



Queensland Treasury Response to Commonwealth Grants Commission Draft Report Attachment 22

Location Costs

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SUMMARY OF QUEENSLAND'S POSITION

Queensland is generally supportive of the Commission's Draft Report proposals to assess three location components; interstate wages, interstate non-wages and regional costs. However, all of three components have shortcomings that need to be addressed to ensure the full impacts of location on delivering state services are captured.

Queensland considers the rationale given for the Commission's decision to discount the interstate wage factors significantly weaken the foundation this assessment is based on. The shortcomings identified are much more than just data certainty issues and therefore Queensland believes the level of discount applied should be higher than 15 per cent.

Queensland believes there is not a strong basis for pursuing an interstate non-wage assessment and any assessment will be heavily reliant on the Commission's judgement. Queensland does not object to the use of judgement but considers it should be used conservatively and not based on questionable modelling of unreliable data.

Queensland believes the current regional cost factors are not reflective of the costs of service provision in remote and very remote regions. The methodology used and the way state data has been utilised is resulting in these costs being understated. Queensland considers the Commission should make a judgement based on state visit experiences, and further data provided by states, to adjust these costs - particularly for remote and very remote regions.

Queensland considers removing the general discount from the regional costs assessment will result in the assessment more accurately reflecting the cost of remote and very remote service provision. Queensland considers the major issues with some states' data should be easily addressed and this would improve data quality and comparability, making a discount redundant.

Queensland's Position on Key Issues

In finalising the assessment of location disabilities in the 2010 Review, Queensland seeks consideration of the following issues:

- Increasing the discount of the interstate wage assessment to reflect the issues underlying the assessment are more significant than data quality issues;
- Conservative use of judgement in the interstate non-wage assessment and reality checking the data used in the assessment; and
- Adjusting the remote and very remote regional costs using judgement based on state visit experiences and additional state provided data;

PROPOSED METHODOLOGY

Structure

The Commission's Draft Report proposed assessing three discrete disabilities in a location suite of assessments:

- Interstate wages;
- Interstate non-wages; and
- Regional costs.

Interstate Wages

The Commission intend to assess the interstate public sector wage differentials using an econometric approach using data from the ABS Survey of Education and Training (SET). As the SET data are only available on a quadrennial basis, the Commission have proposed adjusting the SET factors in between years using data from the labour price index (LPI). State specific adjustments are proposed to the SET factors for the ACT, Tasmania and the NT to address shortcomings in the SET data that produces results, which do not accurately reflect wage levels for these states.

Interstate Non-wages

The Commission proposes using its judgement based on interstate freight and travel cost differentials derived from ABS input-output tables.

Regional Costs

The Draft Report proposes assessing regional costs based on three cost components, wages, non-wages and employee housing. The Commission has developed cost gradients for each for Police and Schools Education by aggregating the costs for each component in each SARIA region. A general regional factor based on the average of the Police and Schools factors will be applied to other categories where the Commission has assessed a disability:

- Community and other health services;
- Welfare and housing;
- Some of the Other Expenses; and
- Rural roads.

Discounting

The Commission has concerns regarding data quality for each of the elements of the location assessments and proposes a 15 per cent discount for all three location component factors.

ASSESSMENT APPROACH

Interstate Wages

Queensland has long been critical of the inclusion of an assessment based on the interstate wage differences. Queensland has concerns regarding the conceptual basis and the methodology underpinning the interstate wage assessment, namely:

- Whether a relationship between wage rates and non-location influences like government policy and cost of living actually exist;
- Whether the econometric approach using SET and/or LPI data produces a pure ‘location’ effect; and
- If an assessment is undertaken, whether the discount applied is sufficient.

Queensland has previously raised arguments about the conceptual basis for the assessment of interstate wages but the Commission appear determined to make an assessment. Queensland remains convinced there is little or no conceptual case for assessing interstate wages needs, but this submission will focus on the methodological issues.

Location Effect

Unlike most of the Commission’s assessments, it is difficult to draw a clear relationship between the models results, and the costs faced by states. Queensland believes this is because the econometric model is overestimating the so-called location effect by not addressing, inter alia, productivity differences, cost of living and policy influences.

Queensland provided information from the Office of Economic and Statistical Research (OESR) demonstrating the location coefficient in the interstate wage model does not merely account for pure location effects, but also encapsulates other differences due to:

- Productivity;
- Living costs;
- Competition for labour;
- Wage setting institutions; and
- Government policy.

Although it is not possible to quantify these influences in a meaningful way, it is clear the Commission’s model does not address them.

The Commission acknowledges the results from the SET based econometric approach do not produce appropriate results because it makes further adjustments to the results for the ACT, Tasmania and the NT. Further doubt about the SET based econometric approach is raised by the Commission’s decision to adjust the results further by using a separate, and incomparable, LPI data set.

The combination of these issues provides further weight to the need for a larger discount than presently proposed, of the interstate wages location effect to reflect the inherent problems with the conceptual case, the model and the data used to produce the interstate wages location factors.

Discount

In the 2004 Review, a 15 per cent discount reflected ‘uncertainties arose because the data used in the analysis were sample data’. In the Draft Report, (page 465) the Commission has decided to apply a ‘general discount of 15 per cent because of data uncertainty’. Although pleased to see the Commission’s current proposal is to apply this discount, Queensland believes when the issues identified on page 465 of the Draft Report, and outlined above, are taken into consideration the discount should be greater.

There are three issues identified in the Draft Report as reasons for the data uncertainty discount:

- How accurately SET data measure wage costs;
- How accurately the model controls for productivity differences; and
- How well private sector wages proxy public sector.

Queensland considers these issues are not merely data issues but particularly the second and third points represent significant structural shortcomings with the interstate wages location assessment. The third point is the very foundation this assessment is built on and if it is not valid, as Queensland believes, it would explain the arguably perverse outcomes that are observed in the current interstate wages location assessment.

At this point of the 2010 Review, these concerns would be best addressed by increasing the level of the discount applied.

Interstate Non-Wage

In Paragraph 49 of the Draft Report, the Commission incorrectly state Queensland did not accept the conceptual case for an interstate non-wage assessment. Queensland has always maintained that although a conceptual case may exist, consistent with the Commission’s Review guidelines, those states that seek to have a disability assessed should provide evidence (including data) and a robust method. To date, Queensland is not aware that any state has provided evidence (or data) to support the existence or materiality of such a disability. Without such evidence, Queensland considers an assessment should not have been progressed.

The Commission are convinced there is a conceptual case for an interstate non-wage disability, and in the absence of data to demonstrate the existence of the disability, they intend to use their judgement. Commission staff have sought to determine a relationship, by state, between differences in costs of interstate freight and travel. Queensland considers there are shortcomings apparent in the derivation of a relationship. The main issues Queensland has identified with the proposed assessment are:

- The use of ABS input-output tables;
- How an interstate travel assessment is developed; and
- The Commission’s use of judgement.

Input-Output Data

Queensland believes using the ABS input-output tables to determine freight costs will overstate expenditure on freight. The ABS has stated these tables cannot separate expenditure on ‘freight’ as opposed to other transport services’. Based on the wide scope of the expenditure included as freight it is likely that significant non-freight costs captured in the analysis.

Queensland accepts the general discount of fifteen per cent will reduce the data uncertainty issues somewhat. If this discount is applied, analysis of the ABS data may assist the Commission form a judgement about interstate non-wage differentials.

Interstate Travel

Queensland considers that if based on actual (state provided) data, the magnitude of an interstate travel assessment is likely to be so small the assessment would not be material. The draft report indicates expenditure on airfares is of the same magnitude as the freight assessment and an assessment is justified.

The Commission proposal is to make a judgement that 50 per cent of expenditure on airfares is interstate. Consultation with the Queensland whole of government travel management unit indicates the majority of air travel in Queensland is intrastate¹. Queensland believes where judgements are used in this assessment they should be conservative as there are significant variations in data sources.

For example, according to the Draft Report the input-output tables put airfares as approximately the same as freight (\$917 million in 2006-07) yet the 2004 Review isolation working papers identify only \$35 million of airfares and travel allowances. Simply applying a discount cannot address these concerns.

Queensland understands the Commission are considering using state provided data from a single state to make an assessment. Although Queensland considers state provided data should be used, and have sought airfare data, it is important to ensure it is policy neutral. Queensland believes state policy determines whether to attend in person or teleconference and the number of attendees. Unless these influences can be unravelled from the state provided data then it is going to be of little use in developing a robust assessment.

In the absence of an alternative method or data for interstate non-wage differences, the derived relationship based on ABS data may help inform the Commission's judgement. The use of a significant discount may reduce the impact of the shortcomings identified above and ensure the Commission's judgement is conservative.

Use of Judgement

Queensland supports the Commission exercising judgement in any assessment it deems it necessary but believes these judgements should be based on sound evidence.

The Commission has estimated that fifty per cent of freight expenditure from the input-output tables relates to interstate freight. The Commission has also estimated the state proportions of interstate freight expenditure based on a questionable weighted freight cost from capital cities. Queensland considers the Commission are using highly questionable means to underwrite their use of judgement in the interstate non-wage assessment.

¹ It is anticipated that data on Queensland government airfares will be able to be compiled and provided to the Commission in the near future.

Queensland would prefer the Commission to clearly articulate that they have used judgements in the absence of data and not purport to be basing judgement on the analysis provided to states thus far. The use of judgements based on questionable analysis reduces the transparency of assessments and reduces the robustness of the Commission's process.

Regional Costs

Queensland supports the Commission's proposal to make a single assessment of regional costs based on state provided data but has ongoing concerns the assessment understates the impacts of the providing services in remote and very remote areas.

Queensland's concerns with the regional costs assessment relate to:

- The slope of the cost gradient in remote and very remote areas;
- How state data has been used or adjusted in the assessment; and
- The decision to discount the factors due to data uncertainty.

Slope of Cost Gradient

Queensland shares the concerns outlined in the Chairman's letter of 3 July 2009 that the location assessments are not 'adequately capturing the inevitable costs' of providing services in remote and very remote regions. In Queensland's case, this is largely due to the Commission's use of SARIA, which does not properly address the state's unique geographical and population settlement issues.

Queensland believes the Commission's average wage methodology is negating the impact of providing services in remote and very remote regions as it ignores the differences in staff experience levels. The assessment should compare staff with similar experience levels to ensure only the extra costs of location are reflected. A first year teacher or police officer will have the same base salary regardless of location but the extra costs of remoteness arise from the locality allowances and the range of other benefits they receive.

Queensland acknowledges that making such an assessment is difficult, but believes the current approach is not accounting for the full impacts of remote service provision. To ensure the true scope of service provision in remote areas is captured, the Commission needs to consider adjusting the regional cost factors. Queensland believes this adjustment can be made simply by amending the state data used in the assessment.

Use of State Data

Queensland considers that a major contributing factor to the cost gradient not being reflective of the actual costs in remote areas is how the Commission have used state data. In particular, Queensland has concerns the Police data provided on a regional and district basis is diluting the true impacts of remote service delivery.

The wage cost data in Figure 22.5 of the Draft Report indicate wage costs for Queensland Police regions appear flat across the SARIA regions at approximately \$60,000 per officer. However, in addition to this data, Queensland provided police station level data² to the Commission in February 2009 that showed a steeper wage cost gradient. Queensland considers this station level gradient is far more representative of the extra wage costs in dispersed stations and should be substituted for the Queensland police region data.

² This data includes only stations in Metropolitan North and South regions and all stations further than 1000km from Brisbane. There are few remote or very remote stations less than 1000km from Brisbane.

The table below shows an updated version of Table 22-6 from the Draft Report comparing the two sets of data and the impact on the gradients.

Table 1- Comparison of Region and Station level police Costs					
	HA	A	MA	R	VR
Regional Costs					
Wages ³	60.2	60.7	62.8	60.7	64.3
Non-Wages	13.1	17	26.9	28.3	45.5
Employee Housing	0	0.3	0.9	3.1	5.7
Total	73.3	78.0	90.6	92.1	115.5
Gradient	1.0000	1.0633	1.2355	1.2560	1.5743
Station Costs					
Wages	69.0	73.7	75.6	80.8	80.6
Non-Wages	13.1	17	26.9	28.3	45.5
Employee Housing	0	0.3	0.9	3.1	5.7
Total	82.0	90.9	103.3	112.1	131.8
Gradient	1.0000	1.1082	1.2594	1.3670	1.6060

Queensland suggests the Commission use this Queensland station data to ensure the full scope of the extra costs of dispersion is captured. As shown, this would not only produce a gradient more in line with the Commission's expectations in the remote areas but also in the moderately accessible areas. This change would go some way towards addressing the shortcomings of SARIA in terms of the Queensland geography regarding the higher costs in areas such as Cairns and Townsville.

If the Commission choose not to use the data presented above in the assessment, Queensland believes the Commission should exercise judgement shaped by this data and their state visit experiences to adjust the gradient to reflect reality.

During the state visit to Queensland, the Commissioners experienced first hand the magnitude of the task of providing services both across the state, and within regions. The Mount Isa Police district covers a very large area made up of a number of smaller communities, generally with large indigenous populations.

Although appearing to be side by side on a map, communities such as Normanton and Burketown are over 7 hours drive from Mount Isa and such journeys are a regular occurrence in this region. The direct costs associated with sending back up officers for incidents, or to cover planned absences, are easily quantifiable but the flow on costs not accounted for include lost time and backfilling the flow-on positions.

The Commission could simply remove the general discount applied to ensure the regional factors reflect the full impact of remote service provision.

³ These wage figures calculated using the Commission's workbooks but with corrections as outlined in an email to Tim Carlton on 04/09/2009.

General Discount for Data Uncertainty

The inclusion of a discount is hard to reconcile with the Commission's view that the location assessment does not fully capture remote service costs. The Commission have applied the discount to allay concerns the state provided data are not comparable or reliable, and because the average of Police and Schools factor (the general factor) is applied to other categories unrelated to these expenses.

Although there is an appealing symmetry in the decision to discount all three location components, the discount should be removed from the regional cost factors as the rationale for its inclusion is weaker than for the interstate components. At the very least, the discount applied to the regional costs factor should be smaller than that applied to the interstate factors.

As discussed previously, Queensland believes there are significant underlying issues with both the interstate wage and interstate non-wage assessments. Both of these assessments are to be discounted by 15 per cent due to 'data uncertainty' but Queensland has concerns that the issues in these assessments are much more significant than with the regional cost data, making a uniform discount inappropriate.

The Commission have concerns the data used to construct the regional factors is not comparable or reliable. In cases where this is a concern, such as schools education, the Commission have removed the data from the analysis⁴. In effect, the Commission are discounting for quality of data that is no longer in the assessment and therefore no discount should be applied.

The Commission also have concerns the general factor is being applied to categories in which the expenditure is not of a similar nature to either education or police. Queensland supports the Commission's decision to use the average of the education and police factors as a general factor to apply to a selection of other categories.

Although the services provided in these categories are diverse, there is no conceptual basis why significant differences in average regional cost gradients would exist. This is backed up by the Commission's statement that the general factor closely matched the gradients developed using state provided data. In the absence of data from all states, a general average is a sound approach and there is no need for a discount. Additionally, regional factors are only applied to some categories where other categories purportedly capture them directly in the methodology. Queensland will provide details of location issues within categories in the relevant assessment category submissions.

Queensland considers the overall impact of using an assortment of location approaches is a significant understatement of regional costs. Applying a discount on top of this unduly penalises states that experience significant dispersion related expenses. Removing or reducing the size of this discount will help to allay the Chairman's concerns about whether the full impact of location will be accurately captured.

⁴ NSW and Victorian schools data have been removed from the assessment calculation as per CGC Workbook 3- Regional Costs- Schools Assessment.