Funding Tasmanian local government in the future: Key issues and reform options

BACKGROUND PAPER FOR THE FUTURE OF LOCAL GOVERNMENT REVIEW

Prepared by the
Tasmanian Policy Exchange

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Acknowledgement of country

We acknowledge the palawa/pakana of lutruwita, the traditional owners of the land upon which we live and work. We pay respects to Elders past and present as the knowledge holders and sharers. We honour their strong culture and knowledges as vital to the self-determination, wellbeing, and resilience of their communities. We stand for a future that profoundly respects and acknowledges Aboriginal perspectives, culture, language, and history.

About the Tasmanian Policy Exchange

The Tasmanian Policy Exchange (TPE) was established in 2020 to enhance the University's capacity to make timely and informed contributions to policy issues and debates which will shape Tasmania's future.

The TPE works with government and community partners to identify and address significant issues where the University can make a positive impact on Tasmania's future. It also works with staff from across the University of Tasmania to develop evidence-based policy options and longer-term collaborations.

The TPE's recent policy analysis includes:

Options for cutting Tasmania's transport emissions

Analysis of Tasmania's carbon emissions

Other TPE background research papers produced for the Future of local Government Review are available on the Review website.

See more at www.utas.edu.au/tpe

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1. Introduction: Funding the future of local government

The Future of Local Government Review (FoLGR) commenced in January 2022 and has progressed through three main stages. Stage 1 involved community consultation, research, and evidence-gathering. Stage 2 focused on developing and testing a broad range of reform options. Stage 3 (the current stage) is concerned with developing and delivering a specific set of reform recommendations to the Minister for Local Government, supported by a clear and practical implementation plan. The Review's Final Report will be delivered on 31 October 2023, after which time the Government will consider and respond to the Board's recommendations.

Reform Outcome 7 (of 8), outlined in the Interim Report, reflected the need to address funding issues, emphasising the crucial importance of a establishing a 'revenue and rating system [that] funds council services efficiently and effectively'. Regardless of any other structural or governance reforms that result from the Review, there are aspects of the current rating and revenue of councils that could be improved. Crucially, any future funding model must be equitable. Equity considerations include both the allocation of Australian Government Financial Assistance Grants and the distribution of the rating burden, with special attention paid to ensuring that rural and regional councils can sustainably fund high-quality services for their communities.

This research report considers how councils are funded and explores some of the ways in which the current system could deliver more equitable, efficient, and sustainable funding for the future of local government in Tasmania.

1.1 The aims and scope of this Report

The question of how best to fund local government in the decades ahead is complex and will be shaped by councils' evolving role and future community needs. The options explored in this report have been informed by the wider policy literature on local government funding, the experience of other jurisdictions across Australia, and data gathered from the Future of Local Government Review's extensive community and sector consultation. The modelling and analysis draw on a wide range of data sources, including Tasmanian council information reported in the Tasmanian Government's Councils Consolidated Data Collection (CDC), and the State Grants Commission.

The report begins with an assessment of whether the current system of funding local government is efficient, equitable and likely to meet the future needs of Tasmanian communities. Good practice funding models from elsewhere will be explored, followed by a discussion of the likely future funding needs and potential reform options for Tasmanian local government.

The Report addresses three broad questions:

1. How is local government in Tasmania currently funded? How does it compare with other jurisdictions?
2. Is the current funding regime:
    - Consistent with accepted principles of good tax design?
    - Efficient and sustainable and likely to enable to councils to meet the future needs of Tasmanian communities?
3. Having assessed the existing funding system the report considers:

- Which funding reform options would enable Tasmanian councils to more efficiently, effectively, equitably, and sustainably meet current and future community needs?

1.2 Outline of the Report

The Report consists of five sections, beginning with this introduction.

Part Two begins with a brief overview of local government funding in Tasmania and how it compares to other jurisdictions elsewhere in Australia and internationally.

Part Three explores the theoretical underpinnings of efficient and equitable tax design, outlining the key principles that should underpin future-focussed reform of Tasmania local government funding.

Having established a set of principles and criteria for funding local government in the future, Part Four provides an assessment of Tasmania's current funding regime against three key criteria: financial sustainability, equity, and future community needs. This section considers several areas of the current system that could be made more equitable and sustainable.

Part Five presents preliminary analysis of potential reform options which could be considered during the technical and implementation phases to follow the present Review, as well as other periodic internal Review processes at the State Grants Commission and Office of the Valuer General, for example. Given that the structure of Tasmania's system of local government will continue to evolve, and reflecting the specific needs of smaller rural councils, much of the modelling is organised using the Australian Classification of Local Governments (ACLG) to establish the impacts of specific reforms on councils of different sizes. This section concludes with an assessment of proposed funding reform options against the criteria outlined in Part Three, along with a discussion of considerations relating to the transition and implementation processes. These options for reform are summarised in Section 1.3 below.

1.3 Summary of key findings and reform options

Criteria	Assessment	Possible reform directions (see Part 5)
Financial Sustainability	Councils are financially sustainable on a cash operating basis but are struggling to maintain infrastructure and services. Small rural councils are especially vulnerable, and most councils will lack the resources and capability to meet future service needs, highlighting the need for funding and structural reform.	• Structural reform and shared services delivered via regional partnerships/revenue-sharing arrangements. • More consistent and progressive rating. • More equitable grant distribution.
Simplicity	While land is a highly efficient and desirable tax base, the local government rating system as currently configured is overly complex, lacks transparency and highly variable between different councils, suburbs and localities, and land uses.	• More consistent rating within and between LGAs. • Less reliance on fixed fees and charges.
Equity and efficiency	Tasmanian councils' existing rating schedules are regressive, meaning that the relative burden of rates is often highest on lower-value properties. This problem is compounded by inequity between council areas, with poorer LGAs typically shouldering a greater rate burden than wealthy ones.	• Progressive marginal rating schemes supported by credible and up-to-date valuation data. • Fuller equalisation enabled by reforms to grant allocation methodology.
Future Need	Without intervention, many smaller rural and regional councils are unlikely to be capable of adapting to rapidly changing service provision expectations and community needs.	• Structural reform and shared services delivered via regional partnership arrangements. • Fuller equalisation enabled by reforms to grant allocation methodology.

2. Funding local government: Current practice in Tasmania and beyond

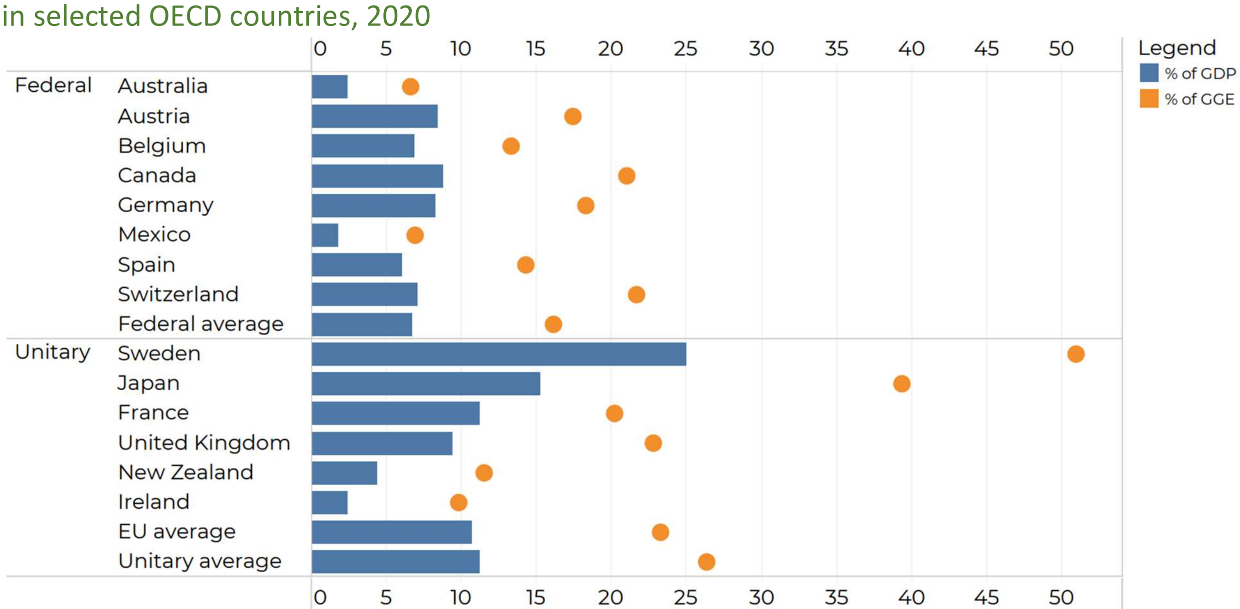
Local governments around the world play a significant and increasingly important role representing and supporting local communities. Beyond a common focus on providing infrastructure and delivering services to promote community development and wellbeing, systems of local government vary significantly according to political circumstances and the specific needs and priorities of the communities they serve. Despite this variation, some basic and fundamental local government roles, functions, and funding practices are more or less consistent across jurisdictions.

Local governments around the world also face many similar fiscal and governance challenges. In a rapidly changing economic and political environment characterised by increasing connectedness Australian and Tasmanian local government can learn from innovative practices close to home and farther afield. This section provides a brief overview of how local government funding in Tasmania compares with other states and other countries, as well as how it varies across Tasmanian councils.

2.1 Local government funding: International trends

In 2021-22, Australian local governments raised roughly $55bn in total revenue from sources including taxation (rates, the largest share at 38% overall), fees and charges, sales of goods and services, interest and dividends, and tied and untied grants or subsidies (accounting for 19% of overall revenue). Although large in absolute terms, the relative size of local government in Australia is small in comparison with other advanced democracies. At around 5.7% of general government expenditure, Australia's local government sector is the second smallest in the OECD, with only Mexican local governments accounting for a smaller portion of total government expenditure. As a share of GDP, Australian local government expenditure is also small relative even to other OECD federations, and especially compared with unitary systems (Figure 1).

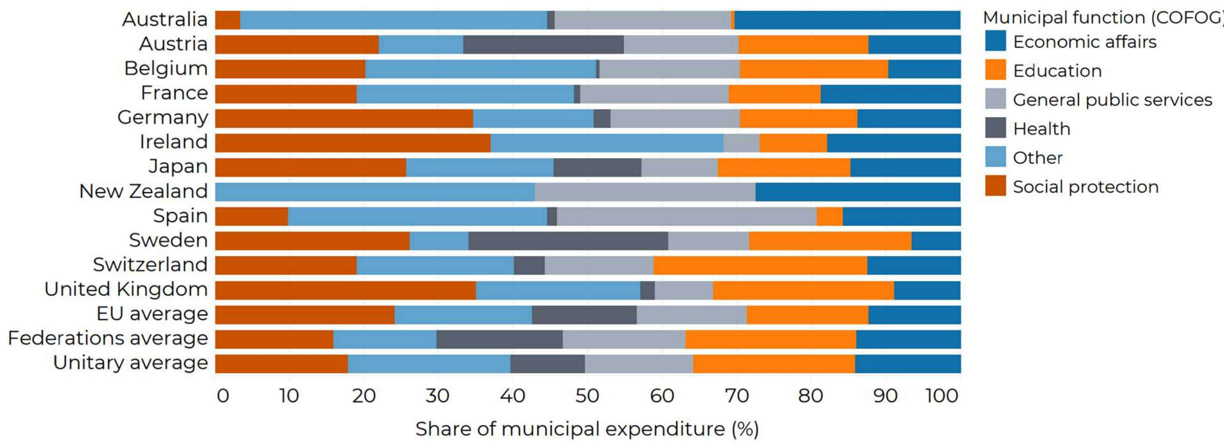
Figure 1: Local government expenditure as a share of GDP and general government expenditure in selected OECD countries, 2020



Variation in local government roles and spending

In addition to their small size relative to other tiers of government and other local government systems around the world, Australian councils are for the most part responsible for a narrower range of roles and functions. More specifically, Australian local governments spend far less on core social services like education, social welfare, and health than the OECD average (as these are mostly the responsibility of higher tiers of government in Australia). In this regard, the categories of expenditure and functions of Australian local government are most similar to those of the Spanish or New Zealand systems (Figure 2 below).

Figure 2: Local government sector expenditure by function in selected OECD countries, 2020



Variation in local government funding

Perhaps surprisingly given their smaller expenditure needs, Australian councils generate a high share of own-source revenue by comparison with other OECD federations. With grants accounting for a smaller share of their overall revenues than all except Switzerland and New Zealand (see Figure 3 below). The portion of this revenue derived from property taxes is comparable to other similar jurisdictions. Though Australian local governments also generate a relatively large amount of revenue from fees and charges (29%), with key sources including utilities (the specific utilities provided at the local level varies between states), parking, and specific charges.

Jurisdictions that cap or limit rate rises rely more heavily on fees and charges given their constrained ability to raise sufficient revenue from taxation (this is especially true of New South Wales but also affects councils in Victoria).

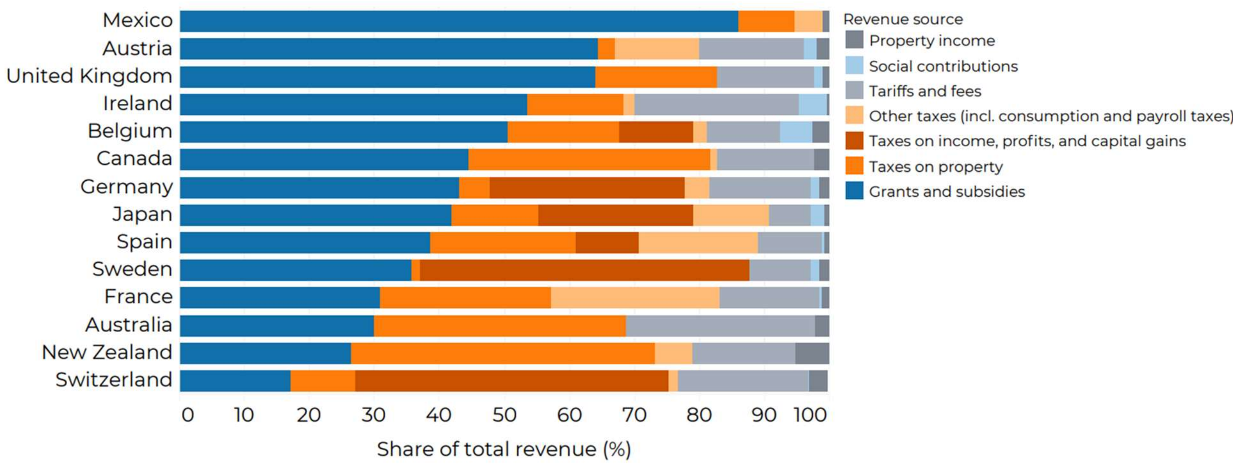
Another explanation for Australian councils' higher-than-average reliance on fees and charges is their comparatively narrow tax bases. In many other national systems (France, Spain, Japan, or Switzerland, for instance), municipal governments generate tax income from a very wide range of different bases (including personal and corporate income as well as various taxes on specific goods and services). Australian and British local governments, by contrast, rely

Australian councils are more financially self-sufficient and less dependent on grants than local government in most OECD countries, though they are also responsible for a far narrower range of functions and services.

almost exclusively upon forms of property taxation which is arguably the most appropriate tax to apply at a local level.

As noted above, rates comprise roughly 38% of Australian local government revenues on average, with grants (29%) and tariffs and fees (29%) accounting for most of the remainder.

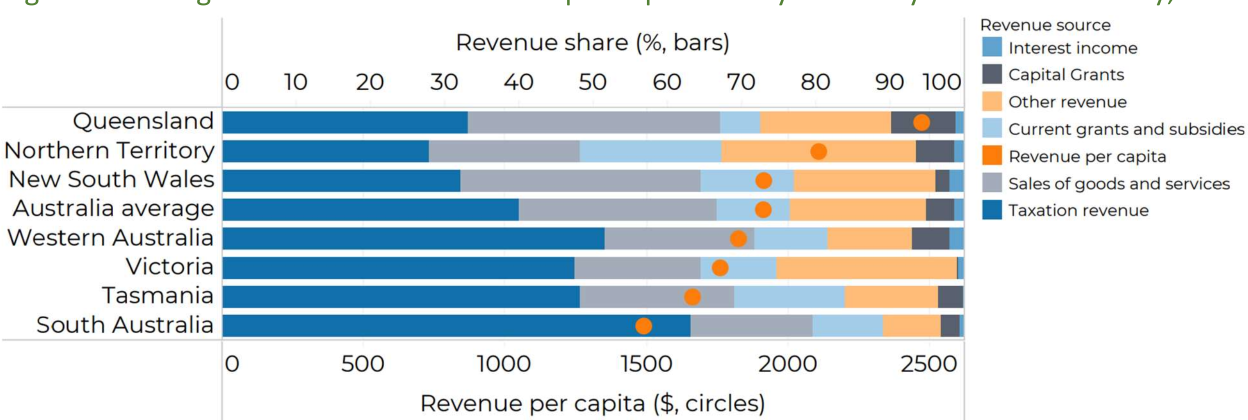
Figure 3: Local government sector revenue shares by source in selected OECD countries, 2021



2.2 Funding local government: How Tasmania compares

Tasmanian councils' revenue per capita is the second lowest in the country behind South Australia, despite receiving 14% of revenue from grants and transfers relative to a national average of 10%. The revenue Tasmanian councils raise from rates is also higher than the national average at 48.3%, though that average is skewed by the comparatively small share of rates in the revenue mix of New South Wales councils (largely a result of that state's rate-capping system) and the Northern Territory. Councils in South Australia and Tasmania rely on fees and user charges less than larger states (Figure 4).

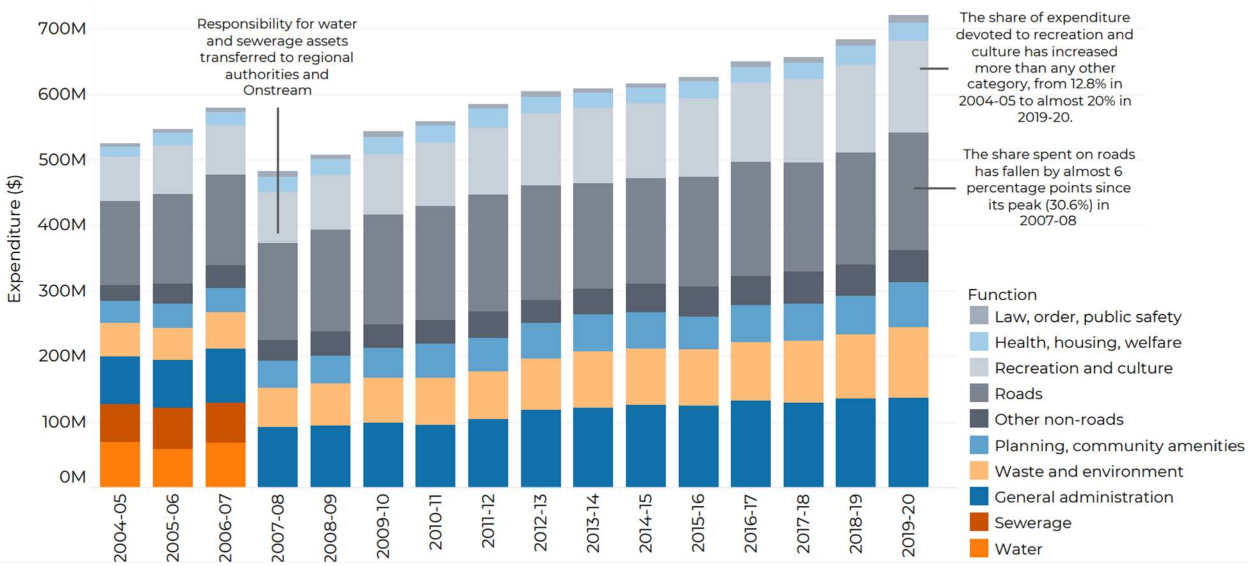
Figure 4: Local government sector revenue per capita and by source by state and territory, 2021



Tasmania's below-average per capital council spending largely reflects the consolidation of water and sewerage assets and responsibilities in 2007. While TasWater is a council-owned entity, its spending is not included in ABS data on council spending (Figure 5).

On average, Tasmanian council rates are lower per capita than any other state and spending per capita is 7.5 % below the national average.

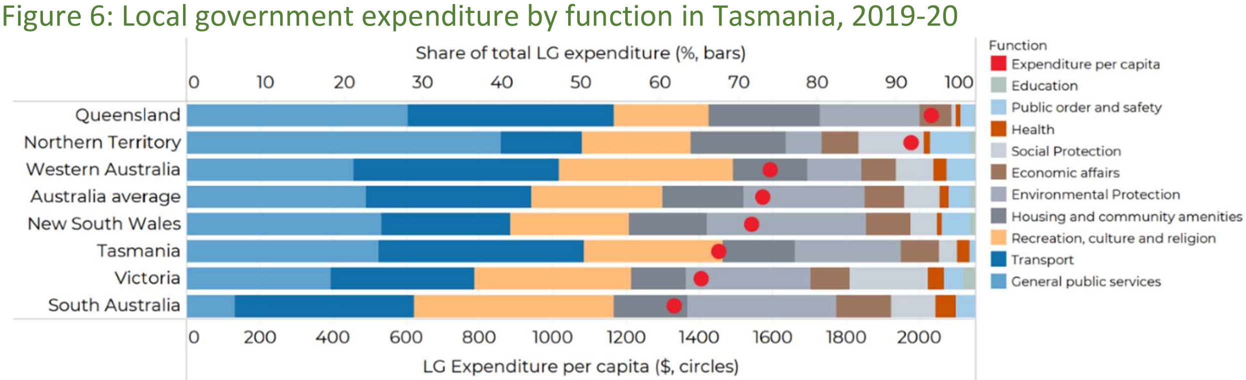
Figure 5: Local government expenditure by function in Tasmania, 2004-05 to 2019-20



Compared to the national average and most other states and territories, Tasmania's spending mix is fairly typical. Tasmania is on the lower end of total council expenditure per capita, but close to the national average on most individual functions except transport, for which it ranks equal second with Queensland behind Western Australia.

As in other Australian jurisdictions, spending by Tasmanian councils on recreation and cultural services has increased significantly in recent years.

Figure 6: Local government expenditure by function in Tasmania, 2019-20

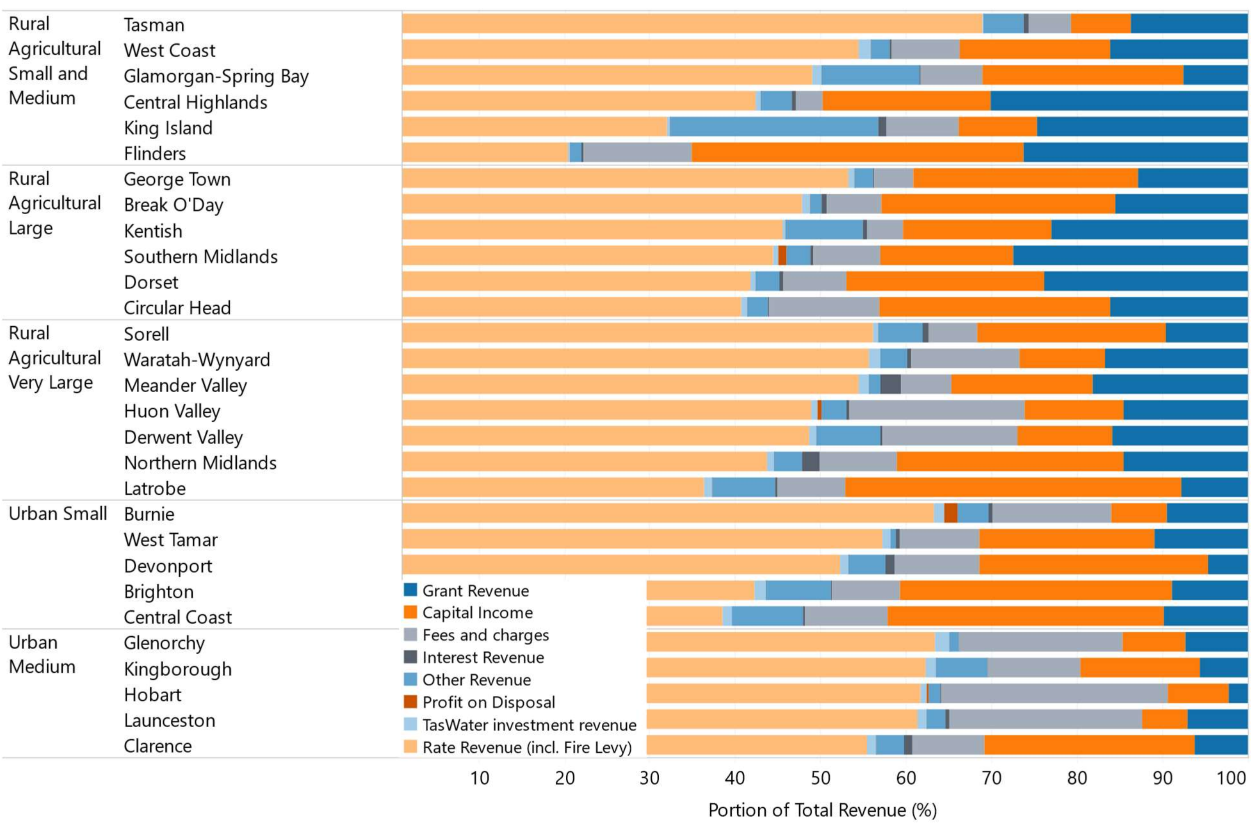


2.3 Variations in funding across Tasmanian councils

For a range of historical and geographical reasons, Tasmanian councils vary enormously in size and in the roles they play, the services they provide and how they are financed. Compared to large urban councils, rural councils with small rate bases and relatively high costs can only meet part of their costs through rates. For example, the City of Launceston has a population of roughly 68,000 and total rate revenues of over $71 million which meets more than 60% of expenditure needs. Flinders Council, at the opposite end of the spectrum, serves a population of under 1,000 and has rate revenue of just $2.8 million (around 20% of total expenditure).

Revenue from rates and other fees and charges are supplemented by a range of tied and untied grants. These account for [approximately 12.5% of local government funding in Tasmania](). Commonwealth Financial Assistance Grants (FAGs) are the single most important source of grant income and are distributed among councils by the State Grants Commission (See 5.4 for more detail). The Commission uses an equalisation formula which considers the road network councils manage and the needs of their communities. Given this approach, smaller rural councils receive a greater share of grant funding relative to their urban counterparts. Such that grant income accounts for more than 50% of total revenue for Tasmania's smallest councils whereas grants account for less than 10% of income for larger urban councils (Figure 7).

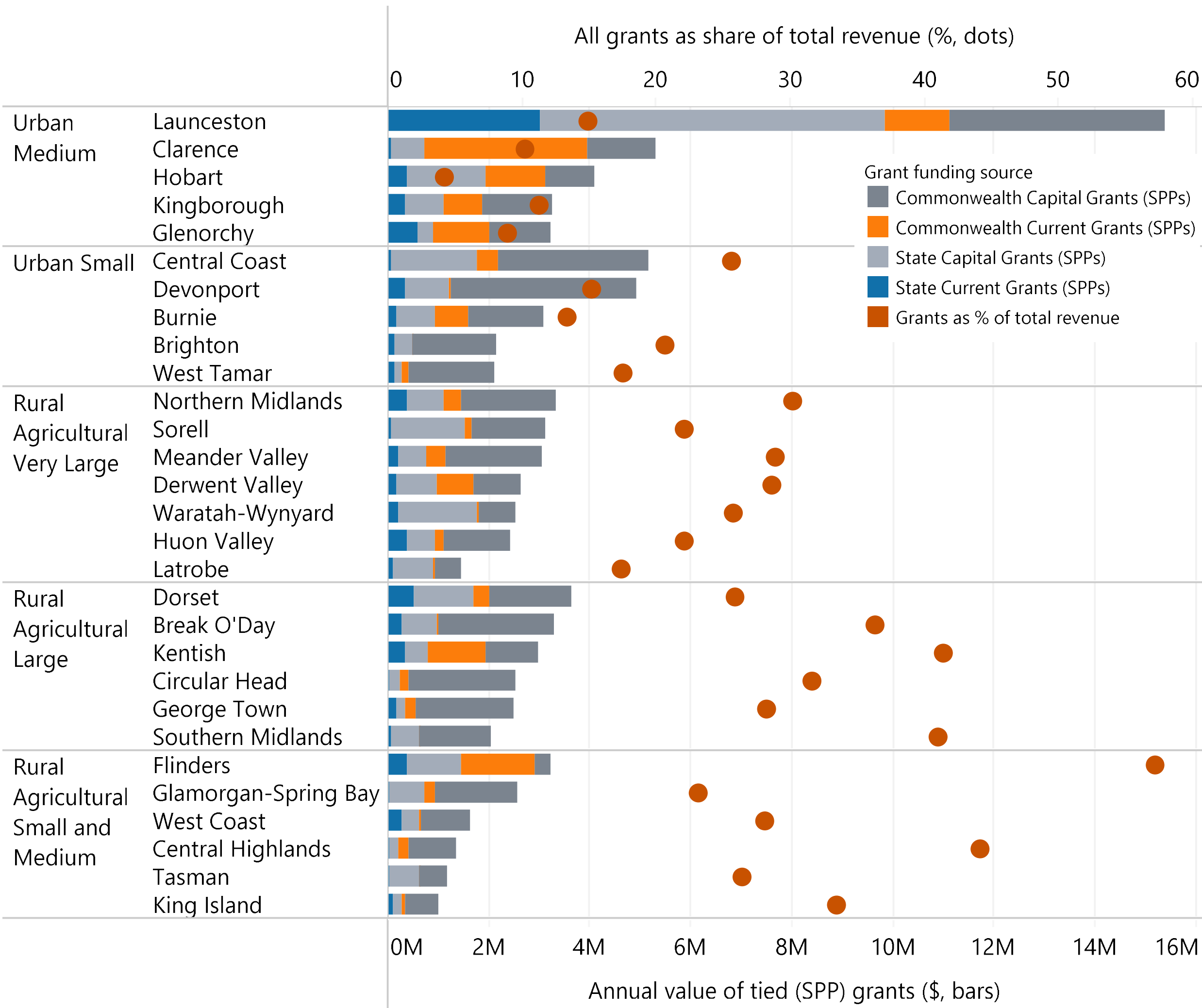
Figure 7: Local government revenue sources by ACLG, 2020-21



The requirement that FAGs be allocated on a full horizontal equalisation basis has helped smaller, rural councils with less fiscal capacity to meet the needs of their communities. However, the quantum of funding distributed on the basis of need isn't sufficient to address all councils' assessed deficits (Section 5.4). Given this deficiency, it is also likely that scale and design of the equalisation regime will have to evolve to meet the changing needs of the local government system and the wider Tasmanian community. The principles that should inform a future funding system are outlined in the next section of the Report and more detailed analysis of options for reforming the distribution of grants to councils are presented in parts four and five.

Untied financial assistance grants represent the largest pool of local government grant funding in Tasmania. However, councils also receive tied special purpose payments from both the state and Commonwealth governments for specific programs and capital projects (Figure 8 below).

Figure 8: Average annual tied (state and Commonwealth SPP) grant funding and all grants as a share of total revenue by LGA, 2015-16 to 2021-22



Like financial assistance grants, these special purpose payments vary enormously among councils, though Launceston stands out as a very significant recipient over the past six years. Although grants represent a fairly modest share of Launceston's overall revenue (15%), in absolute terms they have received more than three times as much tied SPP grant funding as any other council on average since 2015-16.

2.4 Conclusion and key insights

This brief analysis of how the funding of Tasmanian local government compares with national and international practice as well as intrastate variations reveals the following trends.

- The expenditure of local government in Australia is smaller than all OECD countries except Mexico. Australian councils also perform a comparatively narrow range of functions, focussing primarily on roads and other local infrastructure, waste, stormwater, and some social and community services.
- As taxation has become more centralised the international experience is that local government is increasingly being funded by grants and transfers from higher levels of government.
- While the sector as a whole is relatively self-sufficient in terms of revenue raising capacity, smaller rural and regional councils in particular rely heavily on tied and untied grant funding. This is certainly the case for small Tasmanian councils.

The extent to which the mix of grants, rates, and other revenue sources used to fund local government in Tasmania is consistent with the principles of good tax design is assessed in next two sections of this report, while options for reforming the funding model are discussed in Part 5.

3. Future funding design and needs

In order to ensure the continued provision of crucial services and infrastructure to Tasmanian communities, reforms of the kind being contemplated by the FoLGR will be effective only to the extent that they are supported by fair funding models to smooth financial impacts on communities. We all understand that councils require revenue from rates, grant funding, and fees and charges to operate effectively. However, it is equally apparent that determining how much revenue councils need and how it should be raised and spent involves difficult trade-offs between a wide range of political considerations.

Given the inherently contested nature of all taxation, it is important that the design of future funding systems for local government in Tasmania is informed by widely accepted principles of tax design. This section will briefly outline these principles (3.1) and discuss how they can be applied to the design of local government rates as a broad-based property tax (3.2) in combination with other fees and user charges (3.3). The section concludes by considering the implications of the specific reform priorities identified in the FoLGR's *Stage 2 Interim Report* for the future funding of local government in Tasmania.

3.1 Principles of good tax design

The design of any tax system must strike a delicate and difficult balance between several competing objectives. Over many decades, scholars and policy makers with an interest in the economic and financial impacts of taxation have developed and refined a series of design principles to ensure that taxes are fair, efficient, simple to administer, and difficult to avoid.[1] By following and applying these well-established tenets of good tax system design, governments can minimise the unintended consequences and negative impacts of taxation while still raising the revenues required to sustainably deliver quality services to their communities.

Efficiency – minimizing economic distortions when raising taxes

Applying a tax has an impact on taxpayers' welfare and behaviour as well as overall economic efficiency because it distorts decisions about investment, employment, property ownership, and development. When considered at a state or national level, these impacts can in turn have further negative consequences for productivity and economic growth.

If distortions can be minimised and revenue is well spent, however, there will be a net welfare benefit to the community. Therefore, a tax can be considered efficient to the extent that it minimises unintended[2] impacts on the behaviour of actors in the marketplace while maximising revenue and general welfare.

There are numerous technical measures of the efficiency of different types of taxation, but one of the most widely accepted approaches involves modelling the 'marginal excess burden' of taxation, or the

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[1] The core principles of taxation and public finance are clearly articulated in Musgrave and Musgrave *Public Finance in Theory and Practice* (1959). Which in turn have been adopted as a framework for numerous tax and funding reviews in Australia and beyond. This includes the 2009 *Australia's Future Tax System Review* (The Henry Review) as well as reviews of local government finance and rating such as the Victorian *Local Government Rating System Review* (2020).

[2] Some taxes, like tobacco excise or carbon taxes for example, deliberately distort taxpayer decision making by disincentivising behaviours considered harmful or undesirable.

economic cost of raising an extra dollar of taxation. Some key findings of excess burden modelling in the Australian context in recent years are summarised in Table 1 below.

Table 1: Findings from excess burden modelling

Tax Change (most efficient to least efficient)	Economic cost of each additional dollar raised
Broadening GST base to include fresh food	$0.10
Local government rates	$0.23
Payroll tax	$0.37
Income tax surcharge	$0.41
State land tax (narrow base)	$0.48
Property stamp duty	$0.87
Corporate tax increase to 30%	$1.39

Source - Murphy (2016)[3]

These insights suggests that, across Australia as a whole, local government rates are among the most economically efficient taxes available. This is because the tax is simple to apply, only minimally distorts behaviour, and is very difficult to avoid due to the fixed nature of the base (land and/or improved property).

Equity – ensuring the appropriate distribution of the tax burden

The second key principle of good tax system design is equity, or a fair distribution of the burden of taxation between people and places of different means. Tax equity has two dimensions:

- **Vertical equity** is the idea that taxpayers with a greater capacity to pay should shoulder a greater tax burden than people of lesser means. Some taxes are proportional to a taxpayer's income or wealth (applied at the same rate regardless of income or means) while others are progressive, meaning that the rate at which tax is paid increases with income or wealth. The argument for progressive taxation is both normatively desirable and economically efficient according to the concept of the 'marginal value of income': the idea that $50 is more 'valuable' to a poorer taxpayer than a wealthier taxpayer. This is only true within certain parameters, however, and very high marginal tax rates can come at the expense of economic efficiency.
- **Horizontal equity** requires that taxpayers in similar circumstances should be treated in the same way. For example, two people earning the same income or two properties of the same value should be subject to the same level of taxation regardless (within reason) of where or who they are. Maintaining horizontal equity is important for procedural fairness and to minimise economic distortions.

Simplicity – ensuring a tax system is practical, easy to administer and for taxpayers to comply with

A tax system should be as practical and simple as possible in its design to ensure efficient and accurate administration, and to reduce the cost of compliance for taxpayers. A simple, transparent tax system

[3] Murphy, C., 2016 *Efficiency of the tax system: a marginal excess burden analysis*.

that is widely understood is also more likely to be regarded as legitimate in the eyes of taxpayers. As well as being simple to understand, simple, transparent tax systems are usually harder to avoid.

Council rates are among the simplest of all taxes in this regard because it is practically impossible to avoid taxes on improved land value. By contrast, some tax bases (like capital) are far more difficult to tax because they are highly mobile and therefore can move easily to jurisdictions where they will attract a lower rate of taxation. This has important implications for fairness too. While high-net-worth individuals or large companies have a disproportionate ability to avoid or minimise many forms of income and wealth taxation, the difficulty of avoiding land or property taxes means that all landholders can be made to contribute in a manner commensurate with their means.

Sustainability – ensuring that a tax system will be able to meet future revenue needs

The sustainability of a tax system has two dimensions. First, a sustainable tax system should be robust, with limited vulnerability to changing economic preferences, the business cycle, or tax minimisation strategies. Second, it should be flexible and able to grow in line with the overall economy, readily adapting to meet future revenue needs.

3.2 Property tax as a basis for funding local government

Rates based on the improved value of property are the most important single source of income for Tasmanian councils, typically accounting for just under half of their total revenue (Figure 7). This section provides a preliminary assessment of the alignment between local government rates and the principles of good tax design outlined above. A more detailed of analysis of Tasmania's rates regime is presented in Part Four.

Table 2: Alignment between local government property rates and good tax principles

Design principle	Rates on improved property value
1. Efficiency	• As noted above, broad-based property and land taxes are among the most efficient taxes available. • There is a debate about the merits of whether to tax unimproved or improved land value. The disincentive for developing land associated with a tax on improved land value (as in Tasmania) can be mitigated by a differential rate on vacant property (See 5.1.1). Tax on unimproved value, however, risk the creation of both horizontal and vertical equity issues. On balance, therefore, capital improved values are the preferable base (see text box below).
2a. Vertical Equity	• Housing is a major form of wealth in Australia, and well-designed broad-based property taxes are consistent with the principle of vertical equity if we assume that property values are a reasonable proxy of owners' ability to pay. • A property tax regime will be more equitable if concessions are made for asset- rich but income-poor homeowners. The merits of needs-based rate deferral regimes are outlined in section 5.1.5.

	• From the perspective of vertical equity, there is considerable merit in applying a higher differential rate on high-value properties above a certain threshold (See 5.1.1). In order not to disincentivise investment by large scale investors (such as emerging build-to-rent schemes), however, the rate should be applied progressively to individual property values, not the combined value of a person or entity's holdings. • Flat-rate structures or rate schedules with fixed base charges are inconsistent with the principle of vertical equity.
2b. Horizontal Equity	• Rating systems that apply different rates to properties of the same value in different localities are inconsistent with the principle of horizontal equity. • Rating regimes with significant exemptions or that place very different burdens on different land uses or property types are likewise inconsistent with the principle of horizontal equity (though in some cases variations occur for other reasons, see p. 45). • A lack of interregional horizontal equity is a major challenge for Tasmanian local government rates. In some cases, this may reflect different levels of service provision (which is legitimate). Except it often reflects the fact that different councils have to vary their rating effort to fund a given level of service. This should be addressed through equalisation payments, but the limited size of the base grant pool means it cannot achieve true full horizontal equalisation (See 5.4).
3. Simplicity	• Rates based on improved property values are a reasonably intuitive and, in theory at least, simple form of taxation. • Complications arise because the calculation of rates requires three elements: 1. The classification of the land/property being rated (the fewer categories, the better). 2. A credible and up-to-date estimate of the value of the property being rated. The challenge here is that this can't be based on a market or realised value, in contrast to a consumption tax. 3. A clear and consistent rate schedule applied to properties of a given classification and value. • Ideally, a simple and consistent approach to classifying and valuing property and the associated rating framework would be applied across a state. Then councils would simply vary the cents-in -the-dollar rate applied to meet their budget need. • A final factor contributing to the complexity of local government rates in Australia is the fact that state-level land taxes are applied to the same base (albeit with major exemptions). There is a strong case for the integration of council rates and state land taxes in Australia.

4. Sustainability	• Broad-based property taxes are consistent with the principle of sustainability as they are not as vulnerable to vagaries of the business cycle and consumption trends. In fact, taxes on property are the only Australian taxes whose revenues have kept pace with economic growth over the past two decades. • Volatility in property markets can create short term budget challenges and uncertainty for taxpayers, but can be mitigated by using credible and timely valuation methods

In theory, a carefully designed system of local government rates based on improved property values aligns with the principles of good tax design. The extent to which Tasman's current funding regime aligns with these ideas and associated reform options are discussed in parts four and five below.

What is the best base for council rates?

In Tasmania, council rates are set according to valuations provided by the Office of the Valuer General. These valuations provide three different figures upon which councils can levy rates: unimproved land value, capital value (CV), and assessed annual value (AAV). Most Tasmanian councils use AAV to set their rates (a small number do use CV, see Table 9), though this choice varies across the country – in Victoria, for example, the opposite is true and most councils rate CV.

This choice of tax bases is highly consequential and has important implications for equity as well as for investment and development. While different councils likely base their decisions on resident preferences and their own particular mixtures of different land uses, opinions among economists regarding which base is the most efficient and equitable vary considerably.

Some scholars argue that taxing capital improved values is more equitable while taxing unimproved values is more efficient. While this may be true at the aggregate level, others counter that the equity implications of the two bases vary across different parts of the income distribution. For this reason, according to the latter view, the same amount of revenue raised from land value versus capital improved value will be more equitable because wealthier taxpayers are more likely to own underutilised land. Moreover, taxing unimproved values considerably increases the burden on undeveloped land and therefore acts as a proxy vacant property tax, spurring investment and incentivising efficient development.

A further important question concerns whether land or property taxes should be applied only to individual properties or to the combined value of an owner's property portfolio. Most experts agree that taxing the combined value of landholdings, while more efficient, disincentivises very large (often institutional) investors, which explains the problematic dominance of smaller 'mum and dad' investors in the Australian property market.

With these considerations in mind, it may be that the most efficient and equitable approach would be for councils to tax capital improved land value at the individual property level but with a progressive rate, perhaps using a separate higher rate for vacant land. This would ensure that higher-wealth households pay more without disincentivising large and very large investors, while also spurring development of underutilised land.

3.3 User charges as a basis for local government funding

Beyond residential rates, a wide range of fees and charges are the second largest source of funding over which councils have control. In 2021 in Tasmania, fees and charges account for around 23% of revenue, or $246 million. While in New South Wales and Queensland this figure is much higher (29.5% and 32.8% respectively).

User charges are often more politically palatable than other forms of taxation and revenue raising, as residents are usually choosing to use a service and presumably derive a benefit from doing so. From the perspective of good tax design, user charges are legitimate depending on the type of service being provided. A key consideration in the economics literature is establishing whether a good or service is *excludable*, in that access can be limited or regulated and whether a good is *rivalrous*, in that the supply of a good or service is limited and declines with consumption.[4] These two concepts can be used to create a two-by-two matrix to define four conceptually distinctive types of goods and services which, according to the principles of good tax design, should be funded using distinctive approaches.

Table 3: The theoretical rationale for user charges

	Rival Consumption (Finite supply)	**Non-rival in consumption (Consumption doesn't reduce supply)**
Excludable	**Private good** (e.g., food) Benefits captured by consumer Private provision and privately funded	**Club Good** (e.g., destination marketing, streaming service) Benefit tax or user charge on club members, equal to or greater than the benefit
Non-excludable	**Common Pool Resource** (e.g., forests, public car parks, public transport) User charge proportional to private benefit	**Public Good** (e.g., policing, air quality, ABS data) General taxation and regulation as it would be wasteful to discourage use by charging

Table 3 provides a theoretical rationale for imposing user charges on both common pool resources and club goods. In practice, these distinctions aren't clear cut because many goods and services in these categories deliver both public and private benefits, or what Musgrave (1959) defined as *merit goods*. Public car parking is a good example. While a driver receives a private benefit from being able to park their car near the city centre, there are also broader benefits associated with increased community mobility or easier access to retail businesses and so on. One important distinction between common pool resources and club goods is that the providers of club goods can capture the revenue from the products they provide, negating the need for public provision or subsidies. In contrast, without a degree of public subsidy and provision, there will be less than optimal provision of common pool resources. The theory suggests that private contributions should therefore be proportional to private benefits, although other policy objectives – such as redistributing resources to those with less ability to pay – are also legitimate considerations.

[4] See Australia's Future Tax Review (2009), Section E1.

In practice, this means that some user charges and developer contributions are appropriate for some services and infrastructure (see 5.2). However, they should be proportional to the cost of provision less any broader public benefits. In the case of developer contributions or headworks charges, the principles of good tax design suggest that developers should pay the cost of any infrastructure required specifically for a private development. Potentially discounting for the extent to which future rates offset capital costs.

It is, of course, understandable that in the midst of a housing affordability crisis, governments may be tempted to cut or waive headworks charges to encourage investment in new housing supply. However, this would likely result in unintended consequences such as development in areas where land is cheap, but infrastructures costs are very high. A more transparent and efficient approach is to apply headworks charges on a marginal cost basis and provide separate, transparent subsidies to developers building appropriate housing. More detailed analysis of infrastructure charges and other developer contributions is provided in section 5.1.4.

3.4 Funding reform and the *Future of Local government Review*

The Interim Report of the *Future of Local Government Review*, published in March 2023, outlined five specific principles that should inform reform proposals. In addition to ensuring that reforms include the development of fair funding models aligned with the principles of good tax design discussed above, specific reform priorities with implications for future funding include:

- Establishing funding arrangements that reflect the distinctive needs and circumstances facing regional communities;
- Funding arrangements that encourage and support collaboration, consolidation, and regional capacity; and
- Funding arrangements that meet the future needs of the Tasmanian local government sector.

Given these reform principles, the following considerations should be front of mind when developing a future funding system for Tasmanian local government.

Table 4: Reform principles and implications for future funding

Reform principles	Implications for future funding
Needs of regional communities	• Equalisation and grant payment models should promote vertical equity and sustainability. • Ideally rates should reflect lesser capacity to pay in most regional communities (while acknowledging greater community need and cost of service delivery). • Ensure efficient and effective approach to taxing large scale commercial operations in regional communities. • Encourage collaboration, partnership, and structural reform to ensure effective and sustainable councils in regional Tasmania (see below).
Encourage collaboration and structural reform	• Reforms to deliver more sustainable funding for regional communities should be contingent on regional collaboration and wider structural reform. • Models of co-funding from the state to support regional service and resource sharing.
Flexibility to meet future needs	• Reform rating regime complemented by carefully designed grants to provide adequate and efficient funding. • Periodic review and reporting of council-level rating effort and service levels to establish resource need.

This analysis of the principles of good tax design and their application to local government funding can be distilled into four broad criteria that should inform the design of a future funding model for local government in Tasmania:

1. The adequacy and financial sustainability of the current funding model
2. Simplicity and consistency
3. Vertical and horizontal equity
4. Future needs

Analysis of the extent to which the current model used to fund local government in Tasmania is aligned with these principles is presented in next section.

4. An assessment of local government funding in Tasmania

Part Three of this report summarised the principles that should underpin the design of an equitable, efficient, and sustainable funding regime for the Tasmanian local government sector. This analysis identified four key criteria against which Tasmania's current system of funding local government can be assessed:

1. Financial sustainability
2. Simplicity and consistency
3. Vertical and horizontal equity
4. Future needs

This section of the report provides a preliminary, desk-top assessment of Tasmania's current system of local government funding against these criteria as a guide to developing potential future funding reform priorities and options.

4.1 Financial sustainability

First and foremost, a funding system should provide sufficient resources to ensure that councils are able to deliver appropriate services and infrastructure for the communities they serve on an ongoing basis. While such general definitions of financial sustainability are intuitive, assessing what constitutes 'financial sustainability' and an 'appropriate level' of service and infrastructure delivery is more complex and subjective.

There is no legislative definition on what constitutes financial sustainability although there is some guidance on what may constitute adequate services. One of the objects of the Commonwealth *Local Government (Financial Assistance) Act 1995* is to improve the capacity of local governing bodies to provide their residents with an equitable level of services.

To be financially sustainable, a funding system should provide sufficient resources to ensure that councils are able to deliver appropriate services and infrastructure for the communities they serve on an ongoing basis

The Act goes on to require that grants be allocated in a way to ensure that all councils are able to function at or above the average standard of other Tasmanian councils prior to the distribution of grants. The Tasmanian *Local Government Act 1993* also provides general guidance about service provision in that it requires councils (and their councillors collectively) to consider the efficient and effective provision of services and activities.

In terms of financial sustainability, Tasmanian councils are required to prepare detailed financial statements under Australian Accounting Standards which are audited by the Tasmanian Audit Office (TAO).[5] The TAO and the Tasmanian councils Consolidated Data Collection (CDC) dashboard report a wide range of financial indicators that can be used to assess council sustainability and financial performance.[6]

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[5] Tasmanian Audit Office, April 2023, *Auditor-General's report on the financial statements of State entities*.

[6] Tasmanian Council Data Dashboard.

Of these, other Australian jurisdictions[7] focus on three key indicators to provide a an assessment of the short- to medium-term financial sustainability of councils: operating surplus ratios, asset funding sustainability ratios, and debt service cover ratios.

Table 5: Key financial sustainability indicators for councils in the short to medium term

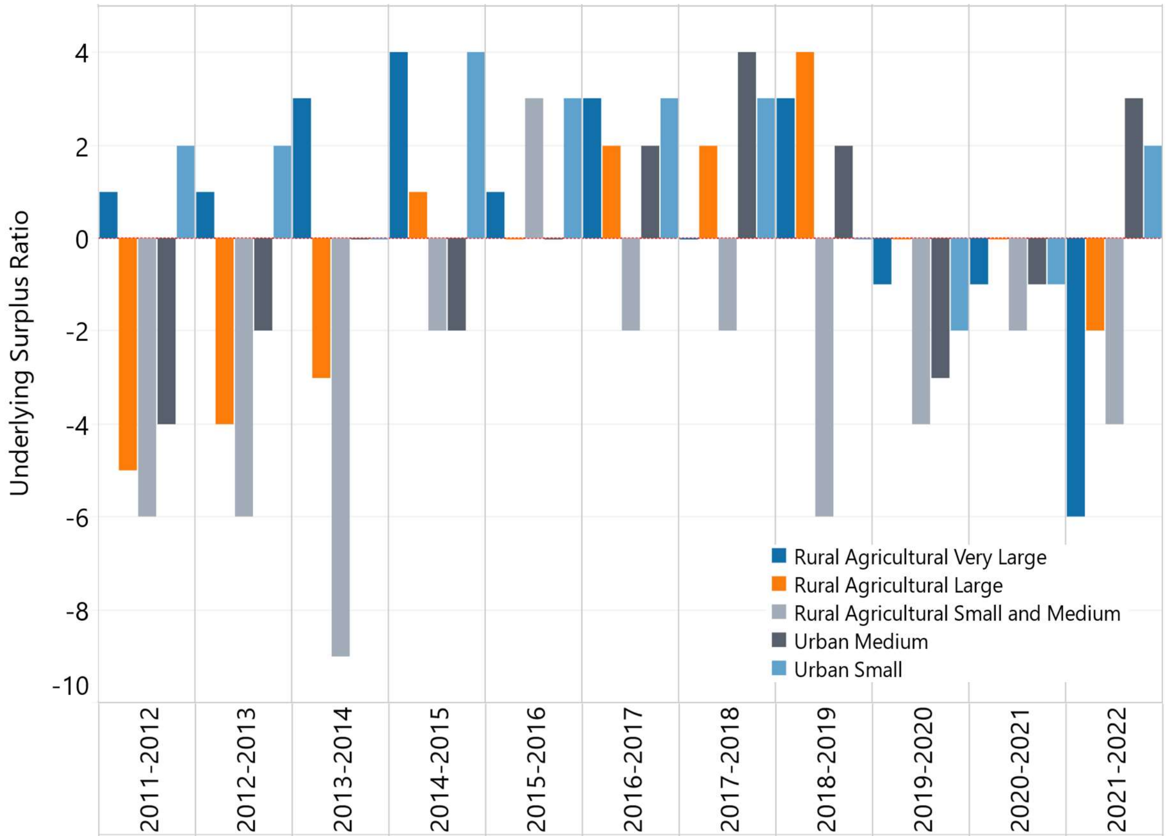
Indicator	Target	Rationale
Operating Surplus Ratio	Should remain positive over the business cycle/medium term.	Indicating councils have the resources/ cashflow to meet operating expenses, maintain infrastructure and service debt.
Asset Funding Sustainability Ratio	Should be 90% or above over time, especially in communities with growing infrastructure needs.	Indicating that council investment is sufficient to maintain existing infrastructure.
Debt Service Cover Ratio	Ideally below 20% and not increasing over time.	Indicating the extent to which debt and other financial liabilities can be met from available cash and liquid assets.

Analysis of the financial performance of Tasmanian councils grouped by the Australian Classification of Local Government (ACLG) against the three key indicators is presented below. While it is important to acknowledge that specific factors and events, such as the COVID-19 pandemic in 2020-21, had a significant short-term impact. The financial performance of individual councils and the sector as a whole, broad financial trends and sustainability challenges are evident in these data.

Figure 9 presents the operating surpluses of Tasmanian councils over the decade to 2022. Overall, Tasmania's councils returned a small operating surplus over the decade despite the budget shocks associated with COVID-19. Looking at the ACLG categories, Small and Medium Rural Agricultural councils have consistently failed to achieve an operating surplus over the same period, highlighting the structural challenges smaller councils face. Figure 10 presents the asset sustainability ratios for Tasmanian councils over the decade to 2022: a key measure of whether councils are spending enough on the maintenance and the replacement of key assets to ensure they can be managed on a sustainable basis into the future.

[7] See for example: WALGA, *Local Government Financial Ratios* and Local Government Association of South Australia, *Financial Indicators*.

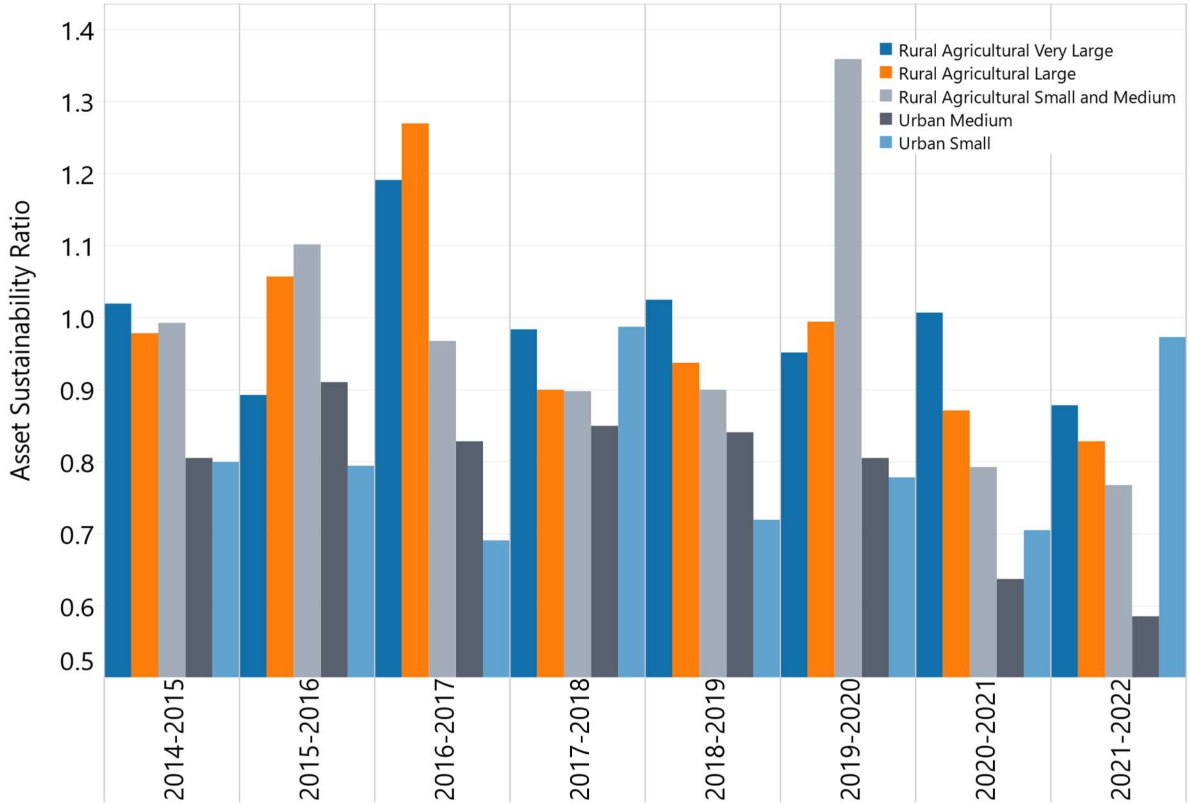
Figure 9: Underlying surplus for Tasmanian councils by ACLG classification 2011-22



Many Tasmanian councils face considerable challenges maintaining and managing assets, and the sector as a whole exhibits inconsistencies in how asset values are reported and depreciated. Challenges maintaining and replacing capital assets can in part be explained by the fact that key infrastructure is often funded by one-off grants from the State or Commonwealth government with councils funding recurrent operating costs and maintenance from existing budgets. In terms of the data, an asset funding ratio of 90% is considered the minimum to maintain the existing stock of assets and although most councils meet this standard, there has been an overall decline in the ratio since 2017. This is one of the few sustainability measures where urban councils appear to be more vulnerable than their rural counterparts. This may be because of inconsistencies between councils in how asset values are reported or because of the significant increase in infrastructure spending of many peri-urban communities in response to strong population growth in these regions.

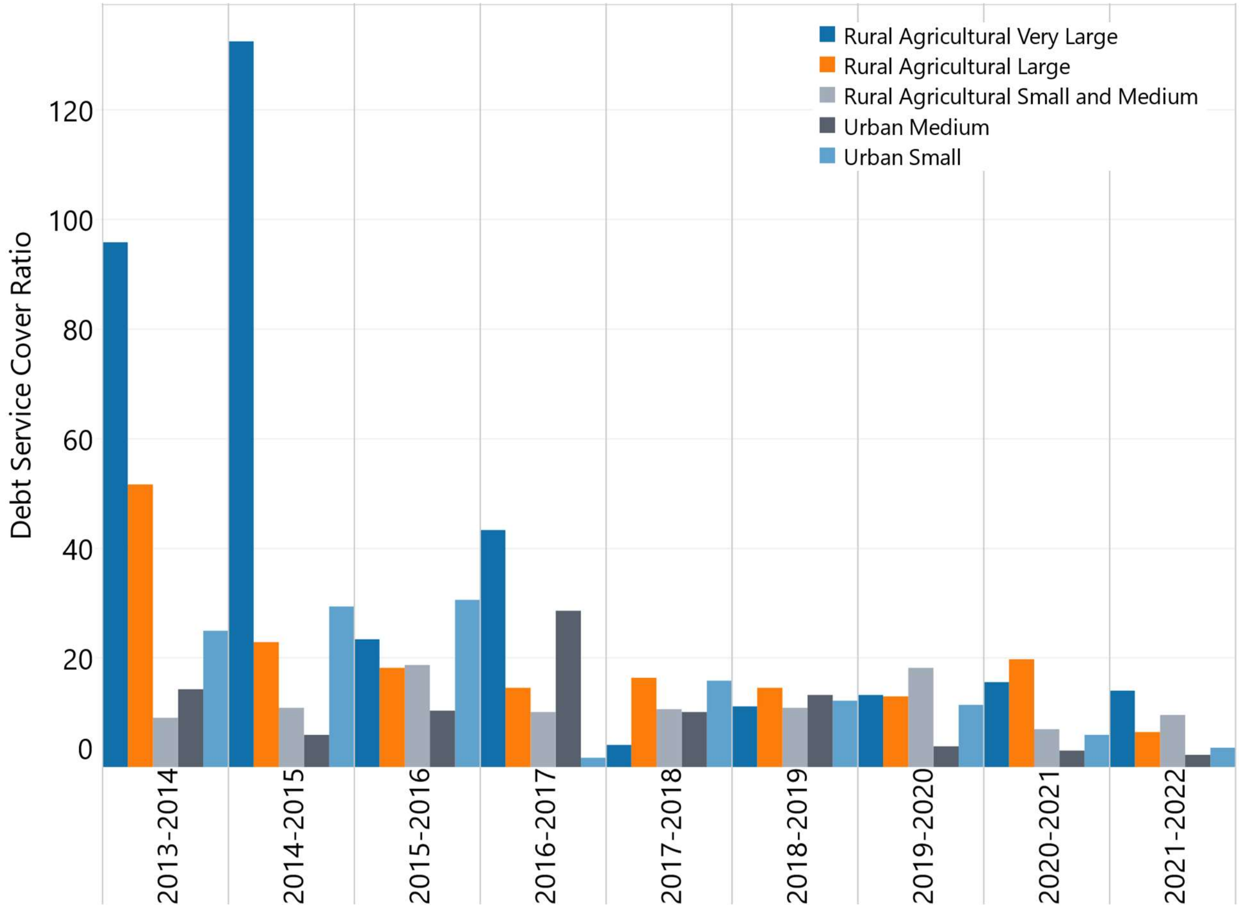
Project-specific grant funding from the State and Commonwealth government can create long-term maintenance liabilities for councils

Figure 10: Asset sustainability ratios for Tasmanian councils by ACLG classification 2011-22. Source CDC Dashboard



Councils' debt service cover ratios show the extent to which councils can service existing debts and liabilities from available cashflow. Figure 11 shows that since 2017, council debt servicing obligations have been relatively stable at less than 20% of available cash (which is considered a sustainable level). However, this ratio is likely to rise in the future, reflecting the significant increase in borrowing costs over the past 18 months. The extent and timing of the increase will depend on the nature of individual councils' borrowing arrangements.

Figure 11: Debt Service Ratio for Tasmanian councils by ACLG classification 2011-22. Source CDC Dashboard



Variations in service provision

The analysis presented above focuses on the financial sustainability of councils and the local government system rather than the more subjective question of whether individual councils across the state have sufficient resources to deliver an appropriate level of services on a sustainable basis. Under the *Local Government Act 1993*, Tasmanian councils have wide discretion about the services and infrastructure they provide with spending priorities and levels of service provision rightly decided by elected officials at a local level.

Research conducted for the FoLGR has identified significant variations in service provision across the sector. Wherein larger urban councils in particular are providing a greater breadth and sophistication of services to their communities.[8] It is possible that lower levels of service provision in smaller, rural councils reflect community preferences. Although there is a good deal of evidence that lower levels of service provision and infrastructure investment are also driven by resource constraints. This evidence includes:

- Regional and remote councils face growing pressures and often play a key role as a 'service provider of last resort'.

[8] SGS 2023 'Functional and Capability analysis' p.10.

- Generally speaking, regional councils support communities with higher needs than those of their urban counterparts (see Section 4.3). Suggesting that – all else being equal – they should be providing a higher level of service in increasingly important areas like social support and community development.
- As a product of both scale and resource constraints, smaller regional and remote councils struggle to acquire and retain the specialist staff and systems required to meet future needs.
- In addition to existing demand for services in rural and regional communities, consultation and research conducted by the Review has highlighted the evolving role and growing importance of the local government sector in the future (see Section 5.3). This will require additional resourcing and structural reform.

Financial Sustainability: Key insights

The data presented above and recent Tasmanian Audit Office reports provide key insights in relation to the financial sustainability of Tasmanian councils:

- Overall, Tasmanian councils are able to meet their operating costs from current funding sources and returned a modest, sector-wide, operating surplus ($8.8 million) in 2021. This is, at least in part, because they have not been subject to rate caps and other funding constraints applied in states such as New South Wales. Residential rates in Tasmania increased by roughly 7.3% on average between 2020-21 and 2021-22.
- Due to their limited rates base, scale, and limited equalisation funding, overall smaller regional councils face more acute financial pressures than their urban counterparts.
- Councils generally, and small regional councils in particular, have responded to cost pressures by offering fewer, lower cost services and/or investing less in asset maintenance and new infrastructure.

Overall, it is likely that councils will require additional resources and will have to achieve significant efficiency gains through structural reform to maintain existing services and infrastructure amid strong population growth and growing community needs.

4.2 Simplicity and consistency

The three broad principles of good tax design were outlined in Part Three of this report:

- Efficiency: to minimise economic distortions associated with raising a required amount of revenue;
- Equity: to allocate the burden of taxation in line with a taxpayers' ability to pay (vertical equity) and to tax individuals, properties, and entities in similar circumstances consistently (horizontal equity); and
- Simplicity: to ensure that the tax system is as simple and consistent as possible, thereby minimising administrative and compliance costs and enhancing the legitimacy of the system among taxpayers.

It is widely recognised that a broad-based property tax is among the most efficient of all taxes due to its very low 'excess burden', or economic loss for each additional dollar raised.[9] Carefully designed, broad-based property taxes are also regarded as being equitable in that the ownership of property is a reasonable proxy for an individual's wealth and ability to pay. Although, as discussed in Section 4.3, council rates in Tasmania tend to be regressive relative to property values.

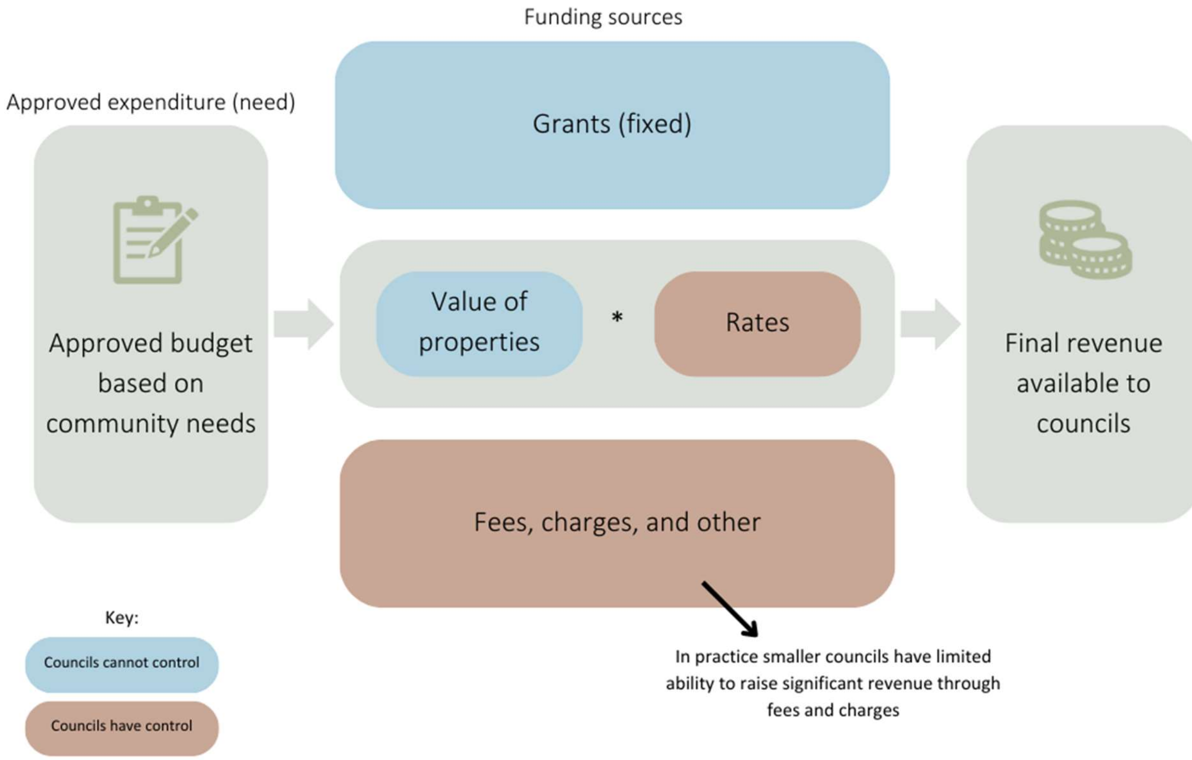
Taxes on property are sustainable, largely due to enormous growth in the value of real estate over recent decades. This is not always true of rates as applied by councils, however, given that they are recalibrated to councils' revenue needs every year. As a result, the revenue they raise does not necessarily increase in line with economic growth or property values. The interaction of councils' rating and budgeting processes in this regard also poses horizontal equity challenges. This is because different councils have increased their rates by very different amounts, even while the distribution of the increase in the value of the base has been relatively uniform.

If this patchwork of rating approaches represented genuine changes or differences in community-level service expectations, it would be more acceptable from the standpoint of principled tax system design. However, as discussed below, this is often not the case.

Perhaps the most significant area where the Tasmanian rating system is at odds with the principles of good tax design is the complex and inconsistent approach to rating, or the process through which the rate applying to a particular property is calculated. The process for establishing the rate councils apply to different types of land is complex and depends to a large extent on valuations provided by the state government and councils' revenue needs as calculated through their budgeting processes. In short, councils decide in consultation with their communities what services they intend to provide, estimate the cost of providing them, and then develop a rating schedule that will generate the required revenue less grants, fees and charges, specific purpose payments (Figure 12).

[9] See Part 3.1 of this report and the Treasury Working Paper.

Figure 12: The budget model of local governments



This 'cost-based' approach to budgeting means that each of Tasmania's 29 councils develop their own 'cents-in-the-dollar' rates which apply to over 200 different categories of land use (Table 6). Councils are also enabled, and arguably encouraged, by legislation to apply differential rates, adding to the complexity of the system overall. In other words, they can – and in many cases do – apply different rates to different types of property in different places. Some councils set floors or ceilings on the dollar value of rates at the property level, while others do not. Some councils apply a uniform rate to all classes of property (Derwent Valley, for instance), while others rate some classes harder than others (the West Coast Council imposes high rates on mines and wind farms, for example). Most councils tax all property within a class at the same rate but some, such as Brighton and George Town, apply different rates to equally valuable properties in different suburbs or localities.

Table 6: Use category codes used for property ratings

Use Category	Code	Number of sub-categories
1. Residential	R	14
2. Commercial	C	45
3. Industrial	I	11
5. Primary Production	L	63
5. Public Service and Institutions	P	45
6. Quarrying and Mining	Q	6

7. Sport and Recreation	S	14
8. Vacant Land	V	6
Number of Categories	8	204

As this process has evolved it has led to a number of outcomes that are inconsistent with good tax design principles:

- The system is complex and it can be difficult to calculate or compare different rates applied by councils across the state. This complexity can undermine the legitimacy of the system in the eyes of ratepayers.
- Rate schedules as applied are regressive with respect to property values due to 'flat' rating and, in many areas, the use of fixed or base charges. This is inconsistent with the principle of vertical equity – see Section 4.3 below for more analysis.
- Similar properties of similar values are rated differently across the state, and sometimes within an LGA, due to community-specific rate schedules. This is inconsistent with the principle of horizontal equity.
- In the absence of access to more efficient funding sources some councils impose high rates on land used for mining or other large-scale commercial activities (see Section 5.1)
- The property valuation regime, whether it be CV (George Town, Huon Valley, Kingborough, and Clarence) or AAV (the remainder) is conceptually sound. However, the method and six-year valuation cycle (with periodic adjustments) used by the Office of the Valuer General (OVG) can result in variations between OVG valuations and market valuations, especially during times of property market volatility. Such variation has the potential to undermine the legitimacy of the regime.

While improved property values are an excellent tax base from which to fund local government, the rating system has become complex and should be simplified and made more transparent as part of a broader funding reform agenda. Specific options for reform are outlined in Part Five.

4.3 Vertical and horizontal equity

As noted in Part Three, broad-based property taxes are a highly efficient and, at least in theory, equitable tax base. Although the way in which they are applied to fund local government in Tasmania could be improved. This is because, in practice, the burden of property taxes in general – and local government rates in particular – often falls disproportionately on households with less capacity to pay. There are essentially three reasons for this.

1. **Fees and charges and fixed floors.** Most Tasmanian councils have fixed floors built into their rating schedules, such that if a cents-in-the-dollar rate on the value of a property falls below a certain threshold, the owner will pay the higher minimum amount. One of the key conceptual foundations of a property tax is the assumption that the value of a property broadly reflects its owner's ability to pay. Rating schemes that effectively inflate the tax applied to an area's lowest-value properties through a minimum payment break this crucial link and unfairly increase the burden of rates on people with the least capacity to afford them.

   The inclusion of fixed fees and charges in households' rate payments in most councils exacerbates this issue further. Most concerning of all are those jurisdictions whose rating schemes consist of a uniform charge imposed on all properties regardless of their value, such that owners of very valuable properties pay rates identical to those of an area's poorest households.

2. **'Flat' rating schedules.** A second feature of many rating regimes which is inconsistent with the ideal of 'ability to pay' is the application of a uniform cents-in-the-dollar rate to properties of vastly different values. The principle of vertical equity recognises not only that wealthier taxpayers have the capacity to pay more than poorer ones, but also that taxation at a uniform rate imposes a relatively greater burden on poorer than wealthier taxpayers (due to a concept sometimes referred to as the 'diminishing marginal utility of income', see Part Three).

   For this reason, 'progressive' rating systems should ensure not merely that taxpayers contribute more in absolute terms as their income increases (proportional taxation), but also that wealthier taxpayers are taxed at a higher rate. Rates as currently applied by Tasmanian councils aren't consistent with the principle of vertical equity, suggesting a need to explore bracketed or 'marginal' rating schedules in which more valuable properties attract higher cents-in-the-dollar rates (5.1).

3. **Up-to-date valuations across all land-use classes.** As noted in the previous section, the third problem is that Tasmania's existing system of property and land valuations established under the *Valuation of Land Act 2001* often fails to provide timely and market-based valuations upon which councils can set equitable and progressive rates. The current system for valuing land follows a six-yearly revaluation cycle with regular adjustment factors but in a volatile property market often fails to reflect market values.

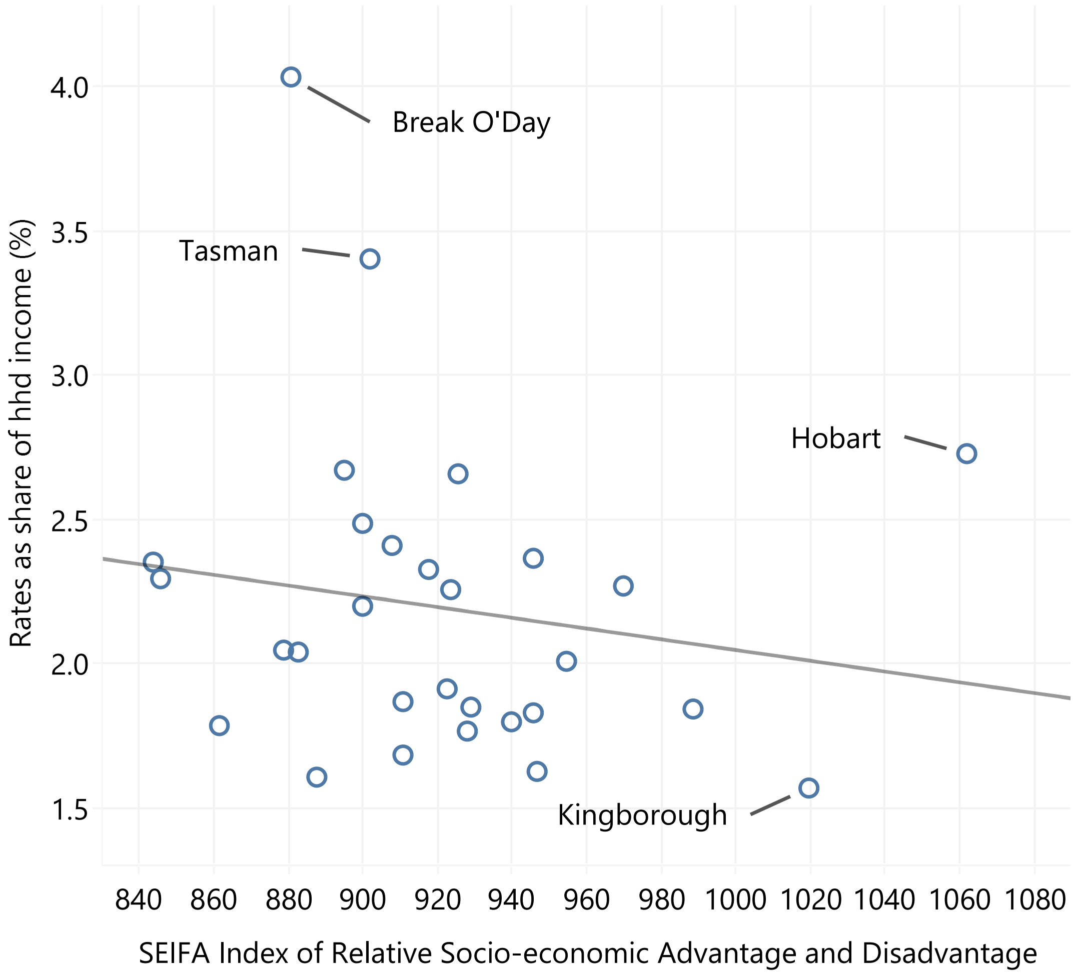
   Crucially, its efficacy also varies considerably between different classes of land, meaning that areas whose rate bases are dominated by residential property rate very differently to those featuring higher-than-average shares of industrial or primary production land, for example. A key consequence of this problem in Tasmania is that the share of those classes of land that are systematically undervalued is greatest in some of the state's poorest communities. Also, the misalignment between statutory valuations and market valuation undermines the broader legitimacy of the rating regime among property owners.

4.4 The distribution of rates in Tasmania

The extent to which these three issues contribute to the inequitable and regressive distribution of rates at the level of councils (as opposed to households within LGAs) is examined below. As Figure 13 and Table 7 illustrate, average residential rate revenue per property (the base to which rates are applied) as a share of median household incomes across Tasmania is inversely proportional to SEIFA Index of Relative Socio-economic Advantage and Disadvantage (IRSAD) scores.

The overall distribution is quite random, highlighting the complexity of the system and the reality that councils apply rates based on their budget needs rather than residents' ability to pay. Significantly, the overall, albeit weak, trendline in Figure 13 is downward sloping. This indicates that rates impose the highest burden on household budgets in some of the state's poorest communities. With Break O'Day and Tasman being particularly noteworthy.

Figure 13: Residential rate revenue per household as a share of median household income by SEIFA by LGA, 2021-22



The overall distribution is quite random, highlighting the complexity of the system and the reality that councils apply rates based on their budget needs rather than residents' ability to pay.

Table 7: Residential rates and household income relationship

	Population	Rateable residential properties	Average rate per property ($)	Median weekly household income ($)	Rates as share of household income (%)
Break O'Day	6506	4353	1751.6	836	4.0
Tasman	2512	3330	1524.9	863	3.4
Hobart	54251	21708	2607.1	1842	2.7
Burnie	19646	8391	1698.3	1225	2.7
Launceston	68388	27925	1806.7	1310	2.7
Waratah-Wynyard	13946	6004	1470.1	1138	2.5
Circular Head	8193	3100	1587.4	1270	2.4
Huon Valley	18239	7578	1507.5	1227	2.4
West Coast	4116	3008	1169.5	958	2.3
Kentish	6479	2398	1456.1	1207	2.3
George Town	7048	3389	1186.2	996	2.3
West Tamar	24569	10393	1652.4	1402	2.3
Glamorgan-Spring Bay	4768	5416	1177.5	1005	2.3
Dorset	6689	3435	1184.9	1039	2.2
Derwent Valley	10516	4292	1321.4	1244	2.0
Devonport	25635	11028	1234.3	1167	2.0
King Island	1603	643	1387.0	1330	2.0
Central Coast	22176	9065	1200.4	1209	1.9
Glenorchy	47289	20378	1284.7	1325	1.9
Northern Midlands	13852	5360	1208.0	1259	1.8
Clarence	59251	26021	1528.9	1602	1.8
Sorell	16230	7662	1327.0	1400	1.8
Meander Valley	20322	8050	1202.3	1290	1.8
Brighton	18595	7437	1251.1	1352	1.8
Latrobe	12204	5296	1149.1	1256	1.8
Southern Midlands	6493	2332	1164.6	1332	1.7
Flinders	1021	876	891.6	1057	1.6
Central Highlands	2160	2457	842.9	1013	1.6
Kingborough	38618	17369	1358.0	1667	1.6

When the above data is analysed further, a clearer picture of how the distribution of rates is varies across different groups of councils begins to emerge. Table 7 reports the widely used measure of residential rates per property divided by median household income and highlights significant variations across Tasmania's 29 councils.[10]

Figure 14 (below) shows the amount of residential rate revenue generated per rateable residential property by LGA, ranked by SIEFA IRSAD scores. In the bottom left and top right quadrants of the figure – within or close to the red band – are councils whose residential rate burdens per household are more or less appropriate to their communities' levels of advantage and disadvantage. Put another way, these are councils whose residential 'rating effort' and SEIFA scores both fall either above or below the median values for the state as a whole.

In the top left quadrant, however, are councils like Waratah-Wynyard or Break O'Day, who impose above-median residential rates despite a below-median SIEFA score, suggesting lesser ability to pay. In the bottom left, the opposite is true: councils like Northern Midlands or Flinders apply a lower-than-average rate despite being more advantaged than the median LGA. At least some of this difference can be explained by LGA's different rates bases. For example, Tasman, which imposes relatively high rates per property in poorer-than-average communities, relies almost exclusively (93.5%) on residential properties for its rates revenue. Meanwhile Flinders, in the opposite quadrant, has a much larger share of primary production land in its rate base.

[10] For example, this method is used in Victoria's *Local Government Rating System Review* (2020), Appendix 1.

Figure 14: Residential rate revenue per residential property by SEIFA by LGA, 2021-22

Scale and local government fiscal capacity

A final important consideration when analysing the distribution of the local government rating burdens is the impact of scale on councils' revenue raising capacity. When assessing councils' expenditure needs, the State Grants Commission applies a cost adjustor for scale across several functions in recognition of the fact that smaller and less populous councils face diseconomies of scale in service provision. While this provides additional funding for some of the state's most disadvantaged communities in the grant distribution process, it is important to recognise that size and scale also impact councils' ability to raise sufficient own-source revenues.

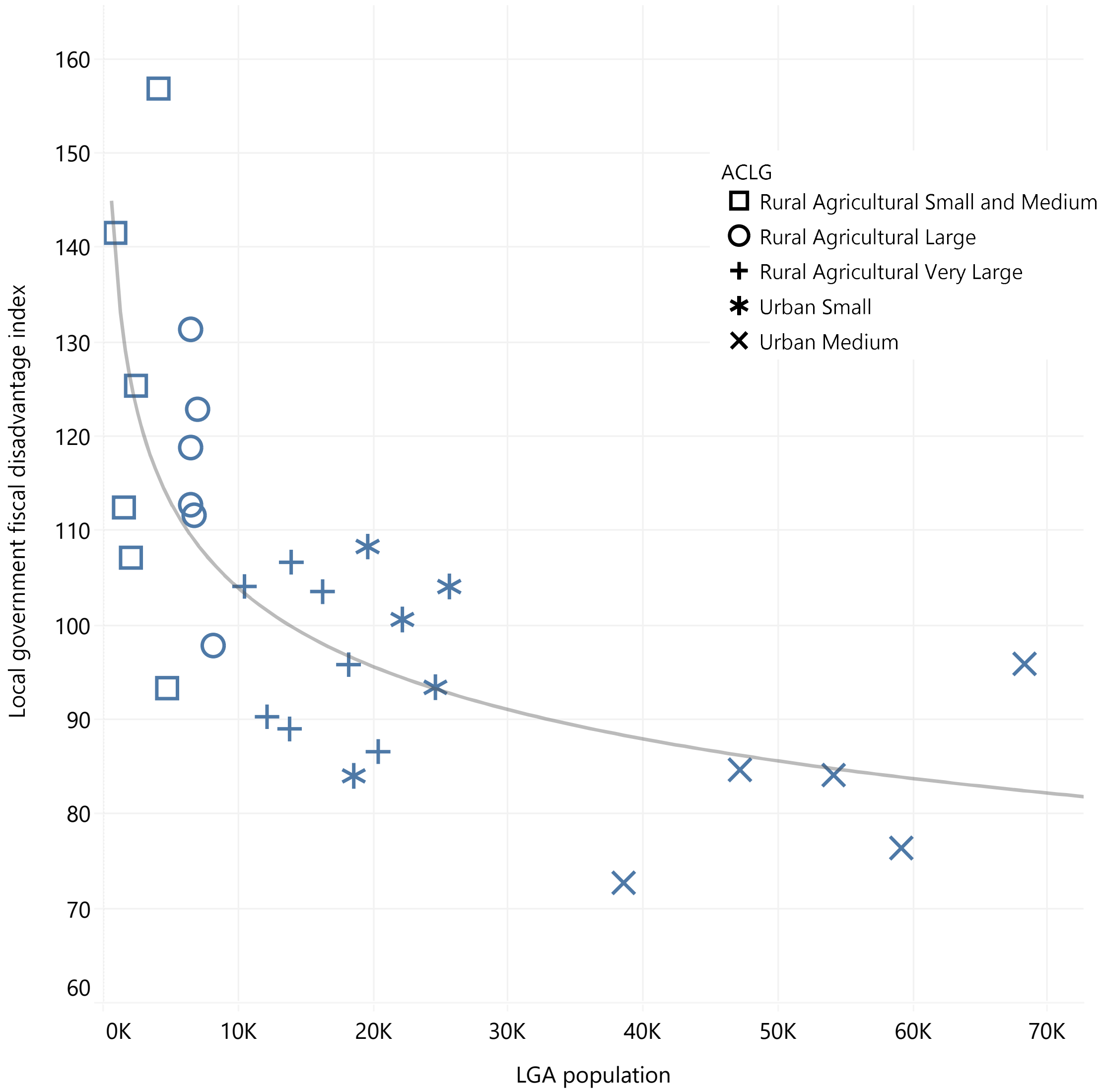
It is clear from this analysis that increasing the population size of smaller rural and remote councils in particular would likely increase the revenue-raising capacity of some of Tasmania's most disadvantaged areas

The below chart shows the correlation between councils' population and their score on a composite index of local government fiscal disadvantage developed for this report.

[11] The direction of the trend in Figure 15 below indicates that larger councils face considerably less difficulty raising own-source revenue than smaller councils, particularly smaller remote councils. The plateauing of the trend as population size increases suggests diminishing returns to scale in council revenue raising capacity. Nevertheless, it is clear from this analysis that increasing the population size of smaller rural and remote councils in particular would likely increase the revenue-raising capacity of some of Tasmania's most disadvantaged areas. For this reason, and as already noted above, the future funding reform priorities outlined in this report should be considered as a part of a holistic suite of structural reforms to rather than in isolation.

[11] The index combines data across five key indicators of local government fiscal need into an unweighted average score. The higher the score, the higher a council's fiscal need (and vice versa). The index has been structured around a median value of 100, meaning that councils scoring over 100 are more fiscally disadvantaged than the median council while those scoring less than 100 are more fiscally advantaged. While the index does include a measure of socio-economic advantage and disadvantage (SEIFA IRSAD score), it is intended to measure the fiscal need of councils, not the advantage or disadvantage of the communities they serve. The indicators included are: household rates as a share of household income; actual revenue as a share of SGC modelled revenue capacity; SEIFA IRSAD score; rate revenue as a share of total area AAV; and current financial assistance grant funding as a share of overall council revenue.

Figure 15: Local government fiscal disadvantage by LGA population size



4.5 Future need and the evolving roles of local government

Any effort at reforming the existing system of local government funding and taxation should consider not only the sector's current funding arrangements but also its likely future needs. Local government in Tasmania, as in the rest of the country, has changed significantly over the past generation and will continue to do so in years to come. Previous UTAS research prepared for the FoLGR on broader national and international trends in local government identified four key broad trends:

1. Centralisation of responsibilities and revenue raising powers;
2. Growth of new functions and expansion of service offerings, including a shift from narrow 'services to property' towards more expansive 'services to people';
3. Increasing need for collaboration and regional partnership models; and
4. Emerging focus on climate change, sustainability, and environmental stewardship.

While some councils may already have the requisite capacity, capability, and scale to keep pace with the rapidly evolving political and economic context in which the sector is operating. Other communities are at risk of being left behind. Specifically, recent changes in the role and functions of Tasmanian local government have exacerbated the divide between larger urban councils and their smaller rural and regional counterparts. There are several key drivers of this divide, but perhaps the most important in Tasmania are demographic change and economic inequality.

Tasmania's population has aged considerably both in absolute terms and relative to the mainland states. Crucially, Tasmania's ageing population is also more decentralised than in other jurisdictions. Meaning that regional communities and their local councils are under pressure to meet growing community service needs. Where migration has helped to balance population ageing in cities, the movement of retirees and older 'sea/tree-changers' to regional areas has made their service provision challenges even more acute.

At the same time, these areas have borne more than their share of the economic consequences of structural economic change. Many urban areas have experienced growth in service sector employment that has matched or more often exceeded the decline of jobs in manufacturing or forestry, for example. This has not been the case in many rural and regional parts of Tasmania, however, resulting in a widening gap between the economic resources available to some of the state's wealthiest and poorest areas. Even as these changes have been taking place, local governments across the board have been called upon to provide an ever-growing suite of services without sufficient revenue growth to fund them sustainably.

In addition to providing established infrastructure and services that require a local approach, the Review's published materials clearly indicate that over the next twenty or thirty years, local government is likely to have a greater role in:

- Engaging, connecting with, and representing local communities to harness their distinctive strengths and needs;
- Advocating for and representing local communities in regional, state-wide, and national partnerships and collaborations. Reflecting a growing recognition of the need to work with communities to develop and deliver innovative place-based programs; and
- Managing climate change risk, local resilience, and emergency response and recovery.

It is beyond the scope of this report to establish the quantum of additional funding local government in Tasmania will require in the years ahead. However, there is clear evidence that a combination of additional investment and structural reform will be required to ensure the sector can meet the needs of the Tasmanian community in the future.

Local Government Capability Index

There is a critically important role of local and municipal governments in supporting communities, promoting wellbeing, and driving innovation. Reflecting this, the Institute for Innovation and Public Purpose at University College London has been developing a comprehensive framework for assessing the governance and program delivery capability of local government. The resulting index is designed to assess whether local government have the capability to play a greater role in addressing their communities' needs, or else whether additional investment is needed to support greater capability.

The program is led by economist Mariana Mazzucato, whose research on the changing role of government in the economy has heavily influenced Australian Commonwealth Treasurer Jim Chalmers.

4.6 Key insights

Tasmanian councils have access to a highly efficient and desirable tax base (improved land value) which, if used effectively and with appropriate equalisation, is capable of supporting and sustaining the sector over the long term.

However, the analysis presented in the section suggests that while most Tasmanian councils are financially sustainable in the short- to medium-term, many are only able to achieve an operating surplus by rationing both asset maintenance and services as well as by increasing rates. These pressures seem to be especially acute in small regional councils and those experiencing rapid population growth.

These pressures have shaped the evolution of Tasmania's rating system such that it is now both overly complex and inconsistent with the principles of good tax design. One of the most concerning findings of the analysis is that the overall burden of council rates in Tasmania is regressive. In that many residents of poorer LGAs pay higher rates per household than in some higher-income LGAs, while also experiencing lower levels of service provision.

In many cases the regressive nature of the rating burden as currently applied is also an issue within councils due both to flat rating and fixed floors, fees, and charges. Nowhere is this more problematic and concerning than in areas where a uniform charge is applied in lieu of a cents-in-the-dollar rate. Such that a council's poorest residents pay exactly the same dollar amount as its wealthiest.

Tasmania's rating system has become both overly complex and inconsistent with the principles of good tax design

Finally, there is significant evidence to suggest that local government will play an increasingly important role in the future which will require additional funding *and* structural reform to enhance the efficiency and sustainability of the sector.

The final section of this report will outline specific reform options which should be considered during the implementation phase of the Review in parallel with the structural reform agenda.

Criteria	Assessment	Reform Priorities (Part 5)
Financial Sustainability	Councils are financially sustainable on a cash operating basis but are struggling to maintain infrastructure and services. Small rural councils are especially vulnerable, and most councils will lack the resources and capability to meet future needs, highlighting the need for funding and structural reform.	• Structural reform and shared services delivered via regional partnership/revenue sharing arrangements. • More consistent and progressive rating. • More equitable grant distribution.
Simplicity	While land is a highly efficient and desirable tax base, the local government rating system as currently configured is overly complex and highly variable between jurisdictions and land classes.	• More consistent rating within and between LGAs. • Greater transparency in relation to rating effort and service delivery • Less reliance on fixed fees and charges.
Equity and efficiency	Tasmanian councils' existing rating schedules are regressive, meaning that the relative burden of rates is high on lower value properties. This problem is compounded by inequity between council areas, with poorer LGAs typically shouldering a greater rate burden than wealthy ones.	• Progressive marginal rating schemes supported by credible and up-to-date valuation data. • Fuller equalisation enabled by reforms to grant allocation methodology.
Future Need	Without intervention, many smaller rural and regional councils are unlikely to be capable of adapting to rapidly changing service provision expectations and community needs.	• Structural reform and shared services delivered via regional partnership arrangements. • Fuller equalisation enabled by reforms to grant allocation methodology.

Table 8: Reform priorities for ratings

5. Funding reform options for the future of local government

An equitable, efficient, sustainable local government funding regime will ensure that Tasmania's councils can provide high-quality services at a fair cost to ratepayers for years to come.

Achieving the right balance requires not only that local governments make efficient and equitable use of their rate bases and other revenue streams. But also, that they are properly supported by well-designed systems at the state level for valuing property, harmonising rating schedules, and equalising fiscal capacity with grants where necessary. At present, the systems and provisions at both the state and local levels for setting rates, valuing property across different classes,[12] and allocating financial assistance grants don't align as closely as they should with the principles outlined in Part Three of this paper.

This section outlines potential future reform priorities for a more efficient and equitable local government funding regime. Given the complex nature of local government funding, the aim is to provide a preliminary assessment of funding reform options.

The funding reform directions outlined below are not intended as an alternative to structural reform but should be considered as an integral part of the implementation of other reforms being considered by the Review. Based on the experience of successful local government reforms in other jurisdictions, it would be prudent to undertake funding reform as one pillar of a broader, holistic structural reform process. This will help to ensure that Tasmania's local government system has both a sustainable structure and adequate funding to meet the needs of Tasmanian communities in the future.

Funding reform options are not intended as an alternative to structural reform but should be considered as one element of the Review's wider recommendations.

As already noted, despite significant variation across different councils, their largest share of own-source revenue is derived from taxes imposed on the 'improved' value of land.

The complexity and diversity of approaches to rating, and of its interactions with valuation and equalisation processes, creates a range of challenges that limit councils' ability to levy rates in accordance with the principles of good tax design as described earlier in this paper. The major issues include:

1. The rating process is complicated, difficult for residents to understand, and highly variable, not just between but also within council areas and property classes.
2. The valuations used by councils to set their rates are not always fit for purpose and nor are they always consistent with market conditions. When valuations are inaccurate, the legitimacy and equity of the rating system as a whole may be compromised.
3. For some large commercial operations where land is not a major factor of production (such as mines and windfarms, for example), improved land value can be an inefficient tax base which often doesn't reflect a business's use of infrastructure nor its ability to pay. Under the current

[12] We acknowledge that reliably estimating market valuations is challenging in a volatile property market with a diverse range of housing stock although new models and methods should be considered.

regime Tasmanian rates can vary significantly over the operating life of a project potentially deterring investment.
4. The highly variable effort applied by different councils in raising rates indirectly compromises the ability of the existing Financial Assistance Grant pool to be distributed in a way that maximises its potential for fuller equalisation and greater equity.
5. Councils are subject to growing and unevenly distributed gaps in their rate bases created by partially and fully exempt property.
6. Rates are a tax on wealth and not income although the two are related. The growing numbers of asset-rich but cash-poor ratepayers – such as retirees and pensioners – limit the scope and prospects of systemic reform and more efficient use of the desirable tax base to which councils have access.

Together, these challenges undermine the fairness, efficiency and sustainability not only of council rating but of the wider funding and equalisation system on which Tasmanian councils depend. This funding reform can't be addressed by local governments alone but requires a cooperative approach. Therefore, reform will be required at both state and local levels to put local government on a more sustainable, secure, and equitable long-term financial footing.

5.1 Reforming the rate base

The complexity of the processes used by councils to set rates has led to a funding system which is inconsistent with the principles of vertical and horizontal equity creating a range of challenges and inequities (see Section 4.2).

Deficiencies with Tasmania's complex rating regime include:

1. The system is complex, inconsistent, and characterised by much variation across Tasmania's existing 29 councils. Making it difficult to understand and compare the distribution of rates across the state.
2. The existing relationship between property valuations and council rates – combined with fixed charges or minimum rates – is regressive, meaning a proportionally higher rate burden is falling on lower-income households and communities.
3. While acknowledging that councils should be able to set rates according to local service preferences and needs, the extent of variation across Tasmanian councils is problematic and is inconsistent with the principle of horizontal equity. Variations in residential rates between councils should be linked to measurable differences in service levels.
4. Some regional councils are applying high rates to large commercial operations in the absence of access to alternative funding sources or other efficient means to tax these operations.

Table 9: Variation in rating methods and rates as a share of total revenue in Tasmanian councils

LGA	Rating method (2022-23 resolutions)[13]	Rates as % of revenue
Hobart	Uniform rate applied to AAV.	59.6%
Kingborough	Variable rate applied to CV with uniform floor.	63.5%
George Town	Uniform rate based on locality, or variable rate applied to CV, with uniform floor.	53.0%
Glenorchy	Variable rate applied to AAV, with uniform floor.	50.7%
Clarence	Variable rate applied to CV, plus fixed fees.	61.9%
Brighton	Uniform rate based on locality, or variable rate applied to AAV, both with floors.	62.3%
Huon Valley	Variable rate applied to CV, with uniform floor.	47.3%
Derwent Valley	Uniform rate applied to AAV, with floor.	45.6%
Central Highlands	Uniform rate applied to AAV, plus fixed fees.	39.3%
Glamorgan-Spring Bay	Variable rate applied to AAV, plus fixed fees.	51.9%
Break O'Day	Variable rate applied to AAV, with uniform floor.	68.6%
Dorset	Variable rate applied to AAV, with uniform floor.	41.7%
Flinders Island	Variable rate applied to AAV, with fixed fees.	26.2%
Devonport	Variable rate applied to AAV, with fixed fees.	57.9%
Central Coast	Variable rate applied to AAV, with uniform floor.	39.3%
Burnie	Variable rate applied to AAV, with uniform floor.	59.0%
Circular Head	Uniform rate applied to AAV, with floor.	50.6%
Kentish	Variable rate applied to AAV, with fixed fees.	44.4%
Latrobe	Variable rate applied to AAV, with variable floor.	41.2%
King Island	Uniform rate applied to AAV, with floor.	27.0%
Northern Midlands	Variable rate applied to AAV, with variable floor.	47.3%
Southern Midlands	Uniform rate applied to AAV, with floor.	32.6%
Waratah-Wynyard	Uniform rate applied to AAV, with floor.	48.0%
Meander Valley	Variable rate applied to AAV, with uniform floor.	52.5%
Sorell	Variable rate applied to AAV, with uniform floor.	47.6%
Tasman	Uniform rate applied to AAV, with floor.	59.2%
West Coast	Variable rate applied to AAV, with uniform floor.	46.0%
West Tamar	Uniform rate applied to AAV, with floor.	63.6%
Launceston	Variable rate applied to AAV, with uniform loading.	55.2%

[13] This list is a simplified descriptions of all council rating resolutions from 2022-23, but many have changed since. In Hobart, for example, the most recent (2023-24) resolutions have changed to a variable rating scheme with higher charges for properties used as short-stay accommodation.

Rate Capping

In some jurisdictions (currently Victoria and New South Wales), state governments have tried to ease the burden of rates on households by imposing 'caps', 'pegs', or other limits on how much local authorities are allowed to raise rates in any given year. While superficially appealing and often politically expedient, there are several conceptual and practical concerns with rate capping:

- Rate capping is undemocratic and undermines the fiscal autonomy of councils. If communities wish to pay more for a higher level or quality of service, they should be able to make that choice themselves. If residents don't like the rates a particular council is proposing, they can vote it out.
- Rate capping assumes that the rate a council is levying at the time the cap is imposed must be appropriate, making it difficult (though not impossible) for a council whose cap is too low to meet community needs into the future. Rate capping has been identified as a cause of high-profile council failures in New South Wales, such as the Central Darling Shire in 2013.
- Rate capping undermines fiscal accountability. State governments can secure short term political benefit by limiting resources available to another level of government without bearing any direct responsibility for the fiscal shortfalls and service gaps that result.
- Rate capping forces councils to rely on alternative, and less equitable, revenue sources such as fees and charges. For example, higher-than-average dependence on fees and charges among councils in New South Wales and Victoria is likely a result of rate-capping.

Towards a simplified rating regime

This section outlines potential future priorities for reforming Tasmania's rating system designed to address some of the deficiencies outlined above. Specific questions concerning the design of a simplified framework and mechanisms to support compliance with it would be subject to consultation. Rating reform options include:

- Councils should have access to consistent and reliable statutory valuation data upon which to set rates. The Office of the Valuer General could consider making greater use of Automated Valuation Methods, especially for annual adjustments of property values to better reflect current price trends.
- In the interests of consistency and simplicity, and given that 'AAV' valuations are a hypothetical estimation of annual rent, consideration should be given to phasing out AAV assessments and basing rates either on CVs or unimproved land values (see 3.1 for a discussion of the merits of these different bases). This recommendation was originally made in the *final draft report of the* 2012 *Valuation and Local Government Rating Review* but has not been implemented by most councils.[14]
- Both rates structures and the classes of property they are applied to should be simplified to establish a more consistent and transparent rating framework across the state. Councils would still have discretion in relation to the actual 'cents-in-the-dollar' rate they apply within this simplified framework.

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[14] *Valuation and Local Government Rating Review, Final Draft Report, October 2012;* Tasmanian Department of Premier and Cabinet; Recommendations 1-3.

- Rates should be proportional or ideally progressive with respect to the value of properties within a given class of property. Floors and fixed charges should be phased out, as they distort the relationship between property values and rates and are regressive in their impact.
- Separate, transparent charges should be established to achieve specific policy goals (e.g., for short-stay accommodation) rather than developing a separate rating schedule.
- An accessible rate deferral model should be established for low- and fixed-income homeowners to support asset-rich but cash-poor residents.
- A revenue sharing model between state and local governments should be considered for large commercial operations to ensure that local communities benefit from hosting these businesses and councils can provide the infrastructure they need without resorting to punitive rating. This is especially true where land isn't a major input cost or means of production.
- If differential rates are to be applied to residential properties, then a higher rate should be applied to the value of properties above certain thresholds (for example, 80% of the LGA median) to ensure that the rate structure is progressive rather than just proportional.

Rating vacant residential land

Tasmania, like many other parts of Australia, is experiencing an ongoing housing crisis and all tiers of government are adopting policies designed to increase housing supply. One of the arguments for using unimproved values as the basis for rating is that vacant land will attract higher rates, creating an effective incentive for developing residential property. An alternative approach is to apply a higher rate to vacant residential land while offering developers or owners a rebate on the difference between vacant and residential rates over a set period, such as 5 years for example. Variations on this approach have been adopted by several mainland councils – for instance Charles Sturt Council in South Australia and Maribyrnong City Council in Victoria – and the policy is similar in design to a number of state land tax exemptions designed to promote the development of vacant residential land while also ensuring that rates are proportional to the real value of properties.

Rating large commercial, mining, primary production, and industrial properties

The rates imposed by councils vary enormously across areas and classes of property but, in many cases, it is clear that this enormous variety is an attempt to compensate for inconsistencies in the way that different categories of property are valued. This an especially difficult issue for councils whose rate bases feature larger-than-average shares of land used for industrial facilities, mining, and other large-scale commercial operations. While complex to design and implement, consideration should be given to applying more 'normal' rates to commercial and industrial land supplemented by more efficient royalties or other output-based taxes imposed by the State with a portion of these revenues reinvested into projects' host communities.

Non-residential rating on the West Coast

The majority of Tasmanian councils apply different rates to different classes of land. This is largely in recognition of the fact that, for example, residential, industrial, and agricultural properties have different economic functions and require different local government services. In most cases, variation of rates between property classes is no more than a few percentage points. In Latrobe, for instance, industrial property is rated at approximately 8.4 cents of assessed annual value while residential properties pay 5.6 cents.

The rating schedule applied on the West Coast, however, is an extreme outlier. Although residential properties are subject to a fairly typical rate of 6.9 cents in the dollar of AAV, mining properties pay over 90 cents and aquaculture properties more than 100. In other words, as currently valued, more than the entire assessed theoretical rent these properties could attract is currently being paid in rates – a clearly unrealistic proposition. This apparently 'extreme' rating strategy highlights two structural problems with the current local government funding system:

1. The level at which rates are imposed on different categories of land is the only meaningful policy leaver for some councils to adjust when raising revenue, especially in poorer regional communities with limited scope to apply fees and charges. While the West Coast's rating approach might seem excessive when compared to some other LGAs, it is far more equitable than applying a uniform rate to its base as currently valued. As this would significantly increase the burden of residential rates in one of Tasmania's most disadvantaged communities.
2. At least for some classes of property, current valuations don't reflect an owner's ability to pay or the local infrastructure and services they use. This is especially true for large commercial operations where land is a minor input into the production process and isn't a good proxy for the economic rent the business is capable of generating. Councils like the West Coast, whose rate base is composed disproportionately of non-residential land classes, are therefore presented with a serious dilemma when designing their rating schedules.

Public finance theory would suggest that economic rents generated by mines, energy projects, and other similar commercial operations are most efficiently taxed according to their output or profits/expenditure, with a portion being reinvested in their host communities. At the very least, valuations that are reflective of businesses' actual capacity to generate income would give councils the information to impose sensible, consistent, and equitable rates across their entire base.

A specific and growing issue in relation to rating large commercial operations concerns the rating of land used for renewable energy and mining projects. In relation to renewable energy projects, the issue in some jurisdictions such as Victoria (see below) is that valuable infrastructure such as wind turbines and solar arrays are deemed to be removable chattels when on leased land (as opposed to freehold) and therefore not included in capital improved valuations. The concern in relation to mines is that they are often exempt from council rates (e.g., New South Wales & Victoria) or rated on a concessional basis. While owners of renewable energy projects and mines do make financial contributions through royalties and other voluntary agreements, there are growing calls for owners to make more significant and transparent financial contributions to councils and regional organisations to maximise the long-term benefits to the communities in which they operate.

Council rates on renewable energy projects in other jurisdictions

Victoria

Under the *Electricity Industry Act 2000*, Victorian energy generators can elect to pay a negotiated sum in place of council rates (this is known as Payment in Lieu of Rates – PiLoR). Solar and wind generators can pay a rate based upon their electricity generation, or a set amount (whichever is greater). Alternatively, if they are a large electricity generator or do not produce solar or wind, they are able to pay a fixed rate with a variable charge based upon their electricity generation. See the PiLoR factsheet for more details.

If these companies and councils do not engage in a PiLoR, then rates and taxes may be charged based upon the capital improved value (CIV). This encompasses the assessed market value and includes land and all improvements (such as buildings). The recent Victorian Supreme Court decision of *AWF Prop Co 2 Pty Ltd (as trustee) v Ararat Rural City Council* [2020] VSC 853 found that turbines and other equipment on a wind farm were not to be included in the CIV (thus leading to a lower valuation amount) in cases where the land was leased for wind farm operations.

New South Wales

The rate amounts charged under the *Local Government Act 1993* are based upon four categories. As there is no specific electricity generation category, they are assessed under 'business' and are still subject to council rates. This includes generators such as Snowy Hydro. The value of rates is calculated based upon value of ratable land and a base amount (which is specified by the council). This may include the profit rental amount. The recent New South Wales Supreme Court decision of *SPIC Pacific Hydro Pty Ltd v Chief Commissioner of State Revenue* [2021] NSWSC found that turbines and other things 'fixed' to the property on wind farms should be included in the rates payable to council.

Council rates on mining operations in other jurisdictions

Victoria

If land is used exclusively for mining, the owner of the land may apply to the council to be exempt from rates under the *Local Government Act 1989*. There have been some calls to have this changed.

New South Wales

Mining has its own designated category of ordinary rates and ratable land in New South Wales. Within this classification, there may be different sub-categories of mining land depending on the type of mining. This means that there may be different rates charged for different sub-categories of mine. Despite this, mining may still be exempt from council rates where it is the subject of a granted mineral claim or held to be exempt (amongst other things). Although many mining companies are exempt from paying council rates, mining companies can enter Voluntary Planning Agreements (VPAs) to help contribute to the cost of infrastructure developments; although the New South Wales Productivity Commission did criticise these as not being truly voluntary in a 2020 report.

Options for taxing mines, energy projects and large industrial operations

The tax applied to large mining, industrial, and energy projects should exceed the improved value of the land they occupy reflecting the public resources they consume (in the case of mines), their use of public infrastructure, and their profits. This is why such projects are subject to local government rates, state land taxes, royalties, payroll taxes, and federal corporate income taxes and potentially carbon taxes in the future.

There is a long-running debate about the best approach to taxing such operations. Most economists agree that the theoretical ideal is a resource rent tax which is neutral in relation to investment decisions and would be born fully by shareholders.[15] Despite this consensus, there is also recognition that resource rent taxes are complex to administer and have attracted strong industry opposition. Given this, an *ad valorem* royalty proportional to value of production is regarded as the next best option, although two mines with identical output will pay the same royalty even if one has lower cost of production and is more profitable.

Using rates based on improved land values to tax the economic rents generated by mining, energy or commercial operations is the least efficient approach. This is because rates are unrelated to output or profitability and are likely to distort investment decisions. A preferable funding option would be to allocate a proportion of mining royalties to host councils or regional partnership funds to invest in infrastructure and communities. Any such royalty sharing scheme would have to be carefully designed and implemented, especially given that analysis of Western Australia's $4 billion Royalties for Regions program found that it failed to fulfil its objectives of creating population growth or curbing population decline in small regional communities.[16]

Integrating the administration of council rates and state land tax

In 2009, The Henry Tax Review recommended (121 (a)) 'moving to a joint billing arrangement for state land taxes and local government rates so that taxpayers receive a single assessment, but are able to identify the separate State and local component.'

Broadening the Rate Base

This report has highlighted the need to simplify Tasmania's valuation and rating system used to fund local government by moving towards a regime where rates are linked in a more consistent and uniform assessments of the improved value of property. Beyond this, broadening the rate base to maximise the number and types of properties included will further enhance its sustainability and efficiency. Tasmania has fewer types of property that are exempt from rates than any other state, except South Australia (Table 10). However, trends such as the growing role of not-for-profit and charitable organisations in the delivery of public services have seen the AAV of partially or fully exempt property in Tasmania increase to approximately $290 million in 2021. This is the equivalent of approximately $20 million in council rates (Figure 16).

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[15] Freeman, J., December 2015 *Royalties or Resource Rent Taxes?* Tax and Transfer Policy Institute ANU.

[16] Standen, J., and McKenzie, F., November 2020 Australian Geographer vol 52, no 1.

Table 10: Collated general categories of rate exemptions in Australia and New Zealand, 2020.

	Govt. Land	Charitable Use*	Religion**	Indigenous Land	Transport^	Conservation	Mining
VIC	✓	✓	✓		✓		✓
NSW	✓	✓	✓	✓	✓	✓	✓
ACT	✓	✓	✓	✓			
QLD	✓	✓	✓	✓	✓		
NT	✓	✓	✓	✓	✓		
WA	✓	✓	✓				
SA	✓						✓
TAS	✓	✓		✓		✓	
NZ	✓	✓	✓	✓	✓	✓	

* *Victorian legislation also separately exempts ex-servicemen (RSL) clubs, however other states and territories do not list them separately from other charitable institutions.*

** *Where properties used for a religious purpose are listed as a separate exemption*

^ *Public land used for transport infrastructure, including toll roads and railway lines.*

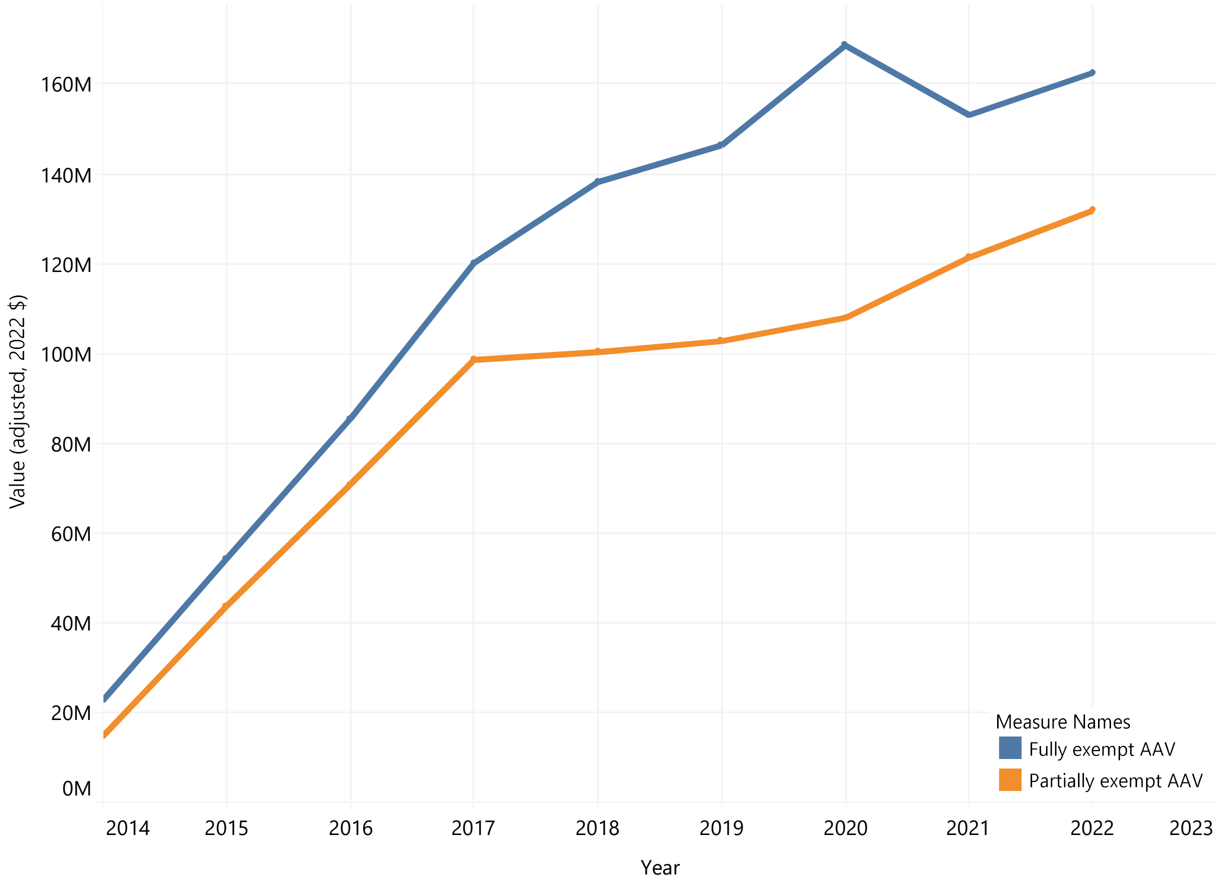
Source: Victorian Local Government Rating System Review

There are clear policy reasons for continuing to exempt some categories of land from council rates. Although the significant increase in the value of exempt land in recent years highlights the need to review the criteria and process through which exemptions are granted. A 2002 review of the financial relationship between local and State government in Tasmania[17] resulted in most State agencies and businesses paying rates, and councils paying state payroll and land taxes. There remain a number of exemptions and anomalies, such as the Hobart Airport, which is currently a privately held leasehold interest of federal land.[18]

[17] Local Government Association Tasmania, 2007 [Assessing Local Government revenue raising capacity](), p. 14.

[18] Under s 114 of the constitution, States cannot impose tax on properties belonging to the Commonwealth. However, the lease for Tasmanian airports includes a clause which requires the private company to pay the rates equivalent to councils or make reasonable endeavors to enter into an agreement to make such payments. The rates are to be based on the valuations made, and only on areas that are sub-leased to tenants or on which financial operations are undertaken. This valuation does not include areas with aeronautical services and facilities (*Clarence City Council v Commonwealth* [2022] FCA 1492).

Figure 16: Total assessed annual value of fully and partially exempt property in Tasmania, 2014-2022



5.2 Developer contributions

The development of new housing or commercial property generates increased rate revenue for councils. However, in most cases it also leads to new or increased infrastructure and service provision costs. These include both the immediate and obvious ‘direct’ services to the developer or property owner – like connection to existing storm water, local road and electricity networks for example – as well as more ‘indirect’ services required to accommodate local population growth in general – such as schools, parks, public transport, and state or local roads.

The economic basis of developer charges from the Henry Tax Review (2009)

"In principle, efficient provision of infrastructure would be encouraged where its users pay for the construction of infrastructure that would be avoidable (that is, not needed) if the development did not proceed. By levying infrastructure charges that reflect these costs, State and local governments provide signals to develop housing in ways and places of greatest value. The cost of infrastructure increases directly with distance from essential headworks and inversely with the density of development … To the extent that a developer can respond to these costs, for example, by choosing to build closer to an existing development or by increasing the density of housing, charging the developer can improve housing supply."

These contributions help to ensure that proponents more fully 'internalise' the broader costs of development decisions, thereby incentivising development close to existing services and infrastructure (Section 3.3). All states and territories in Australia recognise that developers should bear at least some of the infrastructure and service provision costs arising from new developments, and especially greenfield developments. However, different states, territories, and individual councils across the country have widely varying systems for calculating and applying developer contributions.

The Local Government Association of Tasmania (LGAT) has identified four basic 'types' of developer contribution scheme used in Tasmania. At one end of the spectrum are schemes that operate without any process for extracting developer contributions, such that the costs associated with new development are borne more or less entirely by taxpayers. All states or territories have legislative or policy instruments for imposing developer contributions, but this does not mean that all projects attract an appropriate developer contribution charge: a great many do not, including in Tasmania.

In systems of the second type, 'basic contributions via agreements', developer contributions are negotiated on a project-by-project basis between proponents and the relevant infrastructure or service provision authority. This is the approach that operates in Tasmania. The third type of system allows providers of infrastructure to offer developers the option of making a financial contribution offsetting their system impacts in lieu of delivering network or infrastructure objectives required by regulation or legislation. The fourth and most developed approach applies general charges across different types of land use and different classes of infrastructure linked directly to a proposal's demand for, or impact upon, infrastructure networks underpinned by clear infrastructure planning.

Table 10: models of developer contribution scheme (table adapted from LGAT 2022)

	Applies to	Trigger	Advantages	Disadvantages
No contribution (fully subsidised)	None	None	No setup No disincentive to development	High pressure on rates Slow response to development Incentivises inefficient land use and uneconomic development
Basic (contribution via negotiated agreements)	Limited and specific areas, land uses, infrastructure types, and projects	Network capacity limit	Customisable and flexible Responsive to unique or specific development types and needs	Onerous, complex, resource-intensive, and time-consuming Misses many developments Presents opportunities for power imbalance and governance risk
Intermediate (offsets to standards)	Anywhere	Development application where standard not met	Promotes achievement of standard Charge clearly linked to impact and solution	Partial and supplementary Can be unreliable and difficult to predict/project income Limited ability to support quality urban/strategic planning
Advanced (general charging)	Everywhere	Development application based on network impact	Charge clearly linked to impact and solution Provides certainty and predictability for both providers and developers	System can be complex to establish (high setup or transition cost) Calculation methods can be complex for proponents, particularly in the case of very large or unusual developments

Among systems currently in use across Australia, Tasmania's is perhaps the least formal and raises the least money per project. Relative to states with more formal, mature, and structured developer contribution systems, the Tasmanian approach suffers from four main problems:

1. Tasmania's system recovers contributions to a narrow and limited range of infrastructure and service provision types. Focussing mainly on immediate connection to or impact upon utilities and network infrastructure ('headworks') like water and sewerage or stormwater, and open or 'green' space in the case of large subdivisions. As a result, Tasmania charges the lowest developer contributions per lot in the country (some $5000 on average in 2018). Other systems, such as those in place in New South Wales and Victoria, not only raise more money but consider impacts upon a far wider range of social and community infrastructure – such as schools or childcare centres, health facilities, and public transport – in their developer contribution schemes.
2. Tasmania's current arrangements lack transparency, making it difficult for the public to make informed decisions about the scheme's value and difficult for development proponents to plan projects with certainty.

3. The Tasmanian system's reliance on case-by-case negotiated agreements is time-consuming, resource-intensive, opaque, overly complicated, and inefficient. Importantly, it also potentially presents serious resourcing, capability, and governance challenges for smaller councils. Who may lack the time and specialist expertise to extract appropriate value from developer contributions, leading to an unnecessary and inequitable burden on ratepayers.
4. Where most other jurisdictions have clear developer contribution provisions in land use planning legislation, Tasmania's confusing and variable rules are scattered throughout a patchwork several different Acts. Each dealing with different parts of the process or different land uses. As a result, [according to LGAT](), developer contribution rules are "fragmented and isolated from the planning process [and] charges can be easily disputed and appealed, undermining certainty. None of the mechanisms provide a framework for delivering a consistent statewide approach or clear guidance on establishing fully effective and efficient infrastructure contributions schemes. This leaves uncertainty for councils to resolve the extent of their legal authority to apply infrastructure contribution schemes and how schemes should be implemented in a fair and legally defensible way. As a result, Tasmania almost entirely lacks general charging schemes, the most efficient form of infrastructure contributions."

Tasmania's system of developer charges is fragmented and isolated from the planning process; charges can be easily disputed and appealed, undermining certainty.

Addressing these issues would require change in legislation, policies, and practices at both the state and local levels. The Productivity Commission has proposed a [set of principles for efficient and equitable infrastructure contributions]() that could offer a valuable guide for the development of a more effective best practice approach in Tasmania:

- Use upfront charging to finance major shared infrastructure, such as trunk infrastructure, for new developments where the incremental costs associated with each development can be well established and where such increments are likely to vary across developments. This can also accommodate 'out-of-sequence' development.
- For infill development where system-wide components need augmentation that provides comparable benefits to incumbents, upgrades should be funded out of borrowings and recovered through rates or taxes (or via the fixed element in periodic utility charges).
- For local roads, paving, and drainage, the principle of 'beneficiary pays' would dictate that it is most efficient for developers either to pay the full cost or else to undertake the necessary construction themselves and dedicate the resulting assets to council, and in either case to then pass the costs on to residents (through higher land purchase prices).
- For social infrastructure that satisfies an identifiable demand related to a particular development (such as a neighbourhood park), costs should be allocated to that development via upfront developer charges.
- For social infrastructure where services are dispersed more broadly, accurate cost allocation is difficult if not impossible. These should therefore be funded via general revenue unless direct user charges (such as for an excludable service like a community swimming pool) are possible.

Options for reforming developer contributions

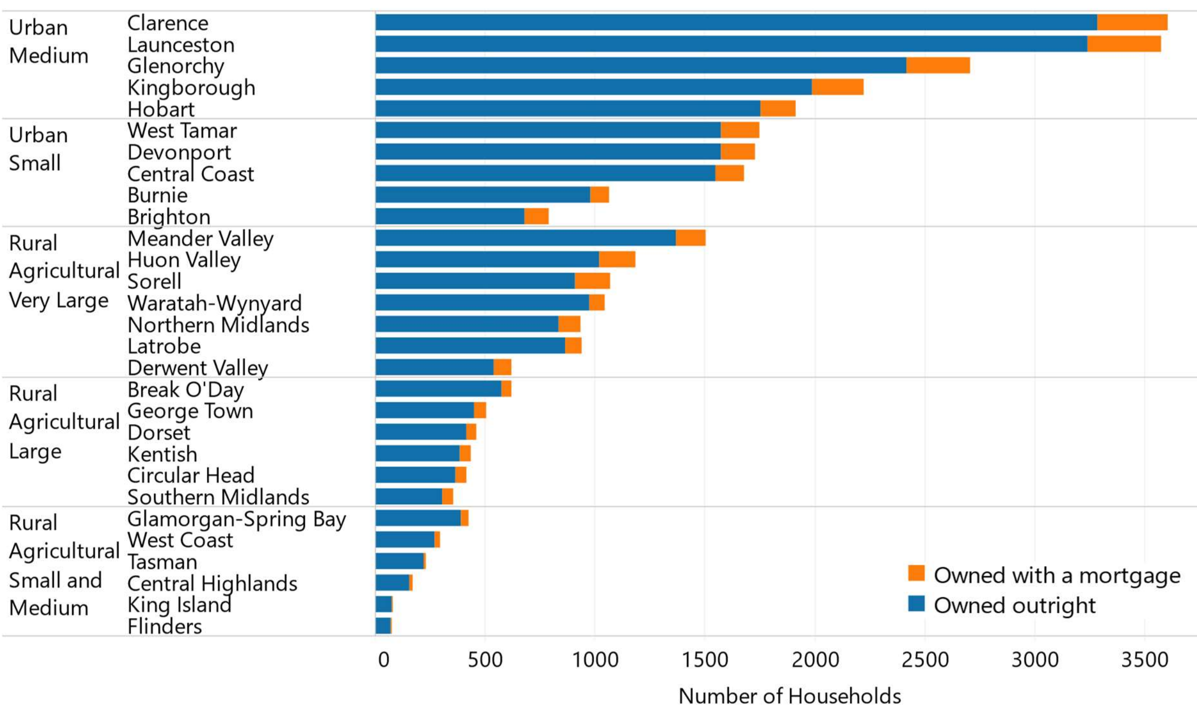
Significant infrastructure investment will be required in the coming decades to meet the infrastructure needs of a growing population. This will increase council's reliance on applying fair and equitable developer contributions.

A consistent and transparent approach to applying developer charges, informed by the principles established by the New South Wales Productivity Commission's 2020 review of infrastructure charging, should be developed during the implementation phase of the Future of Local Government Review.

5.3 Means-tested deferred payment regimes

There is a clear consensus in the public finance literature that improved land value is an effective, efficient tax base which is proportional to household wealth. While the value of property is also a reasonable proxy for a household's ability to pay rates, this isn't true for a significant number of lower-income homeowners such as those living on an age pension (Part 3). Given Tasmania's aging demographic profile and – at least until recently – lower property prices, this cohort is larger in Tasmania than many other parts of Australia. Census-based analysis reveals that in 2021 approximately 32,300 households in Tasmania were homeowners whose main source of income was the age pension (Figure 17). This is just one, albeit large, category of lower-income ratepayers who may wish to access a deferral scheme.

Figure 17: Number of owner-occupied households with the main source of income as the aged pension by ACLG. Source ABS 2021 Census



The established policy response to this equity challenge is the provision of means tested, state-funded concessions of up to $542 per year. Given wider cost-of-living (and budget) pressures, a complementary reform option is to develop and promote a broader rate deferral regime for low-income ratepayers.

While the *Local Government Act* (ss 125-127) provides for the postponement of rates based on hardship, this is a last resort relief scheme rather than a general cost of living assistance measure. Victoria and Western Australia in particular have established (but not widely utilised) rate deferral regimes where pensioners and others facing financial hardship can defer their rates until their circumstances improve or upon the sale of their home.

This approach – wherein eligible aged pensioners in particular could defer their rates (perhaps up to certain limits) until the sale of their home – should be considered in Tasmania. The state government would assume the notional debt or liability (and potentially apply a concessional interest rate) and pay councils the rates owing when they are due. While this model has merit in that it enables low-income homeowners to access equity in their property to meet living costs. Any such scheme would have to be carefully designed and promoted especially given the understandable reluctance of many pensioners to accumulate liabilities against their value of their homes.[19]

Deferral and postponement schemes in other jurisdictions

Council Rate Deferrals

Victoria, Western Australia, and Queensland offer deferral schemes for council rates.

Victoria only offers deferrals for those who would face hardship from paying their council rates. Interest is charged while rates are deferred and the amount becomes payable once the council believes the person will no longer face hardship, or they no longer own or occupy the property.

Western Australia only provides deferrals to owner-occupier pensioners (who automatically have their rates deferred if they do not pay their rates). Interest is not charged on these deferred rates and the total amount becomes payable once the property is sold or the ratepayer dies.

Queensland provides deferrals as a form of concession to both pensioners and those facing hardship as well as select others – such as not-for-profit entities or to preserve land of cultural, environmental, or historic significance (among other things).

Council Rate Postponements

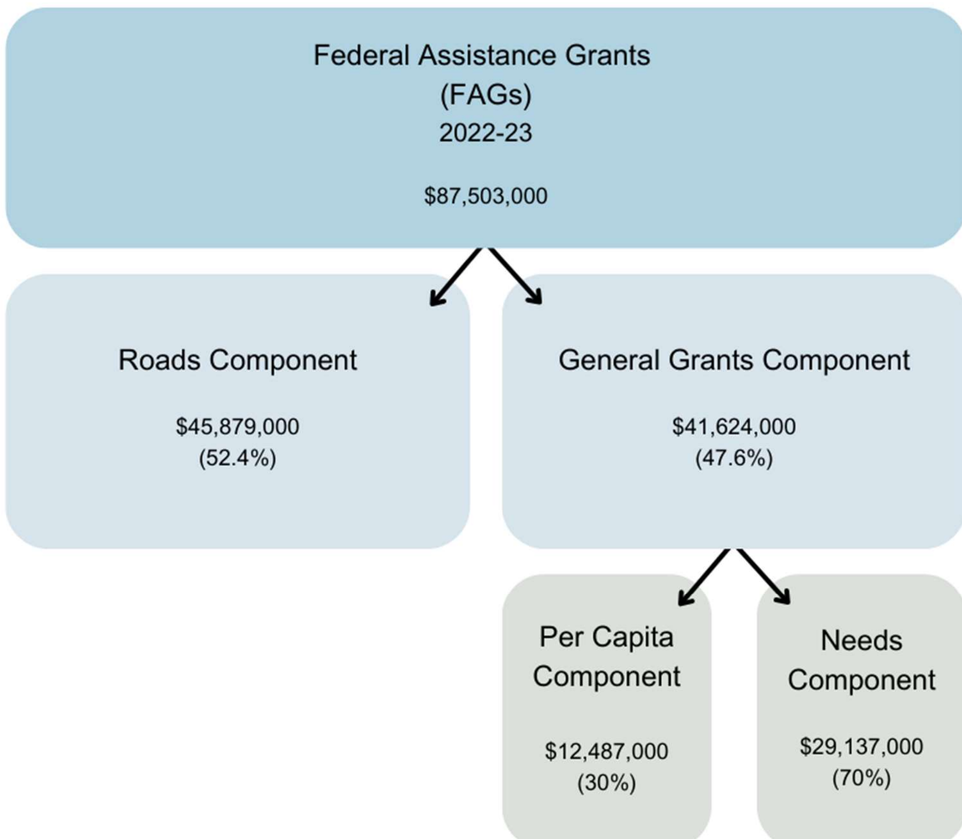
Other states, including New South Wales and South Australia, offer postponements of council rates. Both states offer postponement for age pensioners who are owner-occupiers. However, they must still pay at least $500 of their council rates while the remaining balance is be postponed. South Australia offers postponements to general ratepayers where paying their council rates would cause hardship. South Australia charges interest on the postponed rates (with a 1% higher rate for pensioners), but New South Wales does not. There has been some criticism in New South Wales surrounding the difficulty postponed rates can cause at the time of sale. An inquiry by IPART has recommended the introduction of a state-run rates deferral scheme, essentially allowing pensioners a loan to cover the cost of rates.

[19] Bailey, M., Harris, B., and Wang, T., 2019, *The unfulfilled promise of reverse mortgages: can a better market improve retirement security* Economic Studies at Brookings.

5.4 Options for more equitable grant distribution

Tasmanian councils receive grant funding from a variety of sources, but by far the most important are Commonwealth Financial Assistance Grants. These are untied payments allocated among councils according to need. In 2022/23 the Tasmanian Government received $87.5 million in grant funding from the Commonwealth. This was distributed to Tasmanian councils by the State Grants Commission using an agreed equalisation formula consistent with national legislation and associated principles (see next page).

Figure 18: Process of distributing Commonwealth Financial Assistance Grants to Tasmanian councils



The role and distribution of Commonwealth Financial Assistance Grants

Commonwealth Financial Assistance Grants to councils, which totalled $2.9 billion across Australia in 2022-23, are divided into two pools: a 'general purpose' base grant pool and a roads grant pool. Despite the names, both pools are untied and can be spent more or less however councils wish. As the need-based distribution suggests, the grants serve a crucial equalisation function. Financial assistance grant funding is allocated according to three key principles drawn from the Commonwealth *Local Government (Financial Assistance) Act 1995*:

1. No council can be allocated an amount less than 30% of what they would receive if their state's funding were distributed solely on a per capita basis (s 9(2)(b)).
2. The allocation of funds must be made, as far as practicable, on a full horizontal equalization basis. Meaning that each council should be able to function, by reasonable effort, at a standard not lower than the average standard of other councils in the state. This equalisation must take account of differences among councils both in capacity to raise revenue and cost of providing services (s 9(3)(a), (b)).
3. The allocation of grant funding should be effort- or policy-neutral, such that the particular revenue and expenditure policies of individual councils will not affect grant determinations.

National Principles – Base Grant Distribution

***1. Horizontal Fiscal Equalisation*.** General-purpose grants will be allocated to local governing bodies, as far as practicable, on a full horizontal equalisation basis as defined by the Act. This is a basis that ensures each local governing body in the State or Territory is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in the State or Territory. It takes account of differences in the expenditure required by those local governing bodies in the performance of their functions and in the capacity of those local governing bodies to raise revenue.

***2. Effort Neutrality*.** An effort- or policy-neutral approach will be used in assessing expenditure requirements and revenue-raising capacity of each local governing body. This means as far as practicable, that policies of individual local governing bodies in terms of expenditure and revenue effort will not affect grant determination.

***3. Minimum Grant*.** The minimum general purpose grant allocation for a local governing body in a year will not be less than the amount to which the local governing body would be entitled if 30 per cent of the total amount of general-purpose grants to which the State or Territory is entitled under Section 9 of the Act in respect of the year were allocated among local governing bodies in the State or Territory on a per capita basis.

***4. Other Grant Support*.** Other relevant grant support provided to local governing bodies to meet any of the expenditure needs assessed should be taken into account using an inclusion approach.

***5. Aboriginal Peoples and Torres Strait Islanders*.** Financial assistance shall be allocated to councils in a way, which recognises the needs of Aboriginal peoples and Torres Strait Islanders within their boundaries.

***6. Council Amalgamation*.** Where two or more local governing bodies are amalgamated into a single body, the general-purpose grant provided to the new body for each of the four years following amalgamation should be the total of the amounts that would have been provided to the former bodies in each of those years if they had remained separate entities.

In each state and the Northern Territory, a local government grants commission is charged with distributing their jurisdiction's FAG funding, and each has a slightly different approach to doing so. Broadly speaking, there are two main categories of method:

- The balanced-budget approach (used in Tasmania, the Northern Territory, Victoria, Queensland, and Western Australia) works by developing a hypothetical budget for each council using average expenditure and revenue data, then adjusting for localised service provision costs and revenue-raising capacity factors, and finally dividing available funding among councils according to their share of the notional statewide deficit.

- The direct assessment approach (used in New South Wales and South Australia), on the other hand, starts by developing a set of advantage and disadvantage factors impacting expenditure and revenue-raising capacity across the state as a whole for specific council functions (these factors include considerations like population size and density, topography and drainage, and the presence of marginalised or disadvantaged communities). Councils are then assessed for the presence and degree of these factors and allocated portions of base grant funding accordingly.

Table 11: Federal assistance grants allocation and funding within the Australian states and territories, 2022-23

	FAG funding (2022-23) and breakdown	State share of total FAG pool	Allocation method	Cost adjustment or advantage/disadvantage factors applied by grants commission	Rate capping?
Tasmania	$92,575,128 49% general purpose/51% roads	2.1% of total general-purpose pool, 5.3% of total roads pool	Balanced-budget	Absentee population; climate; population dispersion; isolation; service industry employment; scale (admin & other); tourism impact; worker influx; socio-economic disadvantage (SEIFA IRSD)	No
Victoria	$695,058,225 74% general purpose/26% roads	25.7% of total general-purpose pool, 20.6% of total roads pool	Balanced-budget	Aged pensioners; economies of scale; environmental risk (fire, flood); indigenous population; language; population dispersion; population growth; share of children under six years of age; regional services; location/remoteness; socio-economic status; tourism impact	Yes
New South Wales	$889,866,807 71% general purpose/29% roads	31.5% of total general-purpose pool, 29% of total roads pool	Direct Assessment	Indigenous population; environment (Ha. of non-rateable environmental lands); population; rainfall, topography and drainage	Yes
Queensland	$575,542,869 71% general purpose/29% roads	20.4% of total general-purpose pool, 18.7% of total roads pool	Balanced-budget	Location/remoteness; indigenous population; SEIFA (IRSAD); population dispersion	No
Western Australia	$353,425,821 61% general purpose/39% roads	10.5% of total general-purpose pool, 15.3% of total roads pool	Balanced-budget	Location/remoteness; socio-economic disadvantage; growth; population dispersion; climate; indigenous population; regional centres; environmental risk (fire, cyclone); off-road drainage; medical facilities; special needs	No
South Australia	$191,072,530 74% general purpose/26% roads	6.9% of total general-purpose pool, 5.5% of total roads pool	Direct Assessment	South Australia applies several ‘cost relativity indices’ to each council expenditure function but the specific factors are not listed in the commission’s methodological report	No
Northern Territory	$40,535,788 48% general purpose/52% roads	0.9% of total general-purpose pool, 3.2% of total roads pool	Balanced-budget	Location/remoteness; population dispersion; indigenous population	No

5.5 Reforming the distribution of Financial Assistance Grants within Tasmania

The $41.6 million needs-based pool is allocated using a formula which considers councils' revenue-raising capacity and the cost of providing services to an average standard. While this methodology is sophisticated and achieves a relatively equitable distribution of funding already, it is important to recognise that the needs-based funding pool ($29 million) is not sufficient to meet the assessed statewide revenue gap ($109 million). In other words, financial assistance grants are distributed with the aim of full equalisation but the quantum of funding available is not sufficient to actually achieve it. So while technical reforms to the method by which grants are distributed can deliver more equitable outcomes, in the absence of structural reform they will still be insufficient to put smaller councils on a sustainable financial footing.

> While needs-based assistance grants are distributed to councils relatively equitably it is important to recognise that the funding pool ($29 million) is not sufficient to meet the assessed statewide revenue gap ($109 million).

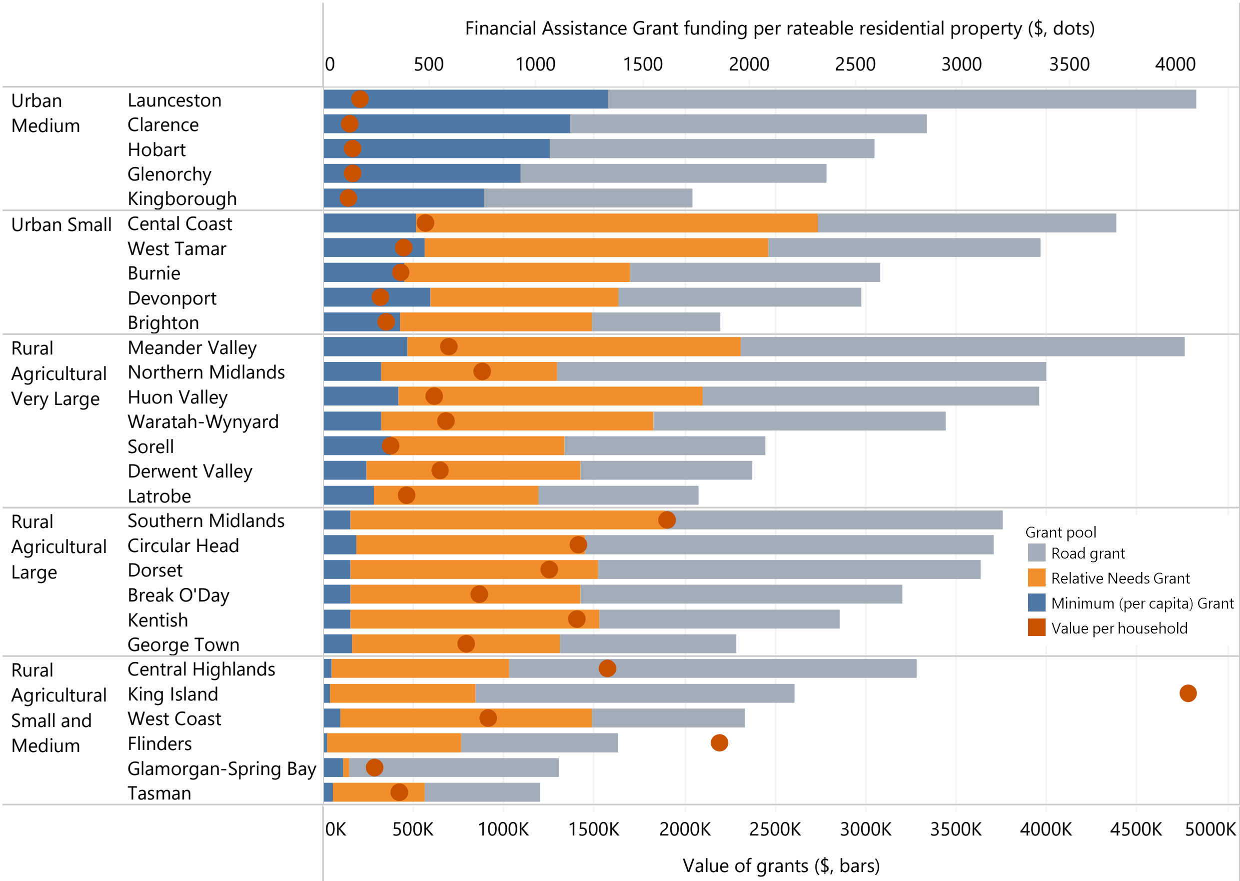
The distribution of FAGs among Tasmanian councils for 2022-23 is presented below (Figure 19). While Launceston receives the largest grant ($4.8 million), reflecting the fact that it is Tasmania's most populous council and has a relatively large council road network, on a per capita and per household basis small rural councils are the main beneficiaries of needs-based funding.

Given that there is insufficient funding in the grant pool to achieve full equalisation, this section outlines some options for changing the distribution of FAGs in a way that would achieve more equitable needs-based funding.

> Reforms designed to ensure a more equitable distribution of grant funding should be considered as part of a holistic suite of reforms designed to improve the effectiveness, sustainability and capability of regional councils.

These options should be considered as part of a holistic suite of reforms designed to improve the effectiveness, sustainability, and capability of regional councils. The analysis presented below reports indicative potential changes in grant funding based on existing LGA boundaries but would need to be recalculated for any reconfigured boundaries resulting from the FoLGR. Under the existing rules, amalgamated councils must continue to receive the grant allocation they would have received as separate entities for a period of four years.

Figure 19: Financial assistance grant funding by LGA and per rateable residential household, 2021-22



Option 1: Allocate entire base grant on a relative-need basis

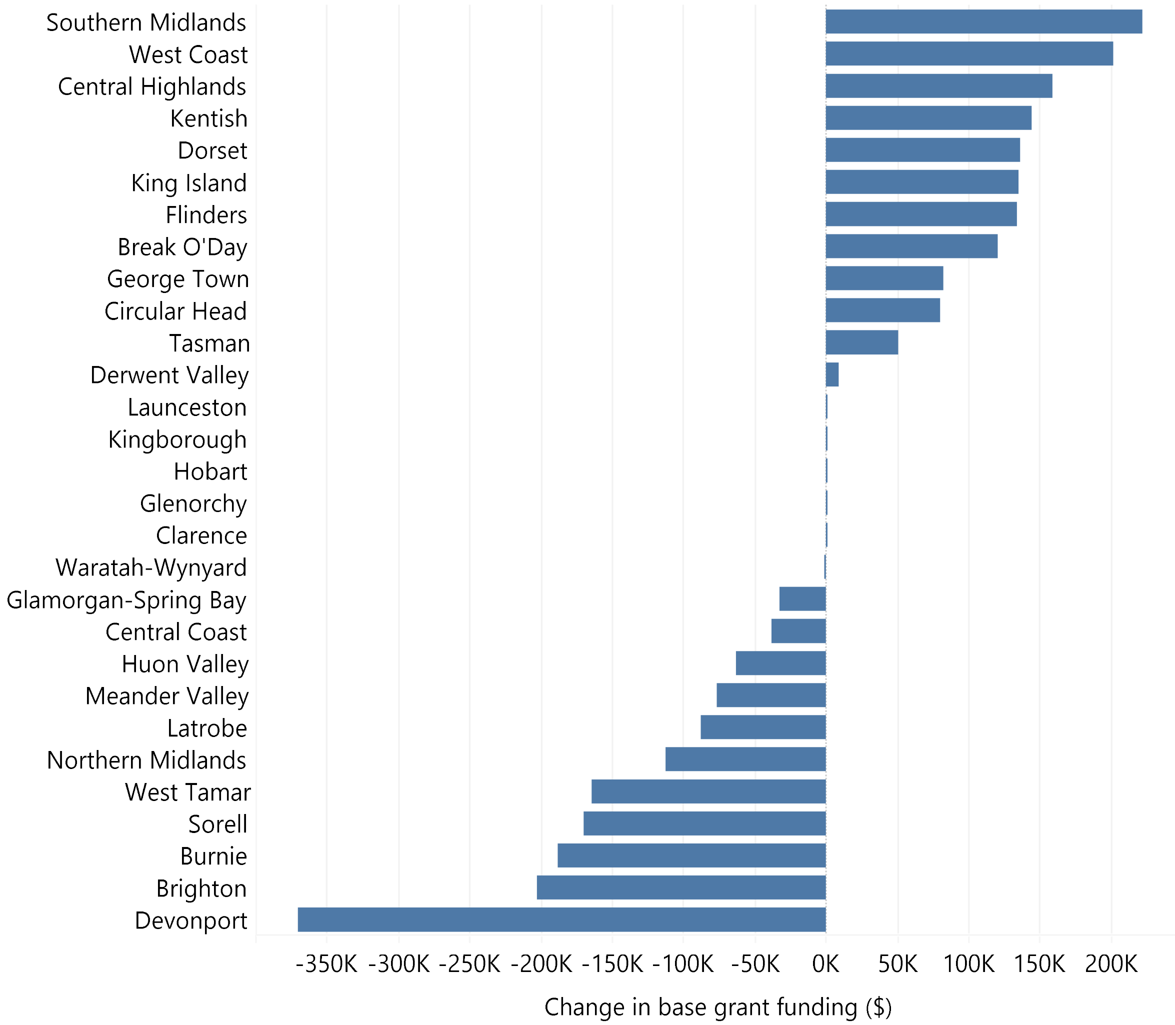
The Commonwealth *Local Government (Financial Assistance) Act 1995* requires that, when distributing base grant funding, state grants commissions ensure that no council receives less than what they would if 30% of the grant pool were distributed on a per capita basis.[20] In Tasmania, the State Grants Commission ensures this requirement is met by quarantining 30% of the total base grant pool and distributing it among councils on a per capita basis before allocating the remaining 70% on a relative-need basis. This is not the norm around the country, however. In some other states, like Victoria, the 30% per capita rule is applied only as a floor which no council may fall below, with the entire grant pool otherwise distributed on a needs-basis alone.

The State Grants Commission has recently explored adopting this approach in Tasmania; doing so would increase the ability of the limited base grant pool to equalise council fiscal capacity as fully as possible. In order to ensure that no council's funding changes exceed those allowable under the current SGC cap-

[20] See also Rural Councils Victoria and SGS Economics and Planning, 2022 *Alternative sources of income for local government* (page 61) for more discussion on the minimum grant and its implications in the context of Victorian councils. The paper notes that 16 councils currently receive the minimum grant that would otherwise not be entitled to any additional funding.

and-collar rules, a transition period would be required to implement this rule change gradually over several years. Figure 20 (below) illustrates the funding impact of this change.[21]

Figure 20: Change to base grant allocations if 30% per capita rule abandoned



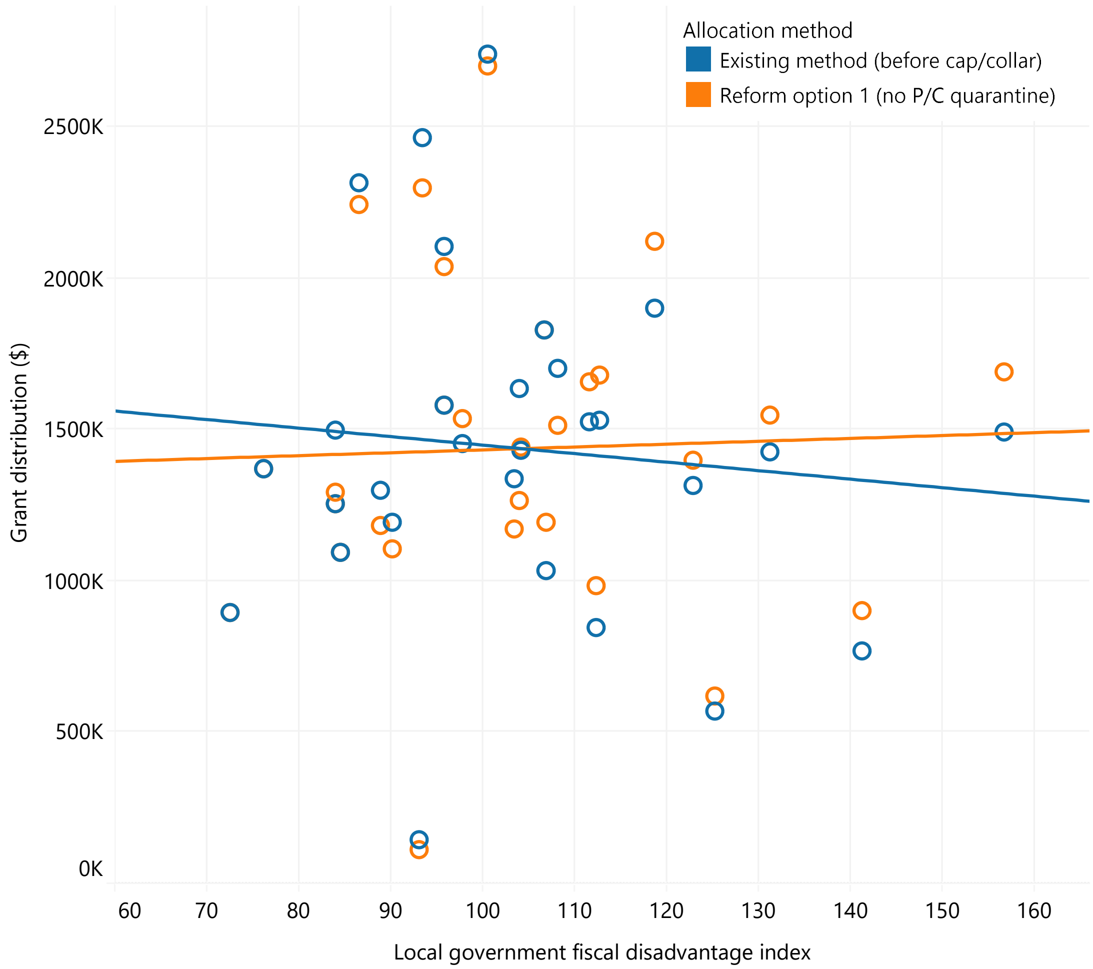
Abandoning the practice of quarantining 30% of the base grant pool for per capita disbursement in favour of a relative-need distribution with a per capita floor marginally improves the equity of the grant distribution overall. The below chart (Figure 21) illustrates how these two approaches compare against the composite index of local government fiscal disadvantage (for an explanation see p.36, footnote 11). The direction and gradient of the trend line in this figure indicates whether the grant distribution is progressive or regressive at a sector-wide level, and by how much. The 'residual' value (the distance between each dot and the trend line) can be taken to represent equity at a council-by-council level. In other words, if two dots of roughly equal fiscal disadvantage are receiving very different grant

[21] These estimates were calculated independently by applying the proposed rule change to relevant State Grants Commission financial assistance grant data. Our results typically vary from the Tasmanian State Grants Commission's estimates in their above-mentioned December 2022 consultation paper by around 0.1%.

distributions, the distance between them can be interpreted as an equity deficit for the purposes of this indicative modelling exercise.

The gradient of the two trends in this example shows that abandoning the per-capita step in the current SGC method makes the distribution (slightly) progressive overall, but still with a very high residual value, indicating inconsistent equity impacts at the level of individual councils.

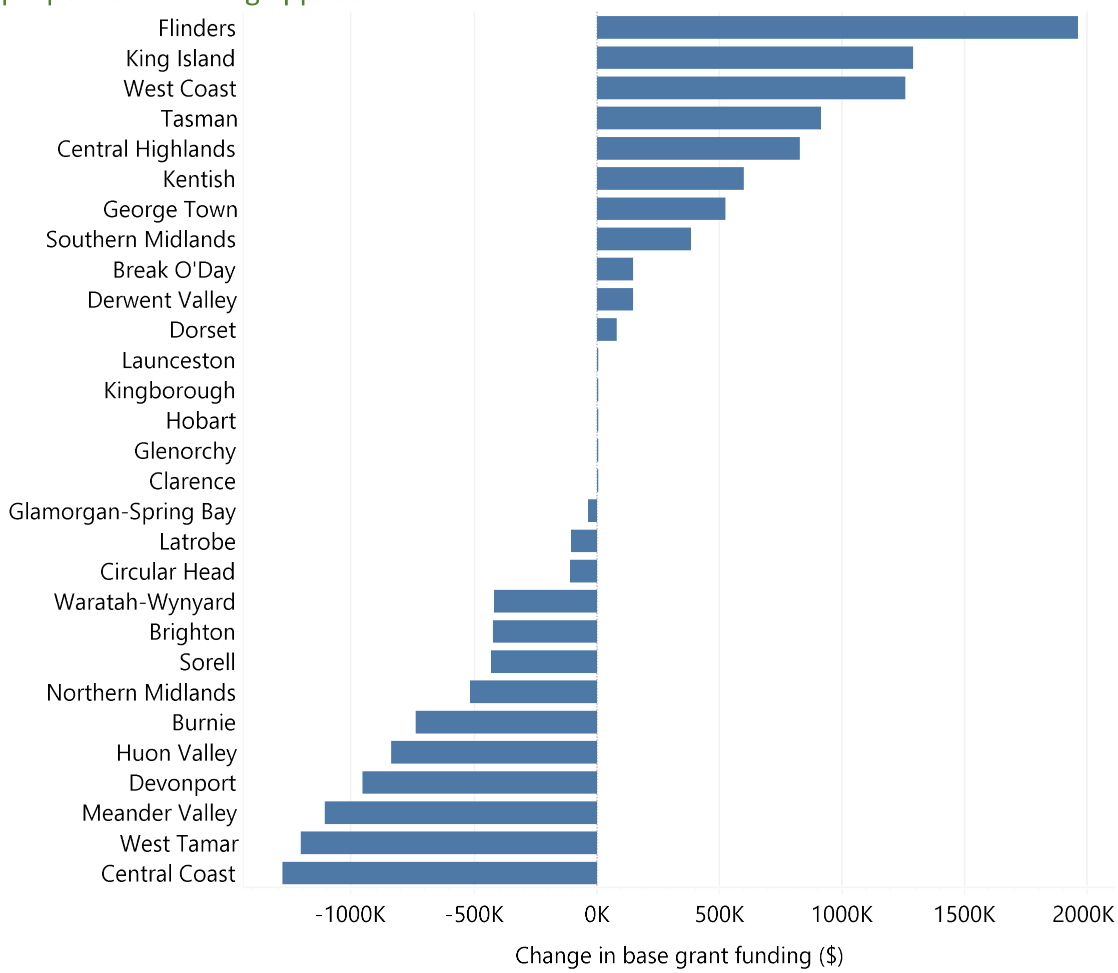
Figure 21: Equity impact of option 1 – per capita rule abandoned



Option 2: Weight allocation of relative need-basis grant to reflect fiscal gaps as a share of councils' assessed expenditure needs ('proportional scaling')

The second, and more significant, option for reforming the distribution of the relative need-basis portion of Tasmania's financial assistance grant pool is to alter the method for weighting councils' funding allocations. Under the current system, councils with same assessed revenue shortfall will receive the same needs-based funding irrespective of the size of their budgets. If the funding pool were large enough to bridge every council's fiscal gap, this would achieve an equitable distribution, but this is not the case. As noted above, in 2022-23 the relative-needs grant pool was roughly $29 million – far less than the SGC's assessed statewide deficit of $107 million. The Queensland Local Government Grants Commission addresses this issue by weighting each council's share of the base grant for the size of its fiscal gap rather than its unweighted share of the total notional deficit in dollar terms. If Tasmania were to apply this method, it would provide councils with a share of grant funding that better reflects the degree of their fiscal need. In order to ensure that no council's funding changes exceed those allowable under the current SGC cap-and-collar rules, a transition period would be required to implement this rule change gradually over several years. The below chart (Figure 22) illustrates the change in each council's base grant if proportional scaling were applied in conjunction with reform option one above.

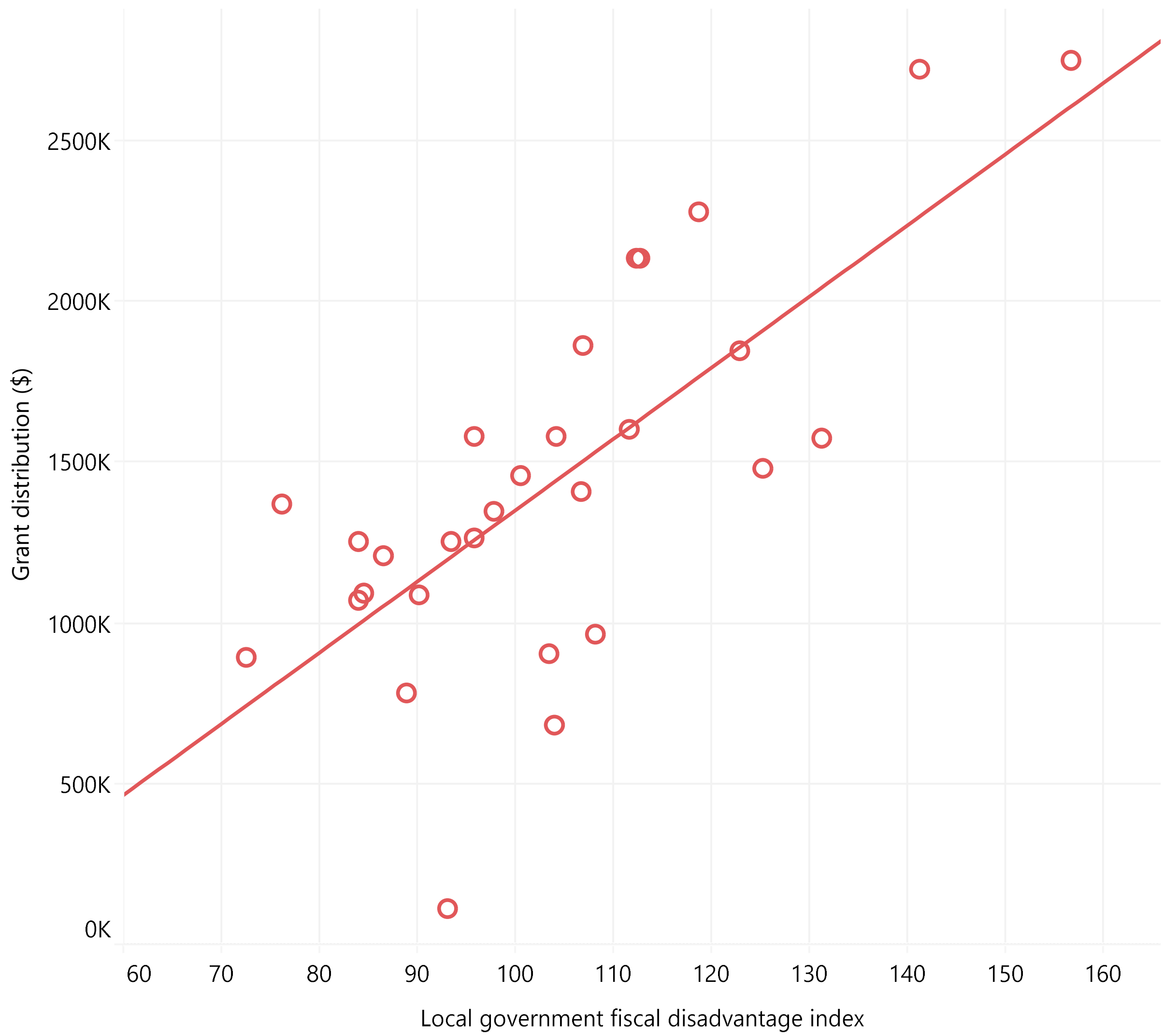
Figure 22: The change to base grant allocations if 30% per capita rule abandoned <u>and</u> proportional scaling applied



As noted above, reforms designed to ensure a more equitable distribution of grant funding should be considered as part of a holistic suite of reforms designed to improve the effectiveness, sustainability, and capability of regional councils. Finally, there is no reason why this method cannot be combined with the existing approach either as a transition strategy or to achieve other policy objectives. It would be methodologically straightforward to use councils' fiscal gaps as a weight in the existing process rather than abandoning the notional deficit approach in its entirety. This option therefore offers broad scope either to shift gradually and flexibly towards proportional scaling or to any other compromise position in between fully proportional and fully 'uniform' scaling as needs and circumstances require.

This approach delivers a significantly more equitable outcome relative to both the existing SGC method and option 1. By comparison with option one, the trend illustrated in the chart below (Figure 23) is not only much steeper (i.e., considerably more equitable overall) but also far more consistent between councils. The much higher residual value of the function in this chart indicates that the grant distribution modelled aligns very closely to individual councils' level of fiscal disadvantage.

Figure 23: Equity impact of reform option 2 (30% per capita rule abandoned and proportional scaling applied**)**

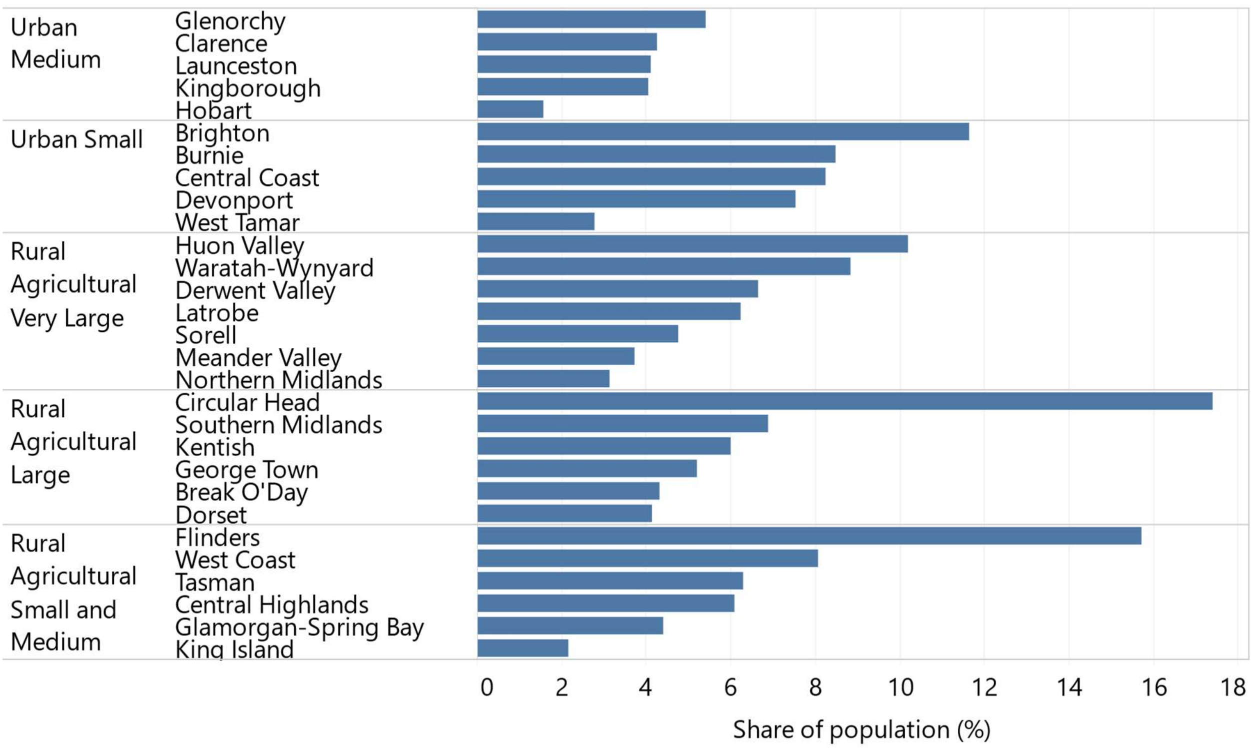


Option 3: Review expenditure cost adjusters to better reflect community need

When calculating councils' notional budgets under the current allocation method, the SGC applies a variety of 'cost adjustors'. This is to ensure that modelled expenditure needs accurately reflect the various advantages and disadvantages faced by different councils in delivering different services. For example, the 'worker influx' cost adjustor reflects the fact that some regions hosting large populations of non-resident workers experience strains on services and infrastructure that are disproportionate to their number of ratepayers.

While most of these cost adjustors are more or less appropriate, there are some anomalies and omissions that need to be considered as part of a broader methodological review. The first is to add a cost adjustor for a region's population share of Indigenous Australians. Tasmania is currently the only state or territory in the country to not apply such a cost adjustor. A recent methodological review in New South Wales found that it was one of their most important and statistically significant predictors of disproportionate pressure on local government expenditure. Figure 24 shows how the distribution of Tasmania's Aboriginal population varies across local government areas. Including a cost adjuster which reflects this distribution will help Tasmanian councils engage with and provide services for their Aboriginal residents.

Figure 24: Proportion of the population that identify as Aboriginal or Torres Strait Islander in Tasmanian LGAs



Another alternative cost adjuster to consider would be to use the SEIFA Index of Relative Advantage and Disadvantage (IRSAD) instead of just disadvantage (IRSD). Currently, for its socio-economic status cost adjustor, the SGC relies on IRSD. However, IRSAD is a more relevant and telling indicator not only of the types of disadvantage that disproportionately impact local government expenditure but also of the impact of the presence or absence of advantage on councils' theoretical revenue raising capacity. Given this report's earlier suggestion of making council rating schedules more progressive, it would follow that including the consideration of advantage as well as disadvantage in cost adjustment is prudent.

5.6 Supporting Regional Partnerships (and mandatory shared services)

Funding reform options outlined in this report have focused on creating a more efficient and equitable funding system for local government while stressing the need for complementary structural reform. Internationally, local governments are becoming more dependent on grants and transfers from subnational and national governments (Part 2). This is because the most efficient taxes on capital and labour are increasingly administered at a national level. Indeed, Australian councils are much more self-sufficient (less dependent on grant funding) than local governments in most other OECD countries (Figure 2.1).

Small rural and remote councils in particular face growing challenges maintaining assets and meeting community need. These are exacerbated by unsustainable funding models as well as insufficient scale to recruit and retain specialist staff and to establish and maintain efficient and effective service delivery and administrative systems. Specialist staff, services and systems could be provided via a state-wide service delivery model. However, this would be to the detriment of regional employment and would risk losing the local knowledge held by local government employees who live and work in their communities.

The New South Wales experience with Joint Organisations

In 2017 the New South Wales government established a network of Joint Organisations (JOs) across regional New South Wales as new entities to work across councils and with state government to deliver better community services and outcomes.

A 2021 Review of the model found that the JOs improved coordination and enhanced regional governance but would require additional and ongoing state funding (ARTD 2021). The Review also found that hosting a JO within major regional council was one five key success factors.

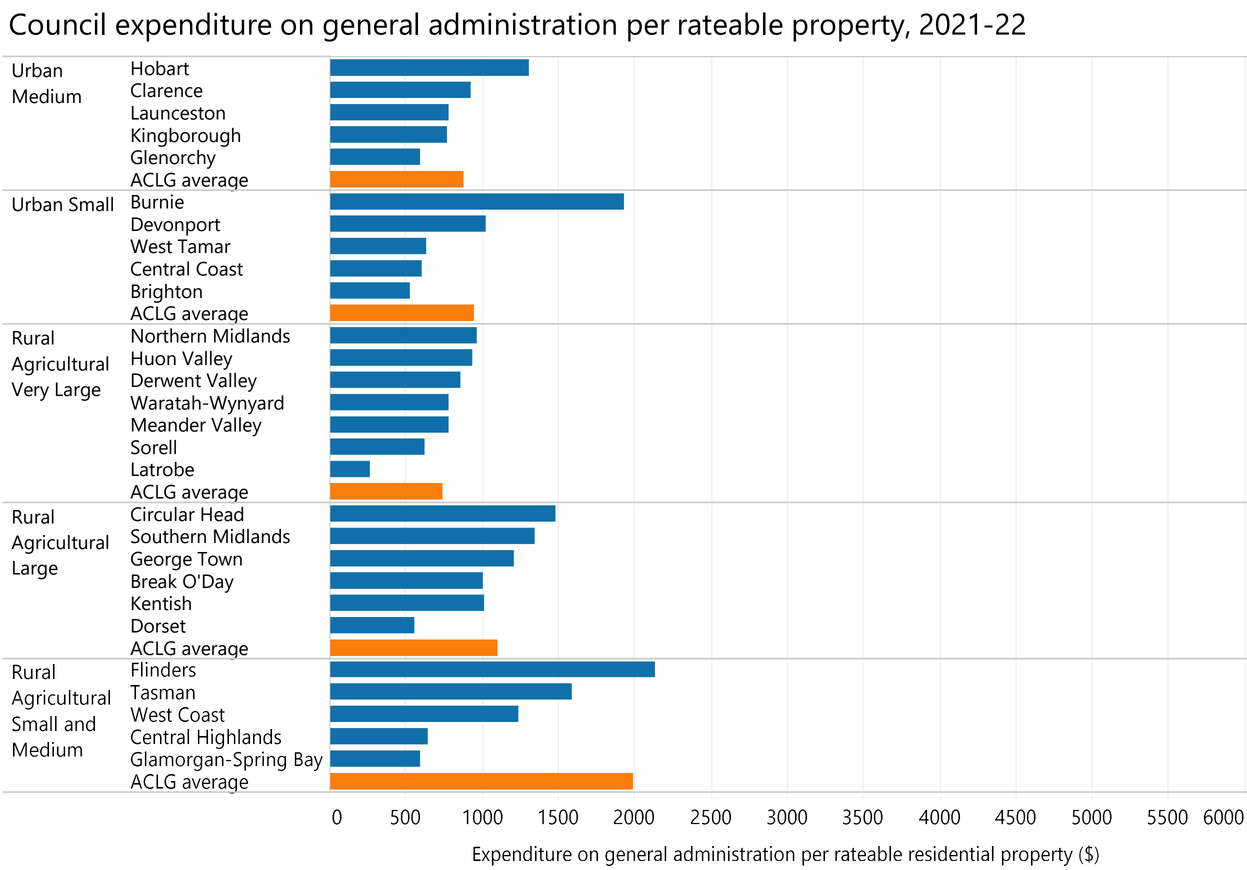
Based on the Review it is reasonable to conclude that a 'hub and spokes' model, where larger regional councils support and provide services to their smaller neighbours, is likely to be more efficient and enduring than establishing a new regional organisation to coordinate and deliver services on a regional basis. Ultimately, any model would have to be determined by councils, state government, and communities.

Supporting voluntary shared services on a regional (or wider) basis is one approach for addressing capability and staffing challenges facing regional councils. Research conducted for the FoLGR has found that voluntary arrangements can be vulnerable to the changing priorities and needs of the councils involved. A recent national review of voluntary municipal cooperation described it as 'shallow and fragile'.[22]

Given the capability challenges facing local government in Tasmania, one reform option is to establish mandated service agreements using a regional 'hub and spokes' model. Whereby a nominated regional council would provide more technical, specialised services and systems to neighbouring councils on a fee-for-service basis.[23] Such a model could address many of the challenges facing regional communities in that it would build capability in the local government system at a regional level; would help retain and build specialist employment in the regions; and would improve the overall efficiency of the system given the fixed costs and economies of scale of many administrative and service delivery systems.

[22] Tasmanian Policy Exchange, August 2022 *Options for sharing services in Tasmanian Local Government*; Sansom, G., 2019 *The practice of municipal cooperation: Australian perspectives and comparison with Canada* University of Toronto.
[23] Sansom, G., 2019 *The practice of municipal cooperation: Australian perspectives and comparison with Canada* University of Toronto.

Figure 25: Fixed costs associated with administrative systems result in higher expenditure per capita on administration in smaller councils



Incentivising a regional hub and spokes model

Determining the services, systems and staff which could be provided through a regional hub model would be achieved through consultation and negotiation between communities, relevant councils, and the Tasmanian government. While the service mix would vary across regions there would be a focus on areas requiring specialist staff and experiencing expertise shortages. Examples include engineering and environmental health services, or where there are clear economies of scale or benefits from shared or common systems. Having established areas where the regional provision of services would deliver community benefits, governance arrangements and service and pricing agreements would have to be developed.

Given the system-wide benefits of a regional hub and spoke model, the Tasmanian government could consider subsidising the cost for smaller councils purchasing services from a regional hub during a transition period to offset the costs of establishing partnerships and to deliver savings to participating councils. Based on the Canadian experience, the state will have an ongoing role in providing a legislative and administrative framework to sustain 'Statutory Regional Partnerships'.[24]

[24] Sansom, G., 2019 *The practice of municipal cooperation: Australian perspectives and comparison with Canada* University of Toronto.

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