangements since quantities are not very responsive to changes in price (or taxes) and thus the taxes involve relatively small distortions.⁸

Indeed, the report finds municipal rates on residential dwellings to be the most efficient form of taxation rendered by state or local government. At a more micro level, some local government taxation bases are more economically efficient than others (as discussed in the following section).

4.2.2 Simplicity

In this context, there are two broad concepts of simplicity:

■ Administrative simplicity

The simplicity with which the tax system is administered and the cost-effectiveness of revenue collection are also important design criteria. Key considerations in this regard include ease of

⁸ Analysis of state tax reform, *Report for the Financial Industry Council of Australia*.

identification of tax payers, ease of collection of tax revenue and time and effort involved in ensuring compliance and enforcement.

Local government rates are in general hard to avoid as real property is immobile, property owners are readily identifiable and councils have legislative powers to force property sales to recover outstanding rates. Consequently, they are relatively easily enforced compared with other forms of taxation. However, as discussed in the following section, the cost-effectiveness of local government taxation can vary based on system design and valuation and rating practices and processes.

■ **Simplicity of compliance**

Tax design must also have regard for its impacts on tax payers. A best practice tax should be easily understood and simple to comply with, ensuring that the burden placed on taxpayers is minimised. In their simplest form, local government rates generally satisfy these criteria well, especially compared with the onerous compliance requirements associated with many state and federal taxes. However, this can vary significantly depending on the rating base employed and the characteristics of the rating system (e.g. the number of differentials). The overt nature of local government taxation (compared with, for example, the GST or personal income tax), means that community concern can readily manifest in way that creates additional costs for administrators.

4.2.3 Equity

There are two aspects that need to be considered in assessing the equity of a tax: (i) who benefits and to what extent (the so-called ‘benefit principle’); and (ii) ratepayers’ capacity to pay.

Benefit principle

If services are reasonably equally accessible to, and valued by, recipients, then stand-alone application of the benefit principle would favour recovering costs by way of an equal charge on all taxpayers. Conversely, if services benefit some ratepayers more than others then consideration should be given to raising taxation revenue accordingly. That is, to differentiating among ratepayers based on the extent to which they benefit. In the context of local government rating, the extent to which this needs to be undertaken explicitly is reduced by the fact that – as outlined above – the benefits of council services are often reflected in property values.

Capacity to pay

The concept of vertical equity recognises that some people and entities have greater economic capacity than others to pay taxes (i.e. they have higher incomes and/or are wealthier) and it is generally deemed appropriate that these groups make a greater contribution toward general tax revenue. This principle is most clearly observable in the personal income tax system, where a progressive taxation scale is applied (i.e. the tax rate increases with income). While vertical equity considerations (and redistributive objectives) fall most appropriately within the realm of central governments, they are nonetheless important considerations for policy makers at all levels, including local government.

4.2.4 Sustainability

Tax system design must also consider the extent to which a sustainable, reliable stream of revenue is provided. Taken in aggregate, the tax system must have the capacity to adequately fund governments' activities and to reliably generate varying levels of revenue as circumstances change. In this sense, the tax base must be a sufficiently robust one, and one which – irrespective of the prevailing economic conditions – can provide councils with a stable, durable basis for raising revenue.

4.3 Application to local government rating

The discussion above highlights, in general terms, the design considerations pertinent to best practice local government rating. In this section, these criteria are analysed specifically in the context of the tax (property valuation) bases that councils have at their disposal and in light of the variety of rating tools councils can utilise in raising revenue.

4.3.1 Valuation base

The three valuation bases generally used throughout Australia and available in Tasmania (under the *Valuation of Land Act*) are land value, capital value and AAV. These bases vary most notably in the extent to which they satisfy the criteria of equity and efficiency, but also in relation to their simplicity, sustainability and cost and simplicity of administration.

Economic efficiency

Land value is a relatively more efficient taxation base than capital value or AAV. Land taxes are generally borne by the supply-side of the property market, which tends in most cases to be relatively inelastic due to the largely fixed supply of developable land (at least in the short term). Consequently, the impact of land-based taxes on economic behaviour tends to be relatively low and hence their efficiency relatively high.

Conversely, capital value (by introducing capital to the tax base) is a relatively less efficient basis for rating, as capital flows are considerably more responsive to changes in price. Consequently, taxes on capital value tend to have a relatively larger impact on economic behaviour compared with taxes on unimproved land.

The efficiency of AAV as a valuation base is dependent on the level of improvements to land. Where land is unimproved, its efficiency will mirror that of land value; where it is improved, it is on par with capital value.

While economic efficiency should be a key consideration in rating system design, local government taxes are typically modest compared with other costs associated with acquiring and holding property. Hence, the impact on economic behaviour from rating using capital value or AAV compared with land value is likely to be relatively marginal in most instances.

Practicality and administrative simplicity

Land value is also likely to be more cost-effective from an administrative viewpoint. Information on land value is generally less onerous to obtain than capital value or AAV as land value is influenced by fewer factors (e.g. there are no buildings or infrastructure to consider).

In addition, land value is collected for other purposes – principally land tax – whereas in most cases the other purposes for which AAV or capital value data used are less significant (for example, the administration of the fire services levy, which currently uses AAV, could be undertaken on an alternative base if AAV was not collected). This point is particularly pertinent given the constraints currently faced in Tasmania – including most notably the shortage of qualified valuers – and in light of Recommendation 121 of the recently released Henry Review, which advocates the alignment of state and local government rating bases.

Capital value tends to be simpler for ratepayers to understand compared with AAV, especially where a minimum rule is in place (see discussion below). Most homeowners, for example, are more likely to be aware of the value of their house than its potential rental yield. In the case of land value, additional issues arise due to the fact that, in the case of developed property, land value is a more abstract concept; one which can be difficult for ratepayers to relate to and hard from them to independently verify. For councils and other rating administrators, this also impacts on the costs of compliance and enforcement as greater ratepayer concern translates into increased queries and contests.

Capacity to pay

Compared with land value, use of capital value or AAV allows local governments to better address capacity to pay considerations. In general, people who live in properties with a higher market value have higher incomes (at least over their lifetimes). Use of capital value therefore means (all other things equal) that owners of higher valued properties pay proportionately more in rates than owners of lower valued properties. Of course, cases of ‘asset poor, income rich’ can still face potential cash flow issues.

Similarly, higher AAV typically reflects a higher level of income (all other things equal) and is – at least over the long run – generally reflective of higher property value (whether land value or capital value). The linkages between AAV and income also mean it may be preferable from a cash flow perspective (rents are a form of cash income), however in many cases AAV is imputed and hence no cash flow is generated. The correlation between land value and wealth, though in many cases significant, is nonetheless weaker.

Benefit principle

Rating using land value more directly addresses the benefit principle criteria than capital value. Land values better reflect any enhancement to property values arising from local government property services than capital value. For example, landscaping and beautification of adjoining open spaces, or provision of drainage or road infrastructure by a council, will have a similar positive impact on the market value of a vacant allotment and an adjoining developed property. The capital value of a property will be affected by all the same variables that affect land value *plus* the effect of any change in the level and cost of built improvements thereon.

The degree to which AAV satisfies the benefit principle again rests on the extent to which the AAV of a given property reflects its underlying value as an asset. Where it does, AAV will be consistent with land value or capital value, depending on whether the land has improvements. Where it does not, the outcome is uncertain.

Sustainability

Managed appropriately, all of the available property valuation bases have the capacity to provide councils with a sustainable long term revenue stream in most cases. However, the valuation bases vary in their inherent stability. AAV is generally a more stable revenue base than capital value and especially land value, where the vast majority of movements in capital value movements are generated.

Rents tend to be slower to adjust than property prices, due partly to the common use of fixed-term contracts, which lock in rates for a given duration. Rents are also not subject to the influences of investor behaviour, which, depending economic and financial market conditions, can be a major source of fluctuation in property markets. However, stability is also influenced heavily by the valuation process which – as the Tasmanian experience demonstrates – can be a major source of volatility itself (irrespective of the valuation base employed).

Summary of valuation bases

Summarising the discussion in the preceding sections, Table 4.1 provides an indicative quantitative assessment of each valuation base against key criteria. In undertaking this assessment, factors specific to the Tasmanian context have, to the extent relevant, been taken into account. For example the added complexity generated by the 4% minimum rule has been reflected in the ranking assigned to AAV.

Naturally, in the absence of detailed analysis, an assessment of this nature is largely illustrative, and hence the strength of conclusions drawn from it limited. Nevertheless, it provides a useful reference point for comparing the alternative bases available in the administration of local government rating.

Table 4.1: Summary of valuation bases

	Economic efficiency	Benefit principle	Capacity to pay	Administrative simplicity	Compliance simplicity	Sustainability
Land value	5/5	4/5	2/5	4/5	3/5	3/5
Capital value	3/5	2/5	4/5	3/5	4/5	4/5
AAV	4/5	2/5	4/5	2/5	1/5	4/5

Box 4: A hybrid base

A further option for consideration is the possibility of a hybrid valuation base, whereby different land uses are rated against different valuation bases. For example, residential and rural uses could be rated against land value, commercial and industrial against capital value.

At a practical level, a hybrid base would allow valuation contracts to be awarded on a land use basis, potentially enabling more firms to tender for contract work (e.g. a commercial, industrial and specialist properties contractor could tender for this segment of the market).

Ultimately, however, a policy decision would be required in order to determine which bases were most appropriate for which land use classes. The key consideration would be capacity to pay – the scope to assess relative capacity to pay would be greater within property classes rated against capital value.

Applying a hybrid base would also require policymakers to consciously determine (and be able to justify) how much revenue they wish to raise from a particular class of property (since there is not a strong correlation between land value and capital value). It may be problematic for a local government to argue that capacity to pay considerations are sufficiently important to warrant use of capital value for determining relative rates payable by properties *within* some land use classes but not for determining the relative proportion of rates payable across different classes of land use.

The experiences of Western Australia in employing an approach of this nature have been characterised by increased complexity and heightened levels of concern among ratepayers. That said, in the Western Australian case, the shortcomings which have emerged have largely been due to the fact that rural and urban land have been treated differently and that the lines between the two have been blurred.

Nevertheless, running a hybrid base is likely to generate increasing levels of uncertainty among ratepayers (particularly when land use changes) and create challenges in the management of land use changes. In addition, while some reduction in valuation work load is likely to be experienced, a level of duplication would exist if separate contractors undertook the valuations within a given municipality. Any gains from only deriving a single valuation for each property would be at least partially undermined by this duplication of effort.

4.3.2 Rating tools

The other mechanism that local governments have at their disposal to influence how the rating system is administered and how the tax burden is distributed across the community is rating tools. Rating tools refer to the structure of the general rate (*ad valorem* with and without fixed and service charges); structure and range of service rates and charges; variations across classes of ratepayers (differentials); and limitations on its value (minimums, maximums or caps).

Differential rates

Differential rates allow different classes of ratepayer (e.g. properties in different localities and/or different forms of land use) to be taxed differently. The application of differential rating does not affect the amount of overall revenue raised, but can mean that properties with the same value but with different uses or in different localities pay different levels of rates.

Differentials therefore provide a tool for addressing both capacity to pay and benefit principle considerations. Commercial uses, for example, may be charged a proportionally higher rate either on the grounds that their economic capacity is higher, or that the benefits they derive from council services are greater. However, careful consideration needs to be taken in applying differentials. As noted above, it is probable, for example, that additional or more ready access to council benefits enjoyed by some properties relative to those elsewhere are already capitalised into property values and hence all other things being equal these properties will pay higher general rates. Capacity to pay considerations are likely therefore to be of more criticality in determining the merit of applying differential rates.

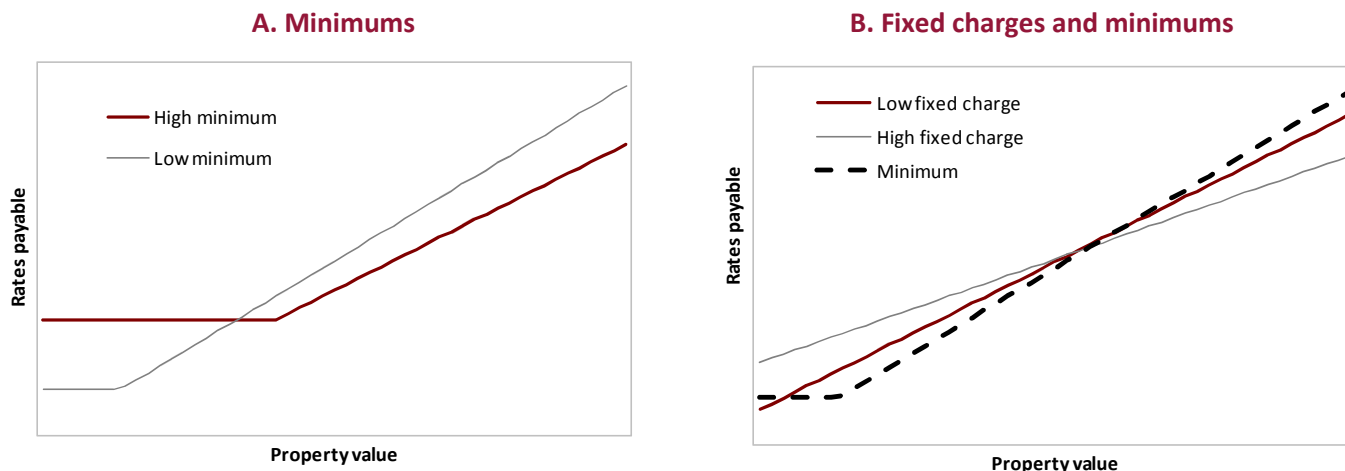
Fixed charges and minimums

The rationale for a rates minimum (i.e. in total dollar terms) or fixed charge stems from the fact that, for many aspects of council services, the benefits are distributed relatively evenly across properties and therefore ratepayers. From an optimal taxation design perspective, a fixed charge is generally preferable to a minimum rate for addressing these considerations. Some services are people-related, or benefit all property owners equally, rather than property values proportionately and a fixed charge can best accommodate this. Application of minimums often results in some (or many) owners of low value properties paying a disproportionate share of the cost of service provision. Chart 4.1 illustrates this point showing, for a given value of total revenue, the impact of an increasing minimum (Panel A) and a minimum compared with a fixed charge (Panel B).

In other jurisdictions many local governments choose to rate using capital values because it better accommodates capacity to pay considerations. While capacity to pay is more closely correlated with capital value than with land value, this correlation is far from perfect. A fixed charge has the effect of reducing the increase/decrease in rates paid by a property with higher/lower value. For example it will result in a property with double the value of another paying something less than double the amount of rates (how much less will depend on the value of the fixed charge). A fixed charge can therefore be used to reduce the influence the value of a property has in determining the amount of rates payable.

However, over-reliance on a fixed charge – or other rating mechanisms with a similar intent – can compromise capacity to pay considerations, especially where capacity to pay (i.e. income or wealth) varies markedly across a council. In the extreme, capacity to pay is entirely undermined by a flat charge. Hence, while a significant fixed charge can also aide in generating stability, the circumstances under which this can be achieved in a non-regressive manner are limited.

Chart 4.1: Effect of different rating tools



Note: Total rate revenue is constant under all scenarios

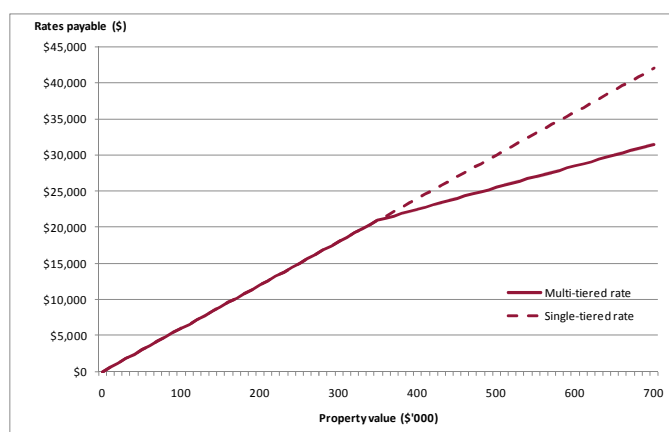
Rates maximum

A rates maximum (i.e. in total dollar terms) provides a mechanism for ensuring no single ratepayer pays a disproportionate share of the total tax burden. In general, effective utilisation of other design mechanisms should eliminate the need for a rates maximum. Multi-tiered rates can be utilised (see discussion below) and outliers or extreme cases can be addressed through remissions, where necessary.

Multi-tiered rates

Another tool for addressing capacity to pay considerations is a multi-tiered rate. In this case, all properties or those within a given class or land use classification are subject to a different rate for that portion of their value above certain thresholds. Utilisation of a multi-tiered rate allows councils to distinguish based on property value, either to decrease progressivity (e.g. as an alternative to a rates maximum), or to increase it (i.e. to help address capacity to pay considerations). The reliance of several councils on remissions and concessions over recent years suggests that it is in this former capacity that it would be most useful.

Chart 4.2 below presents a stylised representation of the impacts of a multi-tiered rate. Under the hypothetical scenario depicted, properties with a value in excess of \$350,000 face a marginal *ad valorem* rate which is half that payable on the first \$350,000. Hence, for example, a multi-tiered rate with these parameters would reduce the rates payable on a property valued at \$700,000 from \$42,000 (broken red line) to \$32,000 (solid red line).

Chart 4.2: Multi-tiered rate; stylised example

Change caps

Rates caps provide a tool for mitigating the impact of volatility. By setting an upper percentage limit for rates increases (e.g. 10% for any individual property when the average increase for all properties is 5%), councils can ensure that no ratepayer experiences an undesirably large change in rates between years or rating cycles. Like over-reliance on a maximum, over-reliance on caps as a long term mechanism for managing rate increases is suboptimal, and a symptom of deficiencies elsewhere in the system. That said, change caps provide an important tool for smoothing the adverse impacts associated with rating reform.

4.4 Implications for this review

At present, the greatest concerns with the current model of local government rating and valuation in Tasmania appear related to the stability of the system. The system's volatility in the face of rapidly changing property market conditions and the implications of this volatility for the distribution of rates across (and in some cases within) property classes has been a major source of concern.

The key question for this review is whether this reflects a system which is fundamentally unsustainable or one which, through some modest modifications and increased utilisation of the tools at hand, could provide Tasmanian councils with the framework to deliver a best-practice model in the variety of circumstances councils face.

However, as noted above, it is also important in a review of this nature to consider the extent to which the system is satisfying criteria beyond those which are its primary motivation. The purpose of this review is not merely to remedy the structural concerns which have motivated it, but rather to comprehensively assess the extent to which it is consistent with practice and the degree to which it provides councils with a robust framework for navigating the future challenges that emerge, given the varying circumstances they face.

In canvassing these issues, consideration must also be given to the current provisions of the *Valuation of Land Act* and the *Local Government Act*, and the extent to which these provide the flexibility required to deliver a best-practice system. As section 3.2 identifies, limitations currently exist in relation to the application of differentials, fixed charge components, minimum rates and caps.

At the same time, the review must also be cognisant of the practical limitations the system faces and the resources councils require to assist in effectively managing their rating system. The administration of rating and valuation is not only a costly undertaking, but a specialist skill for which the supply of practitioners is limited.

Ultimately, the optimal design of a local government rating system hinges on the weights that policymakers (on behalf of the community) assign to different objectives, given the inherent tradeoffs and in light of the practical limitations.

5 Analysing the reform options

Section 3 outlined some of the key issues that have emerged over recent years in relation to Tasmania's property valuation and rating system, finding that the system's ability to manage dynamic property market conditions has been a major source of concern. As a result, rating outcomes have been unstable, with volatility in rates payable and redistribution across land use categories.

In light of this, the discussion in Section 4 assessed, at a theoretical level, the merits of a range of rating tools that might be employed to manage such conditions and as part of a best practice system more broadly. In addition, it also canvassed the relative benefits of the more fundamental options for change, including alternative valuation bases.

This section places the principles and theory of Section 4 into the Tasmanian context and draws on a range of quantitative and qualitative evidence to analyse the extent to which changes to the rating and valuation framework could deliver a more stable and robust model.

5.1 Modelling the case study councils

The analysis draws on the experiences of four councils, selected by the review's steering committee to represent a cross-section of the geographic and economic characteristics of Tasmania's councils.

- **Hobart**, while the state's capital and its residential hub, is also a major commercial centre, with a third of total property value (AAV) utilised for commercial purposes.
- **Latrobe**, in the central north of the state, is predominantly residential, but has a significant agricultural base, with primary production accounting for 16% of property value.
- **Kingborough**, south of Hobart, has the highest proportion of land use committed to residential in the state – 80% of property value.
- **Northern Midlands**, in the central east, is heavily orientated toward agriculture, with 35% of property value accounted for by primary production.

Table 5.1 shows the distribution of property values (AAV) and rates payable across land use categories for each case study council. The separate Technical Appendix (Appendix C through to Appendix F) provides greater detail in relation to the characteristics of the councils, their property markets and their rating systems:

- Appendix C – Latrobe
- Appendix D – Northern Midlands
- Appendix E – Kingborough
- Appendix F – Hobart City

Table 5.1: Distribution of property values and rates payable across land use zones

	Kingborough (2009)		Latrobe (2009)		Hobart (2009)		N. Midlands (2007)	
	AAV	Rates payable	AAV	Rates payable	AAV	Rates payable	AAV	Rates payable
Residential	81%	81%	64%	64%	56%	59%	36%	46%
Low Dens. Res.	n/a		n/a		n/a		5%	5%
Commercial	8%	8%	5%	4%	32%	33%	11%	7%
Industrial	2%	2%	6%	6%	1%	2%	5%	6%
Vacant land	5%	5%	5%	6%	1%	1%	2%	1%
Public purposes	2%	2%	4%	4%	9%	6%	7%	5%
Primary production	3%	3%	16%	15%	0%	0%	34%	29%
Sporting or rec. facilities	0%	0%	0%	0%	1%	0%	1%	1%
Quarrying or mining	0%	0%	0%	0%	0%	0%	0%	0%

Dates refer to most recent revaluation; data refers to the subsequent financial year. Totals may not sum due to rounding.

For each of the case study councils, data was sourced to enable an analysis of the rating outcomes that prevailed in the financial years immediately prior to and post their most recent revaluation. These actual outcomes have been replicated by Access Economics and are utilised as a point of comparison to test the impact of a variety of alternative rating and valuation regimes.

The purpose of the modelling, therefore, is to investigate whether alternative strategies could have assisted in managing the property market conditions that prevailed in the case study councils (both within the current confines of the *Local Government Act* and more broadly). That is, whether a more stable rating outcome could have been generated and hence whether the average change and the variability in rates payable could have been reduced.

The modelling is also employed to examine the potential impacts of a change in valuation base. In this case, the modelling serves to illustrate the transitional impacts of any change, but also how the distribution of rates would have shifted across ratepayers. While the modelling cannot provide a definitive assessment in relation to issues such as capacity to pay, it can nonetheless provide a range of valuable insights.

The Technical Appendix contains detailed modelling outcomes for each case study council. The modelled scenarios are consistent across all appendices (e.g. the second chart in each appendix presents the results of a scenario where differentials have been designed to minimise volatility, the third chart presents the results of a scenario where a 20% fixed charge has been used, and so on).

The remainder of Section 5 provides an overview of the modelling results. Should the reader wish to examine modelling outcomes in more detail, the following analysis also includes references to specific charts in the Technical Appendix.

5.2 Utilisation of the existing rating tools

As Section 2 describes, councils currently have a range of tools at their disposal to manage valuation changes and to influence the distribution of rates across different land use types and ratepayer groups. Many councils have utilised these tools – predominantly differentials, but also remissions – in an attempt to mitigate the volatility generated by revaluations.

Nevertheless, an important initial consideration in assessing the existing rating and valuation system is evaluating whether the mechanisms currently available to councils within the bounds of the *Local Government Act* could be more effectively utilised to manage variable property market conditions.

Three key tools warrant specific consideration: (i) differentials based on land use; (ii) differentials based on locality; and (iii) fixed charges. Of course the appropriateness of these tools under a given set of circumstances hinges on a broader set of considerations than simply stability. The purpose here is merely to demonstrate whether the volatility which has occurred over recent years could have been reduced.

1. Differentials based on land use

Differentiating the *ad valorem* general rate based on land use and adjusting differentials on a year-to-year basis provides a strategy for managing different rates of growth across different elements of the property market (as well as satisfying other rating policy criteria). Indeed, as the rate resolution summaries in the appendices to this report demonstrate, several of the case study councils responded to the fluctuations generated by the most recent revaluation by introducing differential rates.

However, Access Economics' modelling reveals scope to marginally reduce volatility through the utilisation of differentials. In both Latrobe and Northern Midlands, differentials designed solely for the purposes of minimising volatility (i.e. without regard for other design principles) could have marginally reduced the variation in rate changes – even under the somewhat restrictive assumption that the proportion of revenue collected from each land use category is held constant (*Technical Appendix references: Chart C.2; Chart D.2; Chart E.2; Chart F.2*).

The other two case study councils, Hobart and Kingborough, show less scope to reduce volatility through differentials based on land use, primarily due to the different characteristics of their ratepayer base and the different property market trends that have been experienced. In Kingborough, the ratepayer base is dominated by residential property, while in Hobart changes in AAV have been relatively similar across property classes.

2. Differentials based on locality

The available data does not permit a detailed investigation of the potential impacts of introducing differentials based on locality (or, therefore, locality *and* land use). However, in those councils where different localities are exposed to different economic forces (e.g. varying proximity to waterfront), differentiating on the basis of locality would provide a mechanism for managing different rates of property value growth across localities (subject to equity considerations).

Of course the benefits of increasing the sophistication of differentials must be weighed against the resultant increase in complexity – for both administrators and ratepayers. Indeed, the

introduction of differential rates based on locality would require additional analysis and classification of valuation data against defined geographic criteria and hence additional cost and resources.

3. Fixed charges

As noted, the *Local Government Act* currently allows the use of a fixed charge provided it (i) raises less than 20% of total rate revenue; and (ii) is not used in conjunction with a minimum. At present, however, no Tasmanian councils employ a fixed charge.

By introducing a fixed charge, councils can directly eliminate the impacts of property market volatility on a proportion of the revenue base. This occurs because under a fixed charge, a proportion of total rate revenue can be raised using a relatively lower *ad valorem* rate, thereby diminishing the impact of property value variations. Illustrating this point, the modelling demonstrates that all four case study councils could have achieved less volatile rating outcomes with a 20% fixed charge in place. That is, the presence of a 20% fixed charge would have reduced the variation in the percentage change in rates payable following the most recent valuation (*Technical Appendix references: Chart C.3; Chart D.3; Chart E.3; Chart F.3*).

That said, given no Tasmanian council currently utilises a fixed charge, the impacts of introducing a fixed charge must be considered – in other words, the short-term instability required to institute a more stable long-term model must be taken into account. In this respect, the case study modelling demonstrates that the volatility which would be generated in the year of introduction would not considerably exceed that which actually occurred following the councils' most recent revaluation (*Technical Appendix references: Chart C.4; Chart D.4; Chart E.4; Chart F.4*). The impact on ratepayers who experienced a particularly significant rate increase could be managed using change caps (see discussion below).

Of course, a fixed charge has implications for the distribution of rates across property values and hence for capacity to pay considerations. For example, a 20% fixed charge in Northern Midlands – used in place of the minimum currently employed by this council – would see residential properties valued up to \$3,000 (AAV) better off; properties valued between \$3,000 and \$9,000 (AAV) worse off; and those valued above \$9,000 (AAV) better off. This implies that around 2,500 (of the 6,700) ratepayers would be worse off. Alternatively, in Hobart, where there is currently no minimum, properties valued up to \$36,000 (AAV) would incur higher rates under a 20% fixed charge scenario; properties above this value would pay lower rates (*Technical Appendix references: Chart C.5; Chart D.5; Chart E.5; Chart F.5*).

The conclusion to be drawn from this analysis is that introducing a fixed charge would generate a short term increase in volatility, but over the longer term a more stable rating outcome would be realised. In addition, consideration must be given to the impacts of a fixed charge on the distribution of rates, and in particular on equity (capacity to pay).

5.3 Introduction of other commonly used rating strategies

The examples above demonstrate how the rating strategies currently available to councils within the confines of the *Act* could be utilised by case study councils to at least partially reduce the variation in rates payable following their most recent revaluation. However, as Section 3.2 discusses, the *Act* does not afford councils the same level of flexibility (or provide the same level of clarity) that the legislation in other jurisdictions permits. In particular, it does

not allow fixed charges to be utilised to raise more than 20% of general rate revenue; and it does not explicitly allow utilisation of change caps. The potential benefits of these tools – in the context of reducing volatility, but also more broadly – is examined in the subsections below.

1. Higher fixed charges

As highlighted above, the greater the fixed charge, the smaller the proportion of revenue raised through the *ad valorem* component. This means the required *ad valorem* rate (for a given value of total revenue) is lower, in turn lowering the exposure to property market fluctuations. All else constant, therefore, a 50% fixed charge provides greater long term stability than the 20% scenario depicted above.

The case study modelling finds that a fixed charge which raises 50% of total rate revenue could have further reduced rating volatility in all four councils (relative to a 20% fixed charge) - *Technical Appendix references: Chart C.6; Chart D.6; Chart E.6; Chart F.6.* In all cases, the variability in rating outcomes is statistically reduced.

At the same time, the fluctuations generated by the introduction of a 50% fixed charge would be greater than that associated with the introduction of a lower fixed charge. For example, in Latrobe, the proportion of properties experiencing a rate increase greater than 30% would increase from 8% to 23% in the year of introduction (of course, change caps could smooth this over multiple years). Similarly, in Northern Midlands, the proportion of properties experiencing a rate increase greater than 30% would increase from 24% to 34%, and in Kingborough, it would increase from 18% to 29% (*Technical Appendix references: Chart C.7; Chart D.7; Chart E.7; Chart F.7*).

Moreover, the long-term redistributive impacts would be more pronounced. In all councils, lower value properties would pay higher rates. For example, the proportion of revenue derived from the lowest quintile of properties⁹ would have increased from 4% to 6% in Latrobe; 5% to 11% in Northern Midlands; 0% to 2% in Hobart; and 1% to 3% in Kingborough.

2. Change caps

By amending the *Act* to explicitly permit the use of change caps, councils would be able to limit – by definition – the level of volatility in rates changes between rating cycles (achieving a similar outcome to that currently achieved in some councils through concessions and remissions). In this sense, change caps form a critical component of the suite of tools required to effectively manage valuation and rating reform.

For example, case study modelling reveals that a 15% change cap could have reduced the volatility associated with the introduction of a 20% fixed charge (*Technical Appendix references: Chart C.8; Chart D.8; Chart E.8; Chart F.8*). The resultant outcome, unsurprisingly, is that the vast majority of properties experience a rate increase of between 10% and 20% once the cap is in place. A change cap does result in a – temporary – redistribution of the rating burden from properties above the 15% change threshold to properties below, however

⁹ The quintiles used in this report are determined by splitting the distribution of properties into five equal increments based on value. For example if the highest value property was \$10 million, the first quintile would capture those properties valued between zero and \$2 million; the second quintile those between \$2 million and \$4 million; etc.

it nevertheless provides an important means of ensuring that no properties experience excessively large rates changes during periods of transition.

5.4 An alternative valuation base

The more fundamental options for change lie in a shift to an alternative valuation base. As the theoretical discussion in Section 4 outlines, on grounds of administrative efficiency and in light of the inherent practical constraints, there is a strong rationale for shifting to capital value or land value. In order to further assess the implications of a change to the valuation base, however, it is necessary to examine the underlying property valuation bases.

The analysis in this section explores both the impacts associated with transition from AAV to land or capital value, and the inherent characteristics of each valuation base.

5.4.1 Land value

Land value is a fundamentally different valuation base compared with AAV (and capital value). Indeed, for the case study councils analysed in this report, there is no statistically significant correlation between land value and AAV – some properties have a high AAV and low land value and vice-versa.

Hence, transferring from AAV to land value involves a significant level of upheaval for individual ratepayers (*Technical Appendix references: Chart C.9; Chart D.9; Chart E.9; Chart F.9*). In particular, the introduction of land value would generate significant fluctuations in rates payable in its first year. For example, when holding the distribution of rates across different land use categories approximately constant, assuming a 20% fixed charge and with differentials designed to minimise volatility, the modelling results reveal that:

- in Latrobe, the proportion of properties with a decrease in rates greater than 20% increases from 2% to 9%; and the proportion of properties with a rate increase greater than 20% increases from 21% to 34%; and
- in Hobart, the proportion of properties with a decrease in rates greater than 20% increases from 0% to 6%; and the proportion of properties with a rate increase greater than 20% increases from 51% to 58%.¹⁰

However, it must be again emphasised that these impacts are transitory and, moreover, that they could be managed over several years using change caps.

More fundamentally, inherent differences in the distribution of land values (compared with the distribution of capital values or AAV) mean that the burden of rates falls considerably differently under land value compared with AAV (*Technical Appendix references: Table C.2; Table D.2; Table E.2; Table F.2*). In particular, the greater concentration of properties at the lower end of the distribution results in a greater share of the rates burden being borne by the lowest quintile – a trend exhibited by all of the case study councils modelled. The extent to which these changes represent deterioration in capacity to pay is indeterminable without an analysis of household characteristics.

¹⁰ Note that the average rate increase in Hobart was 23%.

5.4.2 Capital value

AAV and capital value are considerably more closely correlated than either AAV or capital value is correlated with land value. That is, properties with a high AAV are extremely likely to have a high capital value and properties with a low AAV are highly likely to have a low capital value (of course, this finding is in part reflective of the 4% minimum rule). Accordingly, the introduction of capital value would not generate the same level of upheaval as land value – neither in the short term or over the longer-term.

Whereas the transition to land value would involve significant change in rates payable for a large proportion of the ratepayer base, the modelling indicates that in all of the case study councils, the volatility generated by moving from AAV to capital value would have been not dissimilar to what actually prevailed between 2008-09 and 2009-10 (*Technical Appendix references: Chart C.10; Chart D.10; Chart E.10; Chart F.10*). Indeed, the modelling indicates that, introduced in conjunction with a 20% fixed charge¹¹ and subject to broadly the same distribution of revenue across land use categories, both the average percentage change in rates payable and the variation in the change in rates payable would have been broadly similar to actual outcomes.

In all councils, introduction of capital value under the assumptions outlined above would also have generated a similar outcome in terms of the distribution in rates payable across the property value spectrum. That is, changes in the proportion of revenue sourced from each quintile would have been modest.

5.5 Improving valuation process and practices

Section 3 identifies that the volatility observed in the rating and valuation system over recent years has been partly a function of property market trends and partly a function of the process and practices through which valuation has been executed. Accordingly, assessing ways in which the valuation system could be improved is a critical aspect of the process of identifying and exploring the options for reform. This section analyses these issues drawing on a range of qualitative and quantitative information. The nature of the proposals being analysed and limitations in the available data mean that analysis to the depth of the preceding sections is not permitted.

5.5.1 Altering the minimum

Increasing the minimum from 4% would see increasing numbers of properties fall onto the minimum rule and would therefore take the system closer to capital value. Conversely, reducing the minimum from 4% could potentially decrease reliance on the minimum rule, reverting the system to a more genuine AAV base. It would also reduce the share of total rates paid by classes of land use that have traditionally had a high proportion of properties affected by the 4% minimum rule, however the precise nature of these impacts cannot be examined in any greater detail due to limitations in the available data.

¹¹ A 20% fixed charge has been modelled for simplicity. As Section 6 notes, there is a case for the fixed charge utilised under capital value to be higher than that employed under land value.

5.5.2 Removing the minimum

A more extreme response to the issues generated by the 4% minimum rule would be to abandon the concept of a minimum altogether, or to limit its application to certain property classes or only those properties where cost-effective valuation is genuinely not feasible.

This would eliminate the instability generated by properties falling onto the 4% minimum rule following a revaluation and reduce the volatility generated through the adjustment factor process. Provided the bounds of any limited application could be clearly defined (i.e. provided properties where valuation is impractical could be objectively identified), simplicity would be enhanced. In the event that retention of AAV is favoured, the discussion forums showed support for this option, with a majority indicating that they endorse its removal from residential property.

5.5.3 Improving the application of adjustment factors

An option for improving the currency of valuation data and therefore smoothing property market fluctuations is the recalibration of the indexation methodology. As Section 2.3.1 outlines, the current approach, while sophisticated in its application, sees properties which are effectively rated against capital value (by virtue of the 4% minimum rule) indexed based on trends in rents – a technique which limits the ability for indexation to smooth increases in rates between revaluations.

A potentially more effective alternative would be to link indexation of properties on the 4% minimum to growth in capital value, based on price movements in different property classes in different localities. While this would not address issues resulting from variation in growth within a given locality (depending on the scale of the defined locality and sophistication of the methodology) it could substantially resolve the deficiency inherent in the current adjustment factor methodology.

While the OVG has indicated that the collation of capital value adjustment factors would generate a non-negligible increase in workload, the additional resource requirements would not be substantial, particularly when compared with increased revaluation frequency (discussed below). However, the OVG has also indicated that gazetting capital value adjustment factors would require refinements to the current legislation.

5.5.4 Increased frequency of revaluation

The most direct and most effective way to improve the currency and accuracy of valuation data is to increase the frequency of valuation from its current six-year cycle. Indeed, as noted above, a move to a shorter revaluation cycle has already been canvassed by the State Government. Increased revaluation frequency can smooth fluctuations during periods of property market buoyancy, however these benefits must be weighed against the associated costs and evaluated in the context of the practical limitations that currently exist.

From both a cost and physical resource perspective, the scope to increase revaluation frequency would be greatest under a land value based system (that is, where AAV and capital values are no longer collected). In this case, the OVG has indicated that costs of revaluation would be reduced by around half, allowing a 2-3 year revaluation cycle to be undertaken on a broadly cost-neutral basis. If both capital value and land value were collected, but not AAV, a

more modest cost saving would be achieved; one which would not alone finance increased revaluation frequency.

It should be borne in mind that if AAV and the 4% minimum rule is retained, any reduction in volatility risk is likely to be modest. A property boom could result in very significant aggregate and relative movements in capital values between revaluations, even if the revaluation cycle is reduced to two years. The fact that not all properties are affected by the 4% minimum rule would only magnify the impact on those that were affected.

A discussion regarding the process and provision of valuation services is presented in the following section.

6 Conclusions and recommendations

The conditions which have prevailed in Tasmania's property market over the last decade have created challenges for, and uncovered limitations in, the state's framework of property valuation and local government rating. Looking ahead, it is unlikely that these circumstances will be repeated over the short to medium term. Indeed, some of the pressures which have built up may in fact abate of their own accord.

Irrespective, it is evident that, assessed against best-practice design principles, the current model – and its application – has limitations which warrant consideration of reform. The system's instability is inherent and is partially a function of valuation practices and processes, but is also symptomatic of a rating framework which, at the very least, requires refinement if it is to give councils the maximum ability to effectively manage their revenue raising.

In considering the options for addressing these issues, there are a range of potential mechanisms at hand, each of which could contribute to a more robust rating and valuation framework to some degree. Ultimately however, the key to delivering a robust, best-practice system for the future lies in combining these mechanisms in an integrated, coordinated fashion that optimises their performance, given the unique circumstances of each council. That is, the recommendations provide here are prescriptions for a robust framework at a general level. The most appropriate rating regime for a given council will hinge on its local circumstances.

Drawing on the analysis presented throughout the preceding sections of this report, this section outlines Access Economics' conclusions from this review and recommendations for reform.

6.1 Rating tools

The conclusions in relation to the rating tools available to councils are summarised below and the legislative implications of these conclusions are outlined in Section 7.1. These recommendations are made irrespective of the valuation base which is employed, but will vary from council to council in the extent to which they are appropriate.

Recommended tools currently available under the Local Government Act

- Differentials based on land use and fixed charges up to the legislatively prescribed limit (20% of total revenue) could be used within the current confines of the Act to assist in smoothing the volatility generated by property price movements.
 - Use of a single fixed charge is advocated in preference to minimums.
- Differentials based on locality are also likely to assist in smoothing volatility in circumstances where geography (over and above land use) is a determinant of volatility, however the trade-off with simplicity must be considered.

Recommended tools not currently available under the Local Government Act

- Fixed charges up to 50% of total revenue would provide councils with greater ability to deliver rating stability and should be considered as part of any amendment of the Act on these grounds, and as part of best-practice design more generally.

- Change caps provide a valuable mechanism for managing implementation and transition processes and hence should be considered as part of any amendment of the Act.
 - Caps should not be relied upon to any significant degree over the longer term; excess reliance signals deficiencies elsewhere in the system.
- Multi-tiered rates provide a mechanism for managing the rates contribution of high-value properties, however their efficacy hinges on the distribution of property values.
 - Multi-tiered rates and transparent concessions should be used – in exceptional circumstances – in preference to maximums.

Tools not recommended

- Allowing scope for a fixed charge to raise in excess of 50% of total rate revenue – or for strategies that employ different mechanisms but pursue a similar outcome – is likely to unduly compromise capacity to pay criteria and is not recommended.
- Placing an artificial barrier under rates through ‘collars’ – or similar mechanisms – potentially compromises capacity to pay considerations and is inconsistent with best practice design more generally.¹²

6.2 Valuation base and frequency

Retention of AAV not supported by the analysis presented in this paper - against no criteria is it deemed preferable to the alternatives. Both alternative valuation bases have benefits relative to the status quo, both have disadvantages. The preferred option therefore lies in the weight assigned to alternative design criteria, in particular the weight placed on capacity to pay. Accordingly, the options below outline the case for each valuation base, and the specifications of its optimal application. A definitive recommendation is not made here.

Option 1: Land value

Land value offers a number of benefits as a base for property valuation:

- it is the most efficient valuation base and the one best suited to addressing benefit principle considerations;
- it is the simplest and least resource-intensive to administer; and
- it aligns with the Henry Review recommendation that the tax bases used by state and local government be better integrated.

However, equity (capacity to pay) objectives would be more challenging to achieve.

Optimal implementation would include biennial valuation (which could be achieved in broadly a cost-neutral fashion), a single, low fixed charge and the use of differentials, multi-tiered rates and concessions as required by local circumstances. The volume of valuation work associated with such a model would mean that a biennial cycle could be undertaken either in-house by the OVG or by private contractors (see Section 6.3, below). The cessation of collection of capital valuations would have implications for the administration of stamp duty, however

¹² Collars are a rating device used to place a limitation on the allowable change in rates payable (e.g. to ensure that no properties experience a reduction in rates).

these are likely to be negligible given the ability to levy stamp duty based on transactions data (as most other jurisdictions do).

Option 2: Capital value

Capital value also offers a number of benefits as a base for property valuation.

- If capacity to pay is a more significant policy consideration – which the Discussion Forums indicated it was for many councils – then capital value may be preferable to land value.
 - As the modelling in Section 5 shows, capital value could satisfy capacity to pay considerations to the same extent that AAV currently does. This would not be achievable under land value.
- It is the most easily understood by ratepayers.
- The cost and resource requirements associated with revaluation process would be reduced, relative to a system whereby three valuation bases are maintained. However, the cost savings generated will be considerably less than if solely land value was maintained (the OVG estimates the savings would be in the order of 15%).

However, capital value is less efficient compared with land value, less suited to addressing benefit principle considerations and more costly to administer.

Optimal implementation would be include four-yearly valuation (50% every two years), with adjustment factors calculated and applied biennially. Not only is there evidence that the current market of private contractors could support this, but, as discussed below, the greater volume of work has the potential to provide incentives for other businesses to enter the market. Indications from the OVG are that it would not be feasible to deliver this model in a cost-neutral fashion (i.e. additional funding would be required). Some of the increased cost is related to more extensive data collection requirements, for example detailed information about the internal structure of buildings on individual properties.

The preferred rating scenario would be a single fixed charge, with differentials, multi-tiered rates and concessions employed as required by local circumstances. While decisions should be made on a case-by-case basis, a relatively high fixed charge would be appropriate under capital value (i.e. compared with land value).

Option 3: AAV

The analysis undertaken throughout this review suggests there is not a strong case for retaining AAV. Most compellingly, the analysis reveals that a similar rating outcome could be achieved under capital value and at lower cost. Against no criteria is AAV deemed preferable to the alternatives.

Nevertheless, if AAV is retained, it is recommended that the 4% minimum rule be applied only to a clearly defined set of circumstances where properties cannot practically be valued. While abolishing the 4% minimum rule would create significant levels of variability during transition, especially for residential ratepayers, this process could be managed through caps and differentials, such that the rule is effectively phased in over several years. Moreover, the long term benefits of a more robust system are likely to outweigh these short term challenges.

If the 4% minimum rule is retained, it will be necessary for adjustment factors to be calculated at least biennially for capital value and applied to properties on the rule. Indications from the OVG are that this would require a several-fold increase in the effort and resources currently required to generate adjustment factors for AAV and land value. Increased frequency of valuation is recommended (as per capital value: four yearly, with biennial adjustment factors), however with no offsetting cost savings, implementing more frequent valuations under AAV would be fiscally challenging.

Summary of findings

The retention of AAV is not supported by the analysis presented in this report. The choice between land value and capital value hinges on the significance placed on capacity to pay considerations and hence rests with policymakers.

If capital value is ultimately identified as the preferred valuation base for Tasmania, consideration could be given to providing councils with the option to choose between capital value and land value. No additional costs would be incurred, as the State Government requires land values to be prepared by the Valuer-General for its own purposes. Charges could be structured such that councils that choose to rate on land value would pay a lesser amount than those which rate based on capital value, to reflect the savings that arise from not having to determine capital values for these particular councils.

While allowing choice of valuation base may give rise to concerns of inconsistency across councils, it should in fact be viewed as reinforcing councils' flexibility to raise revenue in the most appropriate fashion given their local circumstances.

It should be borne in mind, however, that if capital value data was not maintained, the cost of establishing up-to-date capital value data at a future point in time may prove prohibitive. In other words, it may not be feasible for councils to switch from land value to capital value after a certain period of time.

6.3 Valuation process and practice

Access Economics' review has also revealed scope to improve the valuation process and to generate an environment conducive to competition among service providers – the benefits of which would materialise in a more efficient model of delivery and a higher quality valuation service.

Key conclusions in relation to valuation processes include:

- Maintenance of synchronicity with Victoria's biennial valuation cycle is critical to the system's capacity to continue to create a commercial proposition which is attractive to interstate contractors.
- Increased revaluation frequency will increase attractiveness to contractors and therefore the competitiveness of the tender process.
- The limited interest from private subcontractors to perform valuation work in Tasmania is partially a function of the way valuation contracts are currently administered.
 - Continuity of work is critical to the emergence of a strong market for valuation services. The sporadic nature of the current workload diminishes its

attractiveness to private contractors, even acknowledging the other commercial opportunities which can be pursued during the off year.

- Contracting out the derivation of adjustment factors and supplementary valuations (noting that supplementary valuations are currently contracted out during revaluation years) would create a more continuous stream of work for potential contractors, increasing the likelihood both of more interstate firms tendering, and more firms establishing a permanent presence in Tasmania. This is also likely to generate efficiencies through economies of scale and to increase consistency across valuation activities.
- Offering revaluation contracts in multiple cycles would provide greater commercial certainty for contractors, increasing their willingness to invest in the state. Risks associated with poor performance or non-compliance by contractors would need to be managed.
- There is scope to review the model through which the valuation process is funded, with a view to ensuring the distribution of the funding burden is appropriate.

7 Implementation and transition

The primary aim of any reform to Tasmania's valuation and rating system is establishing a robust framework for the future – a well-defined system that is both durable and flexible, provides clarity to councils and equips them to manage their rate-raising activities in an efficient, equitable, cost-effective fashion over the long-term.

To implement this framework, some of the recommendations outlined in the preceding section will need to be incorporated into the *Local Government Act* and the *Valuation of Land Act*. In addition, the steps required to achieve the new framework will involve a level of short-term adjustment for some groups of ratepayers. Nevertheless, there are significant benefits associated with the implementation of a robust and best-practice framework – importantly, an improved valuation and rating system will alleviate existing concerns and ensure that councils have the capacity to effectively manage changing circumstances into the future.

This section outlines the legislative implications of reforming Tasmania's valuation and rating system, and provides some strategies that can be used throughout the implementation process to ease the transition for councils and the broader community.

7.1 Legislative implications

The conclusions and recommendations outlined in Section 6 give rise to a number of legislative implications. In particular, amendments to the *Local Government Act* and the *Valuation of Land Act* would be required to give effect to some of the recommended reforms. This section overviews these changes at a high level; a detailed legislative review has not been undertaken. Access Economics does not specialise in the provision of legislative advice and further expert analysis in relation to the legislative implications of Access Economics' conclusions is recommended.

Changes to the legislation can be divided into interim measures – which can be relatively easily incorporated into the legislative framework, such as the clarification of existing rating tools – and longer-term measures – which will involve more substantive reform, including changes to the valuation base for rating.

It should also be noted there are steps that councils can take to minimise volatility and improve their rating outcomes, in isolation from any legislative amendments. Significantly, councils can make greater use of the rating tools currently available under the legislation – for example, fixed charges up to the prescribed 20% limit could be employed and differentials could be used more extensively.

7.1.1 Interim measures

In the near term, there are a number of relatively straightforward amendments that could potentially be made to the *Local Government Act* to alleviate council concerns about legislative uncertainty and provide councils with additional rating tools that will help them to better manage volatility. These interim measures are not contingent on any reforms to the valuation system i.e. they 'stand alone' and would be useful regardless of which valuation base for rating is chosen.

Amendments to the *Local Government Act* include:

- Inclusion of change caps as a mechanism to manage volatility in the short-term (i.e. during the implementation and transition process) (Section 5.3).
- Greater clarity about the use of differential rates in section 107, such as the inclusion of statutory definitions of the factors by which the general rate may be varied (Section 3.2.3).
- Explicit inclusion of differential minimums, with the maximum value of the minimum being proportional to the variation in the *ad valorem* rate (Section 3.2.3).
- Amendment of section 91(2)(b)(ii) to increase the percentage limit for fixed charges from 20% to 50% of a council's total general rate revenue (Section 5.3).
- Amendment of section 90 to limit the proportion of properties that can be 'on the minimum', thereby ensuring that the general rate cannot be structured as a flat rate (Section 5.3). The concurrent introduction of other measures such as a higher fixed charge and change caps would ease the transition for councils that currently use flat rates.
- Further clarity regarding the use of remissions in section 129, including how remissions can be used to address volatility associated with revaluations (Section 5.2).

7.1.2 Longer-term measures

Reforms to the valuation system, such as the decision to move to an alternative valuation base and/or increase the frequency of revaluations, would require greater implementation lead time due to the complexities involved. Further changes to the rating system could also be implemented over the longer term, such as the introduction of multi-tiered rates and the inclusion of legislative provisions that specifically encourage councils to adopt a 'best practice' approach to rating.

Amendments to the *Valuation of Land Act* include:

- If a decision is made to move away from AAV to either land value or capital value (including for other users of AAV such as the State Grants Commission and the State Fire Commission), section 11 will need to be amended so that the Valuer-General no longer needs to determine all three types of values for each property. The nature of the amendment will depend on whether councils are given the option to choose either land value or capital value, or whether all councils are required to use only land value or only capital value.
- If AAV is retained but the 4% minimum rule is to be changed so that it applies only to properties that cannot practically be valued, section 11(3)(e) will need to be amended and perhaps a new section or sub-section should be included which clearly sets out the new parameters of the 4% minimum rule.
- If AAV is retained, consideration could also be given to changing the definition of AAV so that it becomes a 'gross' value. The current definition excludes GST and reimbursement of council rates and land tax – however, the recent exclusion of water and sewerage charges from council rates means there is additional complexity in calculating AAV.
- Any decision to reduce the revaluation cycle will require an amendment to section 20 (which determines when valuations are to be made) to reflect the shorter time period.

Amendments to the *Local Government Act* include:

- If a decision is made to move away from AAV to either land value or capital value, section 89A(2) will need to be amended to remove scope for councils to use AAV.
- Inclusion of multi-tiered rates, so that properties (either all properties or those within a given class) can be subject to a different rate for the portion of their value above a nominated threshold (Section 5.3).
- Inclusion of measures that require councils to consider relative movements in property prices and give due consideration to the impact on ratepayers when formulating rating decisions (e.g. councils could develop business plans that set out the relationship between specific rate structures and financial management policies). Not only would this help improve public transparency, but it would provide another means of ensuring that councils understand these issues.

It should also be noted that a decision to move to an alternative valuation base will have flow-on effects for other users of valuation information. For example, AAV is currently used by the State Fire Commission to calculate fire levies and capital values are used in the administration of stamp duty.

The implications for other users of valuation information, and reform of other legislation or regulations that will be necessitated by changes to the valuation and rating system, must be considered during the wider review process.

7.2 Managing the transition

The transition to a new rating and valuation framework will naturally lead to some upheaval and adjustment for ratepayers, councils and government departments and agencies. However, these adjustments are likely to be short-term and there are a number of strategies that can be used to manage the transition process, including any costs associated with moving to a new framework. It should also be borne in mind that short-term upheaval will lead to long-term stability, with subsequent benefits for all stakeholders.

Strategies to manage the transition include:

- further modelling to facilitate a comprehensive understanding of the change impacts;
- appropriate use of rating tools to minimise impacts;
- support to councils; and
- broader stakeholder education.

7.2.1 Further modelling

The modelling presented throughout this report has illustrated the impact of a range of possible reform options on four of Tasmania's 29 councils, showing the implications of the introduction of a range of alternative rating strategies and valuation bases. One conclusion to emerge from this modelling is that the impacts vary markedly across councils depending on local characteristics – both the mix of properties across land use classes and the distribution of values within each class.

In the event that fundamental change is recommended by the steering committee, consideration should be given to undertaking – or assisting councils to undertake – modelling to assess the impacts of change on each municipality and help determine the most appropriate rating structure for each council. This is especially pertinent for land value, where the transition impacts will be most significant. As this report reiterates on numerous occasions, the optimal rating strategy for a given council will depend on local circumstances and hence detailed modelling will be an important component of defining this optimal strategy. In assisting councils in the transition to a fundamental change option, modelling for all councils should be therefore considered.

7.2.2 Rating tools

As Section 5 highlights, any substantive reforms (such as changing the valuation base) could be preceded by, and managed with, the application of rating tools such as change caps, remissions and differential rates.

Change caps and remissions could be used by councils to ensure that no ratepayer experiences an undesirably large change in rates. Differential rates could also be used by councils to minimise the impacts on certain groups of ratepayers. For example, differential rates could be used to ‘phase in’ any adverse impacts over a period of time, whereby the *ad valorem* component could be adjusted each year for groups that are undesirably affected following the reforms. The complexity and lack of transparency associated with this, however, means that change caps will usually be preferable.

It has been recommended that these rating tools be included or clarified in the legislation in the near term, thereby ensuring they are available to councils prior to any major reforms. This has two benefits:

- councils will be able to utilise the rating tools to ease the transition to the new valuation and rating system; and
- they will have a greater opportunity to familiarise themselves with the rating tools, and develop an understanding of how the rating tools can be best utilised for their particular local circumstances, before major reform is implemented.

7.2.3 Council support

Consideration will also need to be given to the capacity and capability of councils to manage any changes stemming from the review and the resources required to support them through this process.

Training sessions for rate officers and elected officials should be held at the initial stage of the transition process to ensure understanding. In addition to building technical competence, consideration should also be given to educating rate officers and elected members about the political aspect of rating i.e. the need to give due consideration to community concerns about volatility. Training material should also be prepared and provided.

The provision of comprehensive technical guidance documents and good practice guides, such as model rates notices, would also ensure that councils have sufficient resources to manage the transition process. A simple Excel-based ‘rates impact model’ could be prepared and distributed to councils (accompanied by a user guide and training sessions). The model would

help councils understand the impact of property valuation increases and the subsequent effect on rates given a pre-determined amount of total rate revenue.

After the reforms have been implemented, ongoing training for councils on rating matters could also be a useful avenue of support. For example, the Local Government Association of South Australia provides training seminars for councils. Western Australia also has a Rate Officers Association that provides ongoing support to council rate officers, for example by explaining legislative provisions.

There is also merit in considering the provision of a rating specialist who could be on call to respond to issues and concerns that arise during transition (and potentially also over the longer term). Access to a rating support service of this nature would allow those councils with limited internal expertise to seek support and advice, helping to ensure they continue to implement best practice strategies given their local circumstances. This could feasibly be someone either within the Local Government Division or an independent expert.

7.2.4 Stakeholder education

Another key aspect of managing the transition process will be educating the media, politicians and the community about the reasons for change and the long-term benefits of reform. Engaging these groups throughout the implementation process will also be important.

Education of stakeholders should be aimed at raising awareness and understanding of the local government rating system, highlighting the benefits that will arise through changes to the system. A web page, perhaps hosted by the Local Government Association of Tasmania and/or Local Government Division of the Department of Premier and Cabinet, could be prepared for the media and the community. It could comprehensively outline the purpose of local government rating, the current valuation and rating system, why changes are required, and what the changes will actually comprise.

A series of fact sheets could also be prepared and made available on this web page. Fact sheets would be an ideal way to communicate the changes to the media and the broader community, as they would be written in 'layperson's terms' and provide a succinct outline of local government rating and the reforms. They could also be used to 'debunk' common myths about council rates and highlight the long-term benefits of reform.

Community forums are another means of educating the general public about the proposed changes. Although the Steering Committee intends to consult with the community prior to making its formal recommendations to Government, further community forums should also be held after the recommendations have been accepted and before any changes are implemented. This will provide community members with the opportunity to directly ask questions and understand how the proposed changes are likely to affect them. It will also provide reassurance to community members that measures will be put in place to ensure no-one unduly suffers as a result of the changes.

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Appendix A: Tasmanian council rates 2009-10

Table A.1: Tasmanian rating structures 2009-10, council-by-council

Council	General rate (cents in \$ of AAV)	Minimum general rate (\$)	Variations to general rate (no.)	Waste management charge	Stormwater charge
Break O'Day	6.4	350	1	Y	N
Brighton	2.3	740	15	Y	N
Burnie City	10.7	140	2	Y	Y
Central Coast	8.38	175	0	Y	N
Central Highlands	3.96	300	0	Y	N
Circular Head	6.7	201	0	Y	N
Clarence City	8.48	130	1	Y	Y
Derwent Valley	8.66	None	0	Y	N
Devonport City	12.12	None	4	Y	N
Dorset	7.35	136	0	Y	N
Flinders	7.53	350	0	Y	N
George Town	6	749	15	Y	N
Glamorgan-Spring Bay	6.64	370	43	Y	N
Glenorchy City	6.67	114.45	0	Y	N
Hobart City	6.5	None	0	Y	Y
Huon Valley	6.55	250	0	Y	Y
Kentish	8.65	577.5	0	Y	N
King Island	6.05	215	0	Y	N

Valuation and local government rating in Tasmania

Council	General rate (cents in \$ of AAV)	Minimum general rate (\$)	Variations to general rate (no.)	Waste management charge	Stormwater charge
Kingborough	5.7	245	0	Y	N
Latrobe	5.9	233	4	Y	N
Launceston City	8.29	110	2	Y	N
Meander Valley	5.85	115	2	Y	N
Northern Midlands	1.26	325	11	Y	N
Sorell	11.4	213.4	0	Y	N
Southern Midlands	6.35	220	1	Y	N
Tasman	11.26	250	0	Y	N
Waratah/ Wynyard	7.75	105	0	Y	Y
West Coast	10.87	175.96	3	Y	Y
West Tamar	7.18	127	1	Y	N

Source: Department of Premier and Cabinet, Tasmania

Appendix B: Interstate valuation and rating systems

Table B.1: Valuation methods and rating structures by state/territory

State/ Territory	Valuation method	Revaluation frequency	Valuation service delivery	Rating tools
NSW	Land value only	<p>Every 3-4 years (legislation specifies at least every 4 years).</p> <p>Land values for the purpose of land tax are determined annually.</p>	<p>Contracted out.</p> <p>Valuer-General contracts out provision of land valuation services to private contractors – contracts are based on geographic locations and are usually for a 3-4 year period.</p>	<ul style="list-style-type: none"> ■ General ('ordinary') rate ■ Fixed charge ('base amount' and limited to 50% of total revenue from the rate) OR minimum OR neither ■ Differential general rates (the ordinary rate must be divided into farmland, residential, mining and business; these categories may be further subdivided) ■ Rate pegging – each year the Minister for Local Government sets a rate peg percentage which limits the amount by which each council's overall rate revenue can increase (the rate peg percentage for 2010-11 is 2.6%)

State/ Territory	Valuation method	Revaluation frequency	Valuation service delivery	Rating tools
VIC	<p>Councils may choose from:</p> <ul style="list-style-type: none"> ■ site value – unimproved market value of the land; ■ capital improved value (CIV) – total market value of the land plus improved value of the property; or ■ net annual value (NAV) – annual rental value or 5% of CIV for residential and farmland (must be at least 5% of CIV for commercial/industrial). <p>No councils use site value, 73 out of 79 use CIV and only 6 use NAV.</p>	All properties in Victoria are revalued every 2 years.	<p>Contracted out.</p> <p>Councils are responsible for revaluations – most councils use contract valuers. Valuer-General audits the valuations. From 2012, councils have the option to transfer revaluation responsibilities to the Valuer-General (who will also contract out the valuation work).</p>	<ul style="list-style-type: none"> ■ General rate ■ Differential rates (for CIV only) ■ Caps (maximum allowable rate increase from year to year) ■ Fixed charge ('municipal charge') – limited to 20% of total rate revenue ■ Concessions
QLD	<p>Unimproved value only – market value of land in its natural state before any site works.</p> <p>Proposed reform for 2011: introduction of site value for non-rural land (market value of land in its present state i.e. includes invisible improvements but does not include structural improvements). Rural land will continue to be valued using unimproved value.</p>	Every year for metro areas, every 2-3 years for provincial coastal areas, every 5 years for western regions.	<p>In-house.</p> <p>Valuations are done by Department of Resource and Environment employees.</p>	<ul style="list-style-type: none"> ■ General rate ■ Minimum ■ Differential rates ■ Caps ■ Averaging of values over a 2 or 3 year period ■ Concessions

State/ Territory	Valuation method	Revaluation frequency	Valuation service delivery	Rating tools
SA	<p>Councils may choose from:</p> <ul style="list-style-type: none"> ■ capital value –value of the land including improvements; ■ site value – value of the land without structural improvements; or ■ annual value – three-quarters of the gross annual rental of the land, or 5% of capital value where this cannot be reasonably practically determined. <p>Generally, councils must use capital value, but site value or annual value may be used if already in place or if a council satisfies various public consultation and related requirements. Almost all of the 68 councils use capital value and only 1 council uses annual value.</p>	Annual basis	Councils may make own arrangements but in almost all cases choose to utilise services of SA Valuer-General who utilises own in-house resources for valuations.	<ul style="list-style-type: none"> ■ General rate ■ Minimum (limited to up to 35% of properties) ■ Fixed charge (if no minimum and limited to no more than 50% of aggregate general rate revenue) ■ Differential rates ■ Two-tiered rating ■ Concessions
WA	<p>For rural and fringe urban areas:</p> <ul style="list-style-type: none"> ■ unimproved value (UV) – land value. <p>For urban areas:</p> <ul style="list-style-type: none"> ■ gross rental value (GRV) – gross annual rental including outgoings. <p>GRV becomes the ‘assessed value’ (5% of capital value) where annual rental cannot be reasonably determined. However, all properties used for residential purposes only must be valued on a rental basis (i.e. 5% rule does not apply).</p> <p>Proposed reform for 2011: Assessed value for vacant residential land to be based on 3% of capital value (rather than 5%).</p>	<p>Unimproved value – every year.</p> <p>GRV - every 3 years for Perth metropolitan area; every 3-5 years for country areas.</p>	<p>In-house.</p> <p>Valuations are done by Landgate (WA Valuer-General) employees.</p>	<ul style="list-style-type: none"> ■ General rate ■ Minimum ■ Differential rates ■ Phasing – valuations phased in over a period of time (e.g. 3 years) ■ Concessions

State/ Territory	Valuation method	Revaluation frequency	Valuation service delivery	Rating tools
TAS	Councils may choose from: <ul style="list-style-type: none"> ■ capital value; ■ land value; or ■ assessed annual value (AAV). All councils use AAV.	Every 6 years (although legislation specifies every 7 years)	Contracted out	<ul style="list-style-type: none"> ■ General rate ■ Minimum ■ Fixed charge (if no minimum) – limited to 20% of general rate revenue ■ Differential rates ■ Remissions
NT	Councils may choose from: <ul style="list-style-type: none"> ■ unimproved capital value (UCV), ■ annual value; or ■ improved capital value (ICV). All councils use UCV.	Every 3 years for rateable land	Contracted out	<ul style="list-style-type: none"> ■ Fixed charge OR valuation-based (<i>ad valorem</i>) charge OR both ■ Minimum (for valuation-based charges only) ■ Differential fixed charges, valuation-based charges and minimums
ACT	Unimproved value (land value)	Annual basis	Contracted out ACT Revenue Office engages the Australian Valuation Office to conduct valuations.	<ul style="list-style-type: none"> ■ Fixed charge plus <i>ad valorem</i> rate charged on property value in excess of rate-free threshold (\$16,500 for standard properties in 2010-11) ■ Different fixed charges and valuation charges for residential, commercial and rural properties ■ Averaging of unimproved value over previous 3 years

Source: ALGA (2010), Productivity Commission (2008), Queensland Public Service Commission (2009), state/territory legislation and government websites, consultation