

**Commonwealth Grants Commission Draft
2010 Review Report**

**Victorian Response to 2010
Review Draft Report**

September 2009



Department of Treasury & Finance

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1. Introduction

Victoria has been an active participant in the 2010 Review, from developing the Terms of Reference (ToR), to advising on data sources, assessment methods and materiality thresholds. Rather than purely critiquing Commission Staff's proposals, Victoria has attempted wherever possible to enhance those proposals with data and technical suggestions.

Victoria welcomes the Commission's adherence to the spirit of the ToR throughout the Review. The ToR asks for simpler methods of assessing State needs, combined with the use of more robust data. In general, both have been achieved. The Commission has sought State comments on a hierarchy of issues:

- Have State submissions, supporting data and evidence been misinterpreted;
- Are the proposed methods faulty, for example due to exclusion of material and measurable disabilities; and
- Where the Commission has been forced to make judgments in the face of strong conceptual cases and evidence but without reliable data, can those judgments be strengthened?

This submission therefore identifies areas where Victoria considers that Commission judgment and standards have been applied inconsistently between categories, and where data or evidence has been misinterpreted. We concentrate on categories that are still to be finalised (e.g. Services to Communities), and where Victoria has concerns about methods and/or data (e.g. Location).

Victoria notes the Commission's concerns about the implications of several of the changes it has made to the assessment system. Victoria considers that these concerns may in part be due to the results of the new categories not lining up with preconceived ideas about the nature and extent of disabilities. Victoria urges the Commission not to overly rely on such preconceptions, or the results of past Reviews, in its deliberations leading up to the Final Report. The Commission is now relying on a higher general standard of data than in past Reviews. Wherever possible, this data should be trusted to give a more reliable GST distribution without the need for overarching Commission judgment.

Victoria has always been a strong supporter of horizontal fiscal equalisation (HFE). Victoria considers HFE to be a key principle for a functional federation. The intent of HFE is to ensure that states with limited fiscal capacities are given the capacity to provide similar services to their communities as provided in other states. Victoria considers that the support of states with smaller economies should be the overriding intent of HFE.

2. Capital

2.1 National Network Roads (NNR)

Victoria is concerned that NNR funding has been separated from all other Commonwealth (and State) funding for capital projects. The latter is assessed in the investment component of the investment category, which has ongoing disabilities applied. NNR capital funding is proposed to be assessed APC in its own component of the investment category, meaning it will have no impact on States' overall assessed fiscal capacities.

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The Commission has determined that NNR "...should not affect State fiscal capacities because they reflect the broader transport needs of the nation rather than the circumstances of individual States."

The Commission has premised this APC assessment on the assumption that the benefits from NNR funded projects are national in nature rather than specific to the state in which the project is located. On that basis, the proposed assessment assumes that actual expenditures fully account for state needs. However, Victoria considers that this assumption is too simplistic. Whilst there may be broader benefits from NNR funded projects, the projects invariably also play a major role in servicing local state needs.

This is reflected in the terms of the national agreement underpinning such funding arrangements. The preliminaries of the National Partnership Agreement on Implementation of the Nation Building Program state that:

"Many of the Commonwealth's investment priorities closely reflect State and Territory priorities and interests."

This indicates that projects funded by the Commonwealth *are of local interest* to relevant State and Territory Governments. Many of these projects, if not funded by the Commonwealth, may have been required to be undertaken by the relevant State in some form.

An APC assessment also assumes States have no say in where the money is spent. This is only partly true for NNR payments, since States submit projects for funding. States are unlikely to submit projects that do not service their local State needs, and the Commonwealth is not going to give States money for projects where the State itself doesn't rate the project as important enough to make a funding submission. In short, only projects for which States ask for funding will be funded, which means that States in aggregate do play a significant role shaping where NNR capital grants are spent.

The proposed assessment leads to a piecemeal and inconsistent assessment of roads funding. NNR capital grants will be assessed APC, while matching State funding for the same project (generally 20-50 per cent of the project cost) will be assessed in the investment component of the investment category. Meanwhile, spending to maintain the road in future will be assessed in the Roads category. Thus, the construction and maintenance of the same piece of road will be assessed in three different ways. There is no clear conceptual basis for this inconsistent treatment.

Given that these grants do clearly assess State needs, Victoria considers that NNR capital grants should be treated by inclusion in the service delivery component of the investment category.

2.2 Conceptual issues

Aside from our concerns about the treatment of NNR capital funding, Victoria has raised many conceptual concerns with the Commission's proposed approach in past submissions. Briefly, the direct assessment of capital needs:

- Extends the scope of HFE beyond the net operating balance, despite there being no change in States' circumstances requiring a change of scope;
- Treats capital as a service in itself, when in fact it is an input to service delivery. The annual cost of capital used in service delivery is already recognised in depreciation, so to assess new capital needs, as well as depreciation, is unnecessary; and

- Recognises and applies population dilution effect to total net financial assets, even though there is no evidence that such a dilution effect exists for the GBE equity component of net financial worth. Statistical evidence indicates that in practice, there is no negative correlation between GBE equity and population growth. Moreover, the approach assumes all components of net financial worth are available to earn interest revenue to support general government sector service delivery. This is not the case. Equity in GBEs is not available to earn interest; in some cases dividends may be paid, but these are highly policy influenced and assessed EPC as a result. Ideally, on this basis, GBE equity should be excluded from net financial worth for the purpose of any direct capital assessment,

Despite these concerns, we understand that the Commission considers that a direct assessment of capital requirements is the most effective way forward. Under these circumstances, Victoria considers that the proposed assessment is an appropriate way to undertake a direct capital assessment (the treatment of NNR and GBE equity excluded). In particular, Victoria agrees with the discount applied to recurrent disabilities. This discount is necessary because, as demonstrated in our previous submissions, not all recurrent disabilities flow through to capital requirements. This discounting should also be applied to the depreciation assessment for the same reasons. Any move away from discounting would be unacceptable to Victoria.

Victoria notes that some State, including South Australia and Tasmania, have circulated alternative proposals. Victoria is not convinced that these proposals address our conceptual concerns outlined above and would prefer the Commission's proposal over these subsequent proposals.

3. Location

3.1 Interstate non-wages

Victoria considers the data and method adopted to assess interstate non-wage disabilities (freight and interstate travel) is below the standard required for this Review. A general discount of 15 per cent has been applied to the assessment to reflect concerns about data uncertainty. However, Victoria considers this discount does not reflect the minimal data backing the considerable judgment incorporated in the assessment. The data available (ABS Input-Output data) is very general and, in Victoria's view, not fit for the purpose of assessing interstate freight requirements.

Victoria recognises that the Commission is convinced of the conceptual case for an interstate non-wage assessment, and notes that many costs recognised by the 2004 Review are not being included in this Review due to lack of supporting data. The Commission should not use the minimal data it has on interstate freight to account not only for freight, but for other costs as well. Victoria considers the discounting applied to the proposed interstate freight assessment is appropriate, given the data are not entirely fit for purpose. However, the Commission should not try to account for alleged disabilities that cannot be backed by the data, simply because those disabilities have been assessed in the past.

3.2 Interstate travel costs

Commission staff recently informed States of the possibility of an interstate air travel assessment. The more remote States have campaigned for such an assessment throughout the 2010 Review, but Commission staff have struggled to find reliable data with which to quantify the disability. The proposed assessment would account for extra travel incurred by

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some States because most meetings are held in Canberra, Sydney or Melbourne. However, this premise is questionable, with many meetings rotated among the State capitals.

The Commission should also consider the cost of hosting meetings, when deliberating on the materiality of this disability. There are some cases where it may be cheaper for States to fly representatives to another capital than host the meeting themselves. Victoria notes that sending delegates business class is another policy choice impacting the cost of interstate travel. To properly assess a disability, Commission staff will have to calculate what the average policy is in this area.

Victoria considers such an assessment would be policy influenced. In Victoria's experience, the number of staff sent to meetings is unequal (precluding an equal-per-State assessment as proposed by some States) and random. Numbers seem to depend on where the meeting is held (home States send more delegates, no matter what their population size) and the number of people States consider necessary to cover the agenda. Victoria is aware of cases where the number of delegates to a meeting has been stipulated, but some States send more delegates anyway. This is not something States should be compensated for under HFE.

Victoria is aware of moves to install Telepresence teleconferencing in all State 1st Ministers' departments, and 12 in Commonwealth locations, over the next 3-6 months. This equipment is being funded by the Commonwealth (with recurrent maintenance and depreciation funded by the States) and will be available for any intergovernmental business, including COAG-related meetings, Ministerial Council meetings and meetings of Senior Officials, working groups or officials groups, and bilateral or other ad-hoc meetings between any jurisdictions on the network. This obviously has the potential to significantly reduce travel costs over the timeframe of the 2010 Review.

In summary, Victoria objects to an interstate travel costs assessment. Victoria considers the any assessment will be subject to policy influence, and once hosting costs are taken into account, the disability is unlikely to be material.

4 Roads

4.1 Unsealed road length

Although there may be some minor policy influence in States decisions about sealing arterial roads, such decisions are primarily influenced by traffic volume considerations. The draft report does not make a case that State policy differences are significant. There is no analysis of the impact of State policies regarding sealing roads at different traffic volumes or sealing in high rainfall areas.

Two questions are pertinent here: First, what proportion of sealed rural roads is sealed purely due to high rainfall?; and second, at what traffic volume does each State (climate and community service considerations aside) seal its roads?

Much of Victoria's rural arterial road network is sealed because of the significantly higher traffic volumes associated with higher rural densities compared to other States. The average annual daily traffic (AADT) volume on Victoria's Class C rural arterial roads, ie. the lowest classification of road many of which have been deemed to be unsealed in the proposed CGC assessment, is in excess of 1,000 vehicles per day. This is in excess of the volume carried on many National Highways and primary rural arterial roads in several other States.

Only if the first answer is “significant”, and there are major differences in traffic volumes required to deem sealing necessary in different States should the State-provided data be adjusted. An answer to the first question will be difficult to ascertain, leaving the second question as the main determinant of policy influence.

If there is sufficient difference in policy, a weighted sealing threshold could be calculated and States could have their unsealed road length adjusted by the ratio of their sealing threshold to the weighted threshold. Those that seal roads at higher thresholds than the average would have their unsealed road length reduced since they would tend to have more unsealed and less sealed roads.

4.2 Unsealed road weight

Victoria also questions the unsealed road weight of 0.5 (that is, it costs half as much to maintain unsealed roads as it does to maintain sealed roads) used as a placeholder in the draft report. In Commission position paper 2008/25, the placeholder was 0.15, based on Victorian data only. Since the position paper, updated Victorian data, which showed a weight of 0.11, combined with comparable data from New South Wales (weight about 0.13) and Tasmania (along with non-comparable data from Queensland) have more than trebled the weight.

Victoria questions the 0.5 weight, given the two largest States in terms of population both say it costs only 10 to 15 per cent as much to maintain unsealed roads. If the Commission has weighted these data in terms of the adjusted unsealed road lengths from table 16-4, NSW and Victoria account for 20 per cent of the unsealed roads. For a 0.5 weight to come out of this, the other 80% of unsealed roads would have to be about 60 per cent as expensive to maintain as sealed roads in those States. However, the Commission only has (at the time of printing the draft report) data for at most another 25 per cent of unsealed roads (those in Tasmania and Queensland). Victoria considers the mathematics of this change is unlikely to be backed up by credible data. The weight should therefore be returned to the more realistic level of 10 to 15 per cent.

5 Community and other health

5.1 Location impacts in the subtraction model

Victoria supports the Commission’s proposals for the treatment of Medicare supplementary incentive payments. These payments are not for State-like services and should be excluded from the model.

Victoria has no comment to make regarding the exemption of some hospitals and community health centres from section 19(2) of the Health Insurance Act.

6 Revenue

6.1 Treatment of brown coal royalties

Victoria notes that brown coal has been retained in the energy component of the Mining assessment, in part because it would not be material to change its treatment to non-energy. This is despite brown coal royalty rates being more like those applied to other non-energy minerals, and despite Uranium being classed as a non-energy mineral for this reason.

Victoria considers there is a good case to review this decision in light of recent increases to royalty rates on black coal in NSW and Queensland. In its 2008-09 Mini-Budget, NSW increased its black coal royalties by about 20 per cent from 1 January 2009. The 2008-09 Queensland Budget introduced a progressive coal royalty system from 1 July 2008. Where the average value of all coal produced by a mine exceeds A\$100 per tonne, the value up to A\$100 per tonne will be taxed at \$7 a tonne, with a royalty of \$10 a tonne applied to the value of coal above \$100.

These changes make the gap between brown coal royalty rates and those applied to other energy minerals even larger, and make it more likely a reclassification of brown coal would have a material impact on the distribution. Victoria therefore requests this issue be revisited prior to the Final Report being released, with a view to assessing brown coal alongside uranium as a non-energy mineral.

6.2 Conveyancing duty

Victoria is concerned that the Commission is entertaining requests to increase the number of value ranges used to determine the value distribution adjustment for this assessment. This is despite tests revealing that additional thresholds would not materially affect the GST distribution.

Commission staff have requested information on whether States could provide data on transactions at \$100 000 intervals, up to \$3 million, and over \$3 million, some 31 data points. This compares with the 8 intervals used in the 2004 Review methodology, and the 3 intervals proposed in the draft report.

Victoria considers this latest proposal to be against the terms of reference in terms of simplicity and data quality. It also imposes a greater workload on States for what the draft report says would be immaterial change to the GST distribution. On that basis Victoria objects to the latest staff proposal.

7 CALD

As expressed in previous submissions, Victoria is concerned about the treatment of CALD disabilities in this Review. Victoria provided data of a higher standard than some other datasets used in the Review. However, this data has been ignored because it could not be matched with other national datasets. Use of the national dataset resulted in perverse outcomes that are not matched by Victoria's experience as conveyed to the Commission during the State visits.

CALD disabilities are significant and likely to grow over the period of the 2010 Review (particularly in the health and welfare categories) due to population ageing and Victoria's status as a final destination for many humanitarian migrants.