The outcomes of rate capping 2016-17 to 2017-18

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The outcomes of rate capping — 2016-17 to 2017-18

Rate capping is a system that limits the amount councils can increase their general rates and municipal charges each year. The rate capping framework commenced in the 2016–17 rating year following the passage of legislation in 2015.

We are required to report every two years on the outcomes of rate capping in Victoria and identify any impacts or trends that might be emerging across the local government sector.[1]

This overview provides some key observations about the Victorian local government sector as a whole. We have also released fact sheets for each council as well as the five council groupings (metropolitan, interface, regional cities, large shires and small shires). These fact sheets are available at https://www.esc.vic.gov.au/outcomes-reports.

Observation 1

With three exceptions, all councils complied with the rate capping framework in its first two years of operation.

Each year, the Minister for Local Government sets the rate cap for the coming rating year. Councils must comply with the Minister's rate cap unless they obtain approval from us for a higher cap. In 2016, we approved 6 higher caps for the 2016–17 rating year. The following year we approved 4 higher caps, with 3 applications being for multi-year higher caps.

Table 1 Compliance with applicable rate caps

	Minister's cap	Number of councils with an approved higher cap	Number of compliant councils
2016–17	2.50%	6 (ranging from 3.05% to 6.34%)	79
2017–18	2.00%	4 (ranging from 3.50% to 5.55%)	76

While there is no sanction for councils who do not comply with the applicable rate cap, the one materially non-compliant council committed to returning funds collected in excess of the rate cap to

[1] Section 10E(3) of the Essential Services Commission Act 2001 requires us to prepare a biennial report containing an assessment of outcomes as a result of Orders made under the Local Government Act 1989 and the identification of any trends across the local government sector arising from the caps and of any other impacts of the caps on the sector. In performing this function, our objective is to promote the purposes of Part 8A of the Local Government Act 1989, which includes promoting the long term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure: section 10E(7) Essential Services Commission Act 2001.

ratepayers in the following rating year. The other two councils were found to be immaterially non-compliant, meaning the level of non-compliance was negligible and of no immediate concern.

Observation 2

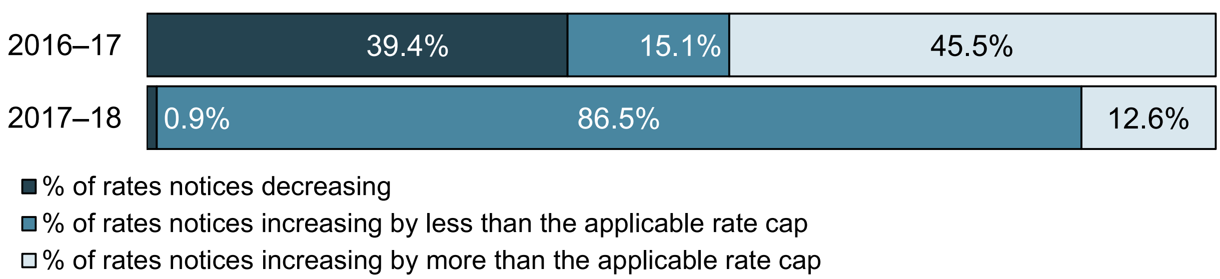
The experience of individual ratepayers varied significantly with many experiencing rate increases above or below the rate cap applicable for their council.

The rate capping framework ensures that *on average* ratepayers don't face rate increases above the rate cap for their council. While the rate cap applies to the average increase in a council area, individual ratepayers will experience increases that differ from the average increase.

This variation in individuals' experience arises because rates are based on property values. All properties were revalued in 2016–17. This saw some properties proportionately increase in value by more or less than other properties in the same municipality.[2] Ratepayers whose property increased in value proportionately by more (less) than others saw their rates increase by more (less) than the rate cap for their council.

In 2016–17, approximately 46 per cent of all ratepayers experienced increases higher than the applicable cap, while 15 per cent of ratepayers saw their general rates and municipal charges increase by the rate cap or less. Over 39 per cent of ratepayers experienced a decrease in their general rates and municipal charges. In 2017–18, which was not a revaluation year, only 13 per cent of ratepayers experienced increases higher than the applicable cap. These increases were generally due to changes in the differential rate applied to a property, changes in property values (for example, because of a renovation or extension) or changes in property classification.

Figure 1 Distribution of capped rate increases and decreases



Data source: Request for information by the Essential Services Commission, 10 councils either did not respond to our request or were unable to provide the relevant data. Note: 2016–17 was a revaluation year.

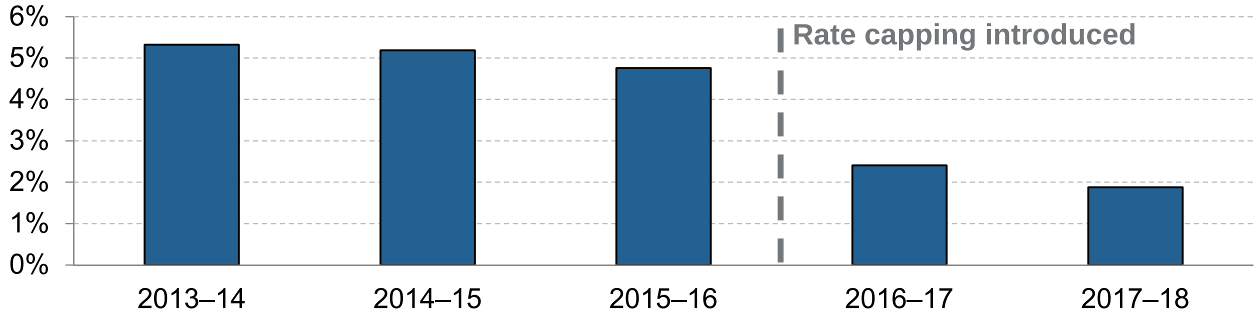
[2] Increases in individual ratepayers' rates can also differ if a property is reclassified (for example from residential to commercial) or the council makes changes to its differential rating structure.

Observation 3

Growth in council revenue generated by rates and charges slowed following the introduction of the rate capping system.

Growth in the sector's total rate per property revenue reduced from an average of 5.1 per cent per annum in the three years prior to the introduction of rate capping, to 2.4 per cent in 2016–17 and 1.9 per cent in 2017–18. This revenue includes both capped rates and charges as well as charges that are not subject to the cap (such as waste charges). In other words, annual growth in total rates and charges per property largely mirrored the minister's rate caps of 2.50 per cent and 2.00 per cent in 2016–17 and 2017–18, respectively.

Figure 2 Growth in rates and charges per property (state-wide average)



Data source: council annual reports (audited), Victoria Grants Commission (unaudited data).

Observation 4

While the rate capping framework reduced the rate of growth in the rate revenue collected per property, an increase in the total number of properties (largely driven by population growth) saw overall revenue growth remain relatively stable across the local government sector.

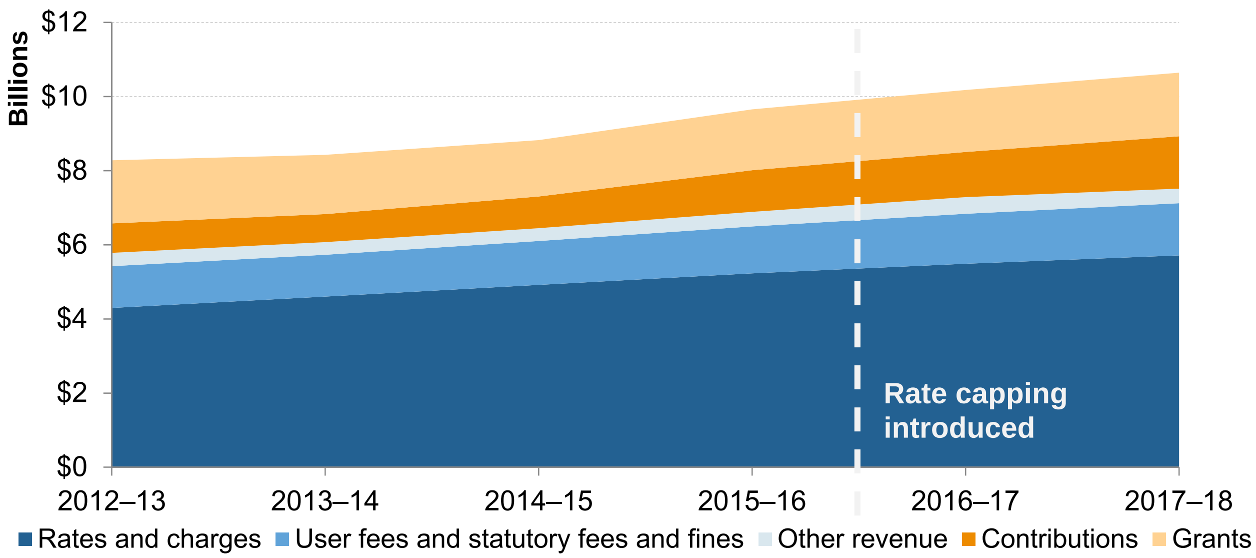
Growth in the number of properties has increased the rate base, meaning growth in total rates revenue was higher than the growth in rates revenue per property (which, as observed above, largely mirrored the minister's caps). In addition, the sector's overall revenue grew due to an increase in monetary and non-monetary contributions from developers and landowners associated with new property developments. Other contributors to councils' revenue growth were increases in government grants and user fees and statutory fees and fines.

Table 2 Growth in rate revenue (state-wide)

	Before the introduction of rate capping (2012–13 to 2015–16)	After the introduction of rate capping (2015–16 to 2017–18)
Average growth in rates revenue per property	5.1%	2.1%
Average growth in total rates revenue	6.8%	4.5%

Data source: council annual reports (audited), Victoria Grants Commission (unaudited data). Note: These figures include both capped and uncapped rates and charges.

Figure 3 Total sector revenue, by source

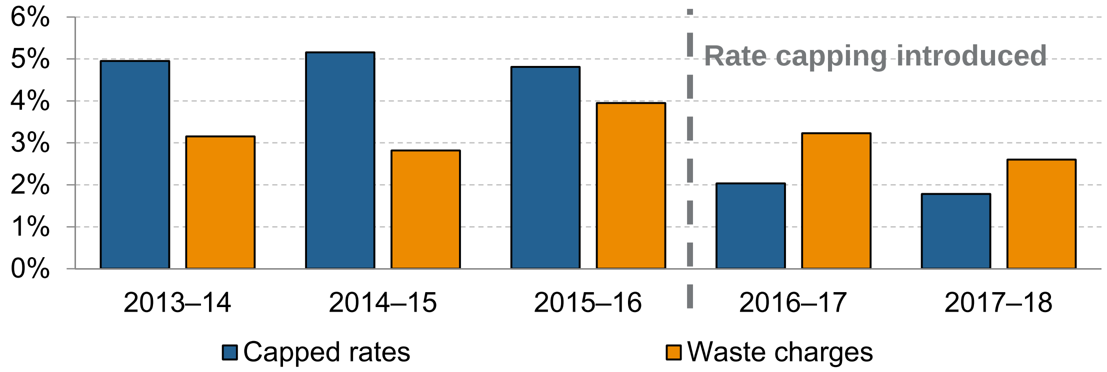


Data source: council annual reports (audited).

> **Observation 5**
>
> Rate caps do not appear to have led to a notable increase in waste charges (which do not fall under the rate cap).

Approximately 12 per cent of the sector's total rates revenue comes from rates and charges that are not capped under the regime. These charges mostly consist of waste charges. Waste charges increased at a rate similar to the rate of increase observed prior to the introduction of the rate cap regime. Despite suspicions raised with us during our 2015 review into rate capping, we have found no evidence to suggest that councils have substantially increased uncapped waste charges as a way of raising extra funds following the introduction of the rate capping framework. As shown in figure 2, although service charges increased by more than general rates and municipal charges after the introduction of the rate capping framework, the rate of increase was largely steady in the three years before and two years after the introduction of rate capping (at about 3 per cent per year).

Figure 4 Growth in capped rates and waste charges, per property (state-wide average)



Data source: council annual reports (audited), Victoria Grants Commission (unaudited).

In the first two years following the introduction of rate capping, three councils introduced new waste charges. This was done in a revenue neutral way, that is, capped rates were decreased to offset the new waste charges.

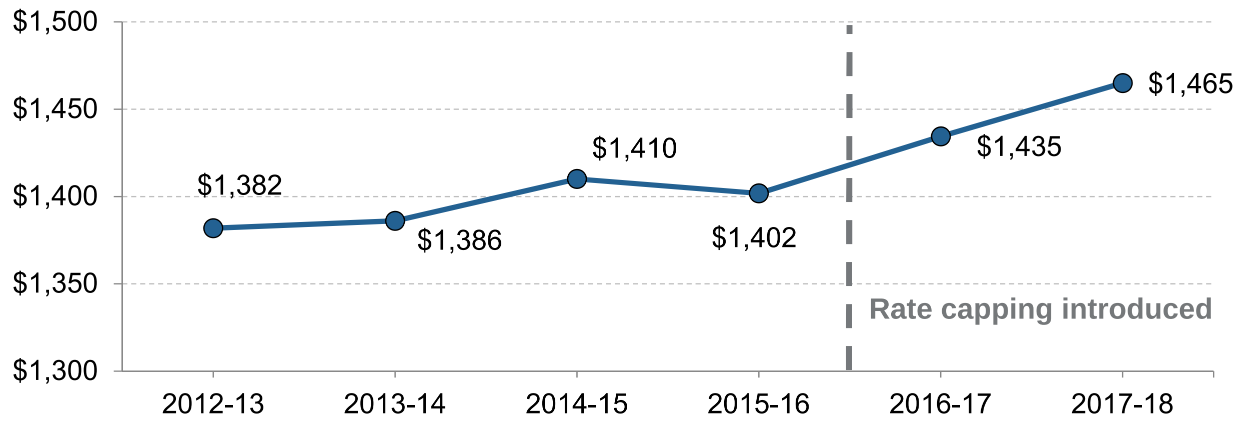
Observation 6

While the sector's overall spending increased in the first two years of rate capping, councils limited increases in some areas of expenditure — most notably employee costs as a result of new enterprise bargaining agreements.

Growth in council expenditure increased at a faster rate in the first two years of rate capping. This is true in terms of councils' total expenditure as well as their expenditure levels per head of population. Although total expenditure was relatively flat in the three years before rate capping, it increased in the first two years of rate capping.

For just over half of all councils, operating expenditure per head of population grew faster in the two years after rate capping was introduced than in the three years before its introduction. Similarly, for 44 councils (including a high proportion of large shires), capital expenditure per head of population grew faster.

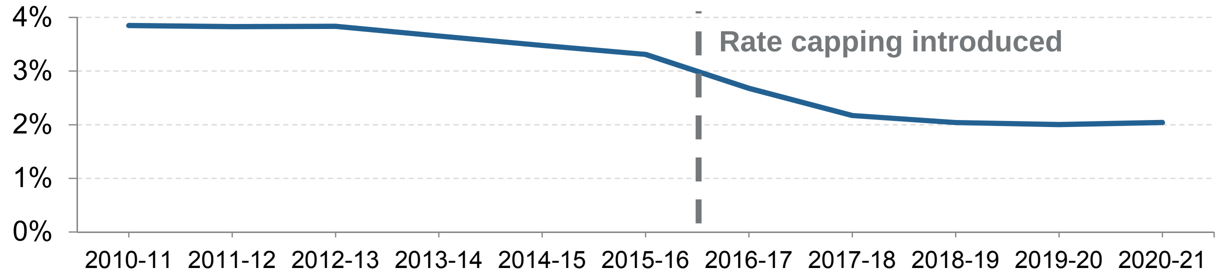
Figure 5 State-wide expenditure per head of population



Data source: council annual reports (audited), Australian Bureau of Statistics 2018, Regional Population Growth, Australia 2016-17 - Revised, cat. no. 3218.0, ABS, Canberra.

While the overall level of expenditure across the local government sector has grown since the introduction of the rate capping framework, growth in labour costs has moderated.

Figure 6 Average salary increases under enterprise bargaining agreements



Data source: council enterprise bargaining agreements; Australian Bureau of Statistics 2018, Wage Price Index, December 2018, cat. No. 6345.0, ABS, Canberra; Department of Treasury and Finance forecast.

Observation 7

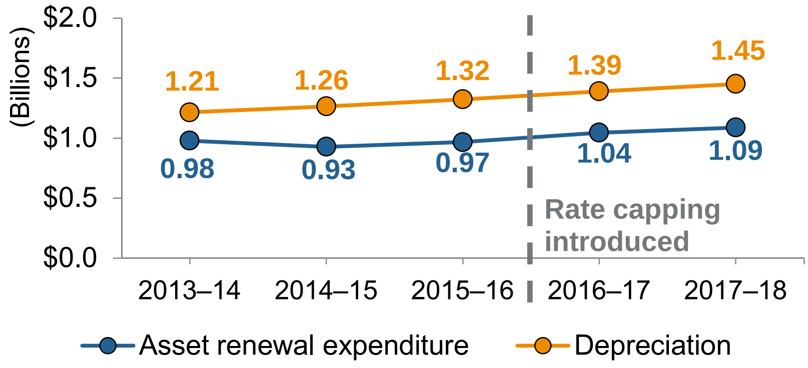
While the sector's asset renewal expenditure increased, the ratio of expenditure to depreciation remained similar to historical levels.

Prior to the introduction of rate capping, there were widespread concerns across the sector about the effect of the rate cap on councils' capacity to fund the renewal gap.[3] Because there is no widely accepted measure of the renewal gap, we used the asset renewal ratio reported in the Local Government Performance Reporting Framework as an indication of whether the renewal gap was

[3] These concerns were raised during our 2015 review of the rate capping framework. See Essential Services Commission 2015, A Blueprint for Change, Local Government Rate Capping & Variation Framework Review — Final Report, September.

increasing or decreasing.[4] The asset renewal ratio remained relatively stable in the two years immediately before and after the introduction of rate capping.

Figure 7 Asset renewal expenditure and depreciation (state-wide)



Year	Asset renewal ratio (%)
2013–14	81
2014–15	73
2015–16	73
2016–17	75
2017–18	75

Data source: council annual reports (audited).

Observation 8

In general, the financial health of the sector remained strong with positive adjusted underlying results, increasing working capital and falling indebtedness.

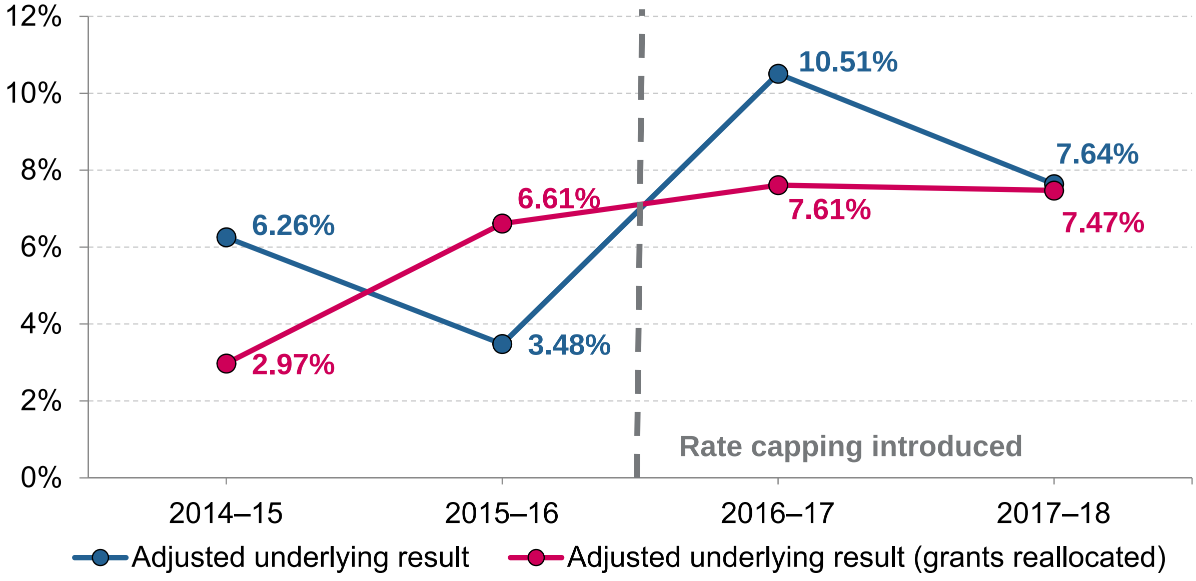
The sector as a whole had a positive adjusted underlying result in each year between 2014–15 and 2017–18, with an average over the four years of 6.2 per cent.[5] An ongoing positive result suggests that the sector as a whole was able to fund the levels of service provided.

While the overall result is positive, we note that 18 councils (mostly regional) reported negative average adjusted underlying results between 2014–15 and 2017–18. Ongoing negative results suggest that these councils will be dependent on external sources of funds (such as state and federal grants) or they must become more efficient in delivering their existing levels of services if they are to avoid rate increases above the rate cap.

4 We note that this measure may not accurately reflect the actual condition of council assets or provide an indication of the size of any asset renewal gap. It does not account for past underfunding of assets. Nor does it account for council choices to upgrade or expand existing assets, or invest in new assets, in place of renewing assets.

5 The adjusted underlying result shows the operating position of a council, that is, its surplus or deficit after non-recurrent revenues (such as one-off capital grants and non-monetary contributions from developers) have been removed. Some of the fluctuation in councils' reported adjusted underlying results was due to the advance receipt of some of councils' annual Commonwealth grant allocations in some years. Because of this, we adjusted for the timing of grant payments for the sector as a whole.

Figure 8 Adjusted underlying result (state-wide)



Data source: Local Government Performance Reporting Framework, Victoria Grants Commission. Note: The 'Adjusted underlying result (grants reallocated)' reflects the reallocation of commonwealth grant revenue to the year it relates to rather than the year of receipt.

Over the same period, working capital increased steadily, with a number of councils building up cash reserves to fund capital works or repay loans in the future. With average working capital of 255 per cent across the four years, the sector as a whole was able to meet its short-term obligations.[6]

Indebtedness trended downward for the sector as a whole between 2014–15 and 2017–18. Over this period, average indebtedness for the sector was 21 per cent suggesting that the sector was able to meet its long-term liabilities.[7] The total value of long-term interest bearing loans and borrowings across the sector fell from $1 045 million in 2014–15 to $975 million in 2017–18. While a number of councils reduced their long-term debt levels and forecast further debt reductions in the future, there are some councils that continue to have high levels of debt.

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6 Working capital is defined as current assets (cash savings and assets that can be sold, for example vehicles) as a percentage of current liabilities (debts payable within 12 months).

7 Indebtedness is measured as a council's non-current liabilities (mainly bank loans, but also including future long service leave and landfill restoration obligations) as a percentage of its own source revenue (which is revenue within the council's control like rates and charges and user fees).

Conclusion

Rate capping has reduced rate increases for the average ratepayer, but population and associated property growth, together with increases in revenue from other sources has kept the growth in the sector's overall revenue relatively stable over time.

In the first two years of rate capping, the sector increased its overall expenditure on services and infrastructure. Asset renewal expenditure increased in the first two years of rate capping although it remained below the level of depreciation.

While some councils continued to have adjusted underlying deficits or high levels of debt, all councils had sufficient liquidity (working capital) to meet their financial obligations and, in general, the financial health of the sector remained strong.

The observations and conclusion presented in this overview relate to the sector as a whole. See our fact sheets for information on each of the 79 individual councils.

We will continue to monitor the outcomes of rate capping and expect to release our second report in 2021.