



# **COMMONWEALTH GRANTS COMMISSION**

**DISCUSSION PAPER CGC 2002/39**

**THE SUPERANNUATION ASSESSMENT**

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## INTRODUCTION

### *Background*

1. As part of the 2001 Update, the Commission was asked to ‘review and adopt a standard and method for the superannuation category assessment which optimises fiscal equalisation’ As a result, it decided that an accrual based standard and method of assessment should be adopted. It also decided that, to optimise equalisation, transitional arrangements were required to ensure that, over time, the needs associated with State unfunded superannuation liabilities were recognised in the equalisation process.

2. The Commission reached this conclusion because it believed that, while full equalisation could be achieved under either a cash or an accrual standard<sup>1</sup>, this would not necessarily be true in any transition from cash to accrual standards. Without transitional arrangements, a move from a cash to an accrual superannuation standard would be inconsistent with equalisation of all superannuation costs. This was because any unfunded superannuation liabilities at the point of change would be included neither in the old cash standard (because they were not yet funded) nor in the new accrual standard (because the relevant superannuation expenses had accrued prior to the introduction of the accrual standard).

3. Thus special arrangements were introduced to take into account unfunded superannuation liabilities. The overarching principle was, over time, to give each State the capacity to provide services at the same standard. The Commission noted that equalisation would not be achieved fully for each service in each given year, but that it should be fully achieved over time.

4. Attachment A provides details of the present assessment.

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<sup>1</sup> Under cash accounting, all payments towards State superannuation costs in a year were treated as expenditure and included in the superannuation standard. If cash accounting had continued, all relevant costs would have been included in the standard at least when benefits were eventually paid. Thus, in the very long term, all State superannuation costs would be equalised. Under accrual accounting, the operating statement includes accrued expenses, whether or not the expenses are funded, and nominal interest on unfunded liabilities. If the superannuation standard had always been based on the operating statement, all relevant costs would have been taken into account, and thus equalised when they accrued. Either a cash or an accrual approach would therefore eventually equalise all superannuation costs.

## APPROACH

### *State Views*

5. State views fell into three groups:

- (i) those that supported the assessment;
- (ii) those that rejected the basic approach; and
- (iii) those that advanced arguments about changes to disability factors.

6. New South Wales said that unfunded superannuation liabilities were not an accrual expense but a balance sheet item and that including such an item in an expenditure assessment was conceptually flawed. New South Wales argued for confining the superannuation assessment to the accrual cost of superannuation, consistent with the Commission's overall approach. It saw the Commission's approach as a departure from the internal standard and as making an adjustment to redress past assessment errors (new territory for the Commission).

7. Victoria repeated its arguments that:

- (i) an accrual or cash basis should be used in the assessment, not a combination of both;
- (ii) a five year accruals standard should be used with no transitional adjustment for a portion of unfunded superannuation liabilities at the commencement of 1998-99;
- (iii) 10 years was a completely arbitrary timeframe for the transitional arrangements which reflected neither the time over which States had accumulated the liabilities nor the period in which they intended to fund them (35 years would more closely approximate this)<sup>2</sup>; and
- (iv) nominal interest on the outstanding liabilities not already included in the standard should be excluded.

8. Victoria argued that attempting to equalise the stock of unfunded liabilities was inconsistent with both cash and accrual accounting. It said that 'paydowns' of unfunded superannuation liabilities were balance sheet transactions and that inclusion of such transactions was fundamentally against the Commission's principles (stated in the 1999 Review) of equalising the recurring operating expenses incurred in providing services.

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<sup>2</sup> Victoria does not suggest, however, that we substitute 35 year for the 10 presently in use. Doing so would move the standard closer to a cash basis and may or may not better reflect what States are doing.

9. The other States either supported the present approach (Western Australia, Tasmania, ACT and the Northern Territory) or did not comment (Queensland and South Australia).

### ***Commission Views***

10. As noted in *Discussion Paper 2002/3, Scope and Structure of the Standard Budget*, the Commission is not inclined to change its approach to the Superannuation assessment. It believes that the decisions it took in the 2001 Update should apply in the 2004 Review. Despite the comprehensive consideration of the issues then, New South Wales and Victoria do not accept the outcome and have argued for a change.

11. However, no new arguments have been advanced. Thus, the Commission proposes to continue the two part assessment:

- (i) an accrual assessment of needs associated with accrued expenses and an equal per capita (EPC) assessment of nominal interest on unfunded liabilities which have been already equalised; and
- (ii) transitional arrangements which will bring States' unfunded liabilities and nominal interest on unfunded liabilities into the equalisation process over a ten years period which commenced in 1998-99.

12. The accrual assessment better reflects State annual costs and the way they are now choosing to manage and account for their superannuation expense. However, to optimise equalisation, the transitional arrangements are also considered necessary to allow for unfunded superannuation liabilities because:

- (i) not all annual accrued expenses had been equalised in the past;
- (ii) what had been equalised depended on the different policies of the States; and
- (iii) the costs of holding and meeting presently unfunded liabilities are real costs to State governments, regardless of when they are brought to book.

13. The use of a cash based assessment in the earlier years of the review period and an accrual assessment in the later years was necessary in the 2001, 2002 and 2003 Updates for reasons of data availability. It was also consistent with the approach used in other categories. In the 2004 Review, a mix will not be necessary as accrual data will be available for all years.

14. The question of an appropriate period for the transitional arrangements was a difficult one. The Commission considered it inappropriate to use State policy as a guide as this would be tantamount to maintaining a cash standard — including funding of liabilities when States actually funded them. It concluded that a transitional arrangement needed to be in place for enough time to avoid a large impact on relativities, but short enough so that it was indeed transitional — that is, it came to an end within a reasonable period. It decided

that 10 years would be a reasonable period over which to equalise States' capacities to fund their existing unfunded liabilities without disturbing grant shares too greatly.

15. The correct treatment of nominal interest on unfunded liabilities was also given careful consideration. At the beginning of the transitional period, this is a legitimate accrual superannuation expense included in ABS's accrual Government Finance Statistics. There is no reason to exclude it. However, the transitional arrangements achieve full equalisation of unfunded superannuation liabilities and including nominal interest subsequently would involve double counting. To deal with this, the Commission will treat nominal interest on unfunded liabilities on an EPC basis once the transitional period is over. During the transitional period, nominal interest on unfunded liabilities that have already been equalised will be treated by the EPC method.

16. The Commission continues to believe this to be the best way to optimise fiscal equalisation, even though it is a complex assessment. It:

- (i) ensures that all expenditure on superannuation is brought into the process;
- (ii) does not continue the transitional arrangements over an extended period; and
- (iii) is not too disruptive of the relativities and State GST revenue provisions.

## **DISABILITIES**

### *State Views*

17. **Historical factors.** New South Wales proposed that the Commission should apply the same disabilities to the unfunded liability as are applied to the accruing expense<sup>3</sup>. It argued that this would be simpler, consistent with the original cash assessment and not double count superseded disabilities from earlier years.

18. **CSS and PSS.** The Northern Territory obtained self-government in 1978 but did not establish its own superannuation scheme until 1986. The ACT received self-government in 1989 and its public service was established in 1994, but it still uses the Commonwealth's superannuation schemes. Northern Territory employees are members of either the Commonwealth Superannuation Scheme (CSS) or the Northern Territory Government and Public Authorities Superannuation Scheme (NTGPASS). ACT employees are members of either the CSS or the Commonwealth's Public Sector Superannuation

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<sup>3</sup> Salary related expenditure relativities are used to construct the disability applied to accruing expenses. An average of an historical series of expenditure relativities, calculated using the methods which applied in each review, are applied to the unfunded liabilities.

Scheme (PSS) which was opened in 1990. Both Territories inherited employees with CSS membership following self-government.

19. The ACT and the Northern Territory sought an increase in the disability (which is presently 5 per cent) that recognises the additional unavoidable costs they face in providing superannuation payments to those of their employees who are members of the CSS. They also sought recognition of the additional administrative costs they face. Further, the ACT sought an allowance for above standard cost of the PSS that replaced the CSS in 1990, arguing that it must offer comparable superannuation arrangements to the Commonwealth if it is to attract comparable staff.

20. The Northern Territory suggested that its costs due to CSS membership of its employees were 15 per cent greater than they would have been had all employees been members of the NTGPASS. This scheme has an actuarially assessed cost of 10 per cent, compared to 18 per cent for the CSS (and 9 per cent at the Superannuation Guarantee (SG) Minimum rate). The Northern Territory claimed that its additional costs, on average, over the next 8 years, have been estimated by the New South Wales Government Actuary to be about \$17 million per annum. The actuary also estimated that the Northern Territory incurred an additional \$110 000 per annum in Comsuper administration fees which represented the Commonwealth's share of the fee for employees with prior Commonwealth service (a Commonwealth responsibility).

21. The ACT provided evidence to suggest that it incurred \$30.7 million more per annum on CSS members (at an actuarially assessed cost of 24.3 per cent) and \$6.8 million more on PSS members (10.5 per cent) than it would if it could provide superannuation at the SG rate. It also incurred \$2.5 million in 2001-02 on administration costs. It argued that the Commission should recognise these administrative costs as a disability because, unlike the majority of superannuation schemes, the CSS and the PSS have the employer paying the administration charge rather than the employee.

22. The ACT also argued that the disability should be calculated in a way which recognised not only the difference in unit costs of the scheme but also the number of employees in the schemes; that is, the disability should recognise the full costs. It noted that the Commission's present allowance gave the Northern Territory \$15.7 million and the ACT \$5.3 million per annum.

### *Staff Views*

23. ***Historical Factors.*** Commission staff are not inclined to recommend that the Commission apply the same disabilities to both the accruing expense and the unfunded liabilities. It would be simpler but not appropriate. The disabilities which are most relevant to unfunded liabilities are those which applied in the year in which the liabilities accrued. Although those disabilities were calculated using different methods to those used at present, they have never been applied to the unfunded liabilities and are the best estimate we have of the disabilities that were relevant at that time. As an historical accumulation, the average of the disabilities assessed over the period in which the liabilities were acquired gives a reasonable measure of relative need.

24. Although we are not inclined to accept the New South Wales proposal, we are examining ways of better constructing the historical disability factor. As a minimum, we are likely to apply weights based on the size of the standard in each year to the historical factors before they are added and averaged. This requires the assumption that unfunded liabilities were accumulated at the same time and rate as States incurred standard expenditure.

25. *CSS and PSS.* The ACT and the Northern Territory have made a case in support of their claims for an allowance. Commission staff are inclined to recommend to the Commission that additional superannuation costs incurred by the Territories for members of the CSS inherited at the time of self-government should continue to be recognised. However we do not intend to recommend any disability associated with CSS membership after self government (or after some date close to self government). We are also inclined to accept that the Commonwealth share of the administration fees currently incurred by the Northern Territory is a disability. We are not inclined to accept any additional costs associated with the PSS as its costs are considered to reflect standard levels. Nor are we inclined to accept the claim that the ACT must offer the same superannuation conditions as the Commonwealth Government to allow it to obtain comparable staff.

26. For these views to be changed, the Territories would need to demonstrate why more than the 'inherited' CSS costs should be included. We think they could have established their own schemes from close to the time of self-government, or from the time of the establishment of their public services separate from the Commonwealth.

27. The questions that need to be answered are:

- (i) Does the ACT really have no choice but to tie its superannuation arrangements to those of the Commonwealth?
- (ii) What is superannuation actually costing the Northern Territory (18 per cent) and the ACT (24.3 per cent)? Do the Territories have notional funds? A copy of reports of the actuaries referred to in their submissions would be appreciated.
- (iii) What should the Commission accept as the standard State policy for superannuation – the 10 per cent proposed by the Northern Territory, the 9 per cent (or SG amount) proposed by the ACT, or something higher to recognise that all States had much more generous schemes in the past?
- (iv) What should the Commission recognise as a disability as far as administration fees are concerned:
  - the whole amount of the fee, as proposed by the ACT; or
  - the Commonwealth's share, as proposed by the Northern Territory?

28. The Commission staff accept and will recommend to the Commission that at least the CSS imposes some unavoidably high superannuation costs on the ACT and the Northern Territory. On the basis of the evidence presented, it seems that the present allowance of 5 per cent may underestimate the disabilities of the Northern Territory and the ACT. We will need to liaise with the Treasuries to ensure that the allowance made for these costs adequately recognises the unavoidable costs associated with Commonwealth policy.

## ATTACHMENT A

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### SUPERANNUATION ASSESSMENT IN THE 2001 UPDATE

1. This category comprised, until 1997-98, expenditure on the contributions of governments to superannuation funds or superannuation payments for those employees and holders of public office whose salaries are included in the Commission's standard budget. From 1998-99, it comprised:

- States' accrued expenses for superannuation for those employees and holders of public office whose salaries are included in the Commission's standard budget;
- components for nominal interest on equalised and non-equalised unfunded liabilities; and
- a transitional component of 10 per cent of the outstanding unfunded liabilities as at the beginning of the 1998-99 financial year.

It included superannuation relating to hospital and urban transit but not trading enterprises because the operating transactions of these were excluded from the standard budget.

2. A two-part assessment was adopted for the category for those years where an accrual standard has been used (1998-99 onwards). This is the assessment method that will apply for all years of the 2004 Review. It comprises:

- (iii) *an assessment of needs* associated with accrued expenses, with nominal interest on unfunded liabilities which have been already equalised assessed by the equal per capita method; and
- (iv) *transitional arrangements*, over the ten year period which commenced in 1998-99, when the States' unfunded liabilities and nominal interest on unfunded liabilities will be brought into the equalisation process.

3. In 2000-01, the standard for this category was \$528.99 per capita and represented 11.06 per cent of total standard expenses. Compared to an equal per capita assessment, the Superannuation assessment redistributed about \$206.2 million away from New South Wales, Victoria, Queensland and the ACT, to Western Australia, South Australia, Tasmania and the Northern Territory. Table 1 shows the redistribution.

**Table 1** EFFECT OF ASSESSMENT ON GRANTS DISTRIBUTION — SUPERANNUATION

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust <sup>(a)</sup>
Contribution to U2002 relativities	-43.0	-126.8	-5.3	65.1	22.5	34.9	-31.2	83.7	206.2

(a) Total redistribution.

Source: CGC Working Papers 2002 Update.

### *Assessment Structure*

4. The assessment structure is shown in Table 2. The component weight on nominal interest on equalised unfunded liabilities changes each year as the transitional arrangements progress. It was zero per cent in 1998-99 and – 1.71 per cent in 1999-2000

**Table 2** ASSESSMENT STRUCTURE — ACCRUAL STANDARD AND TRANSITIONAL ARRANGEMENTS, 1998-99

Expenditure component	Component weight	Factors	Basis of calculation
	%		
Accrued expenses	30.40	Expenditure relativities	Based on the wages and salaries disabilities of those expenditure categories which include a wages and salaries component, including CSS adjustment.
Nominal interest on equalised unfunded liabilities	0.00	None	EPC.
Nominal interest on unequalised unfunded liabilities	28.65	Historical factor Interest rate cost factor	Based on the average of the superannuation category factors for the last 20 years. As used in the Debt Charges category.
Outstanding liabilities	40.95	Historical factor	Based on the average of the superannuation category factors for the last 20 years.

Source: CGC Working Papers 2002 Update.

### *Factor Calculations*

5. The section below explains the derivation of the expenditure relativities factor, the historical factor and the interest rate cost factor.

6. ***Expenditure relativities factor.*** The expenditure relativities factor was calculated for each year of review and for each State as follows:

- (i) the gross standardised expenditures of all relevant categories were recalculated with the disability factors not related to salaries (ie. the accommodation and electricity components of the input costs disability, dispersion and isolation) set to one;
- (ii) the category standardised expenditures calculated above were weighted by the proportions that wage and salary expenses represented in each category;
- (iii) the weighted standardised expenditures were aggregated to derive the total standardised expenditure which related to wages and salaries;
- (iv) the standardised wages and salaries related expenditure of the ACT and the Northern Territory was multiplied by a factor of 1.05 to account for higher employer costs because some employees remain in the CSS scheme; and
- (v) the category expenditure relativities factors were derived by dividing the adjusted standardised expenditure (per capita) by the Australian average.

7. Table 3 shows the factor for 2000-01.

**Table 3 EXPENDITURE RELATIVITIES FACTOR FOR 2000-01**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
2000-01	0.98729	0.93346	0.99071	1.05284	1.00350	1.11364	1.13983	2.18472	1.00000

Source: CGC Working Papers 2002 Update.

8. **Historical factor.** The historical factor is assessed to measure the disabilities influencing the quantity of the unfunded liabilities States would have accrued over a twenty year period on a standardised basis. It is calculated as the average of the category disability factors for the 20 years from 1978-79 to 1997-98. It takes account of the non-policy differences in the size of each State's unfunded liabilities.

9. Neither, the ACT nor the Northern Territory have been accruing unfunded liabilities for the whole of the 20 years. It is reasonable to expect that, other things being equal, they would have a smaller unfunded liability per capita than other States.

10. As the ACT did not accrue any superannuation liabilities before self-government, the Commission calculated the twenty year average for the ACT by assuming that its category factor was zero before self-government.

11. For the first three years of self-government, the Northern Territory was only responsible for a proportion of its superannuation liabilities. The balance remained the responsibility of the Commonwealth Government. For these three years the Commission

assessed an actual per capita factor for the Northern Territory. These were of a much smaller order than the factors for other States. The Northern Territory factors were calculated using actual per capita factors for the first six years of self-government and full factors for all other years.

12. Table 4 shows the calculation of the historical factor. The same factors are used for each year and the average will always be calculated over the 20 years immediately preceding the change to an accrual standard. These factors will not change.

**Table 4** CALCULATION OF HISTORICAL FACTORS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
1978-79	0.97014	0.98086	0.95827	1.14280	1.14548	1.31164	0.00000	0.00000
1979-80	0.96908	0.98208	0.95116	1.14371	1.13247	1.32853	0.00000	0.00000
1980-81	0.97325	0.99004	0.95504	1.11696	1.12351	1.30393	0.00000	0.00000
1981-82	0.96454	0.99948	0.96920	1.11646	1.09110	1.29710	0.00000	0.17521
1982-83	0.96661	1.00257	0.95783	1.10595	1.09803	1.30908	0.00000	0.09974
1983-84	0.96920	1.00383	0.95256	1.09966	1.09985	1.31178	0.00000	0.15857
1984-85	0.97391	0.94747	1.05839	1.05732	1.07915	1.21952	0.00000	2.45040
1985-86	0.97398	0.94764	1.05854	1.05756	1.07919	1.21967	0.00000	2.45057
1986-87	0.97701	0.93546	1.05889	1.04921	1.06817	1.17964	0.00000	2.65618
1987-88	0.98224	0.91628	1.02347	1.08929	1.00154	1.09492	1.02900	2.28220
1988-89	0.98146	0.91760	1.02434	1.08561	0.99804	1.09848	1.02851	2.30670
1989-90	0.98131	0.91746	1.02418	1.08544	0.99788	1.09830	1.02834	2.30632
1990-91	0.98185	0.92009	1.02124	1.08423	0.99423	1.10118	1.02896	2.28640
1991-92	0.98294	0.91828	1.01799	1.08581	0.99602	1.10216	1.02088	2.32148
1992-93	0.98277	0.91813	1.01782	1.08563	0.99585	1.10197	1.02071	2.32109
1993-94	0.99105	0.93954	0.99067	1.04620	1.00385	1.09542	1.12007	2.09462
1994-95	0.98938	0.94060	0.98789	1.04746	1.00457	1.10461	1.11987	2.11482
1995-96	0.99130	0.93905	0.98377	1.04854	1.00686	1.10003	1.12273	2.12370
1996-97	0.99203	0.93432	0.98712	1.05064	1.00519	1.10510	1.11213	2.14925
1997-98	0.99284	0.93553	0.98325	1.05231	1.00173	1.10273	1.12182	2.15528
Historical factors <sup>(a)</sup>	<b>0.97935</b>	<b>0.94931</b>	<b>0.99908</b>	<b>1.08254</b>	<b>1.04613</b>	<b>1.17929</b>	<b>0.58765</b>	<b>1.62263</b>

(a) This factor shown here has not been population weighted.

Source: CGC Working Papers 2002 Update.

13. *Interest rate cost factor.* The interest rate cost factors are the same as those used in the Debt Charges assessment and are presented in Table 5.

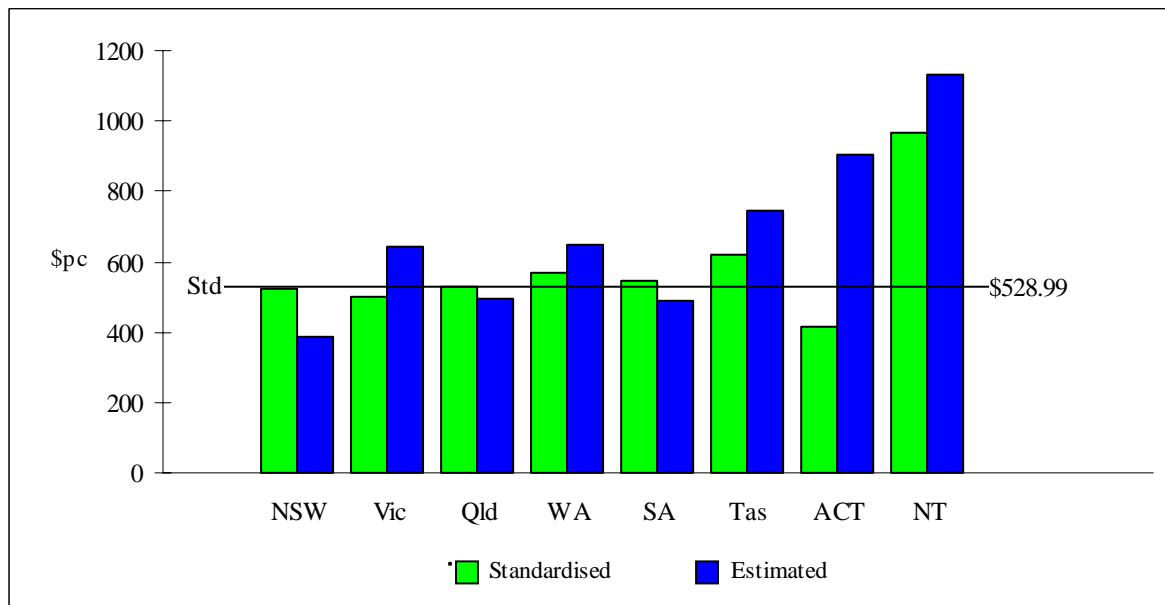
**Table 5** NOMINAL INTEREST ON UNEQUALISED UNFUNDED LIABILITIES COMPONENT — INTEREST RATE COST FACTORS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
All years	1.00000	1.00000	1.00000	1.00500	1.01500	1.03000	1.03000	1.03000

Source: CGC Working Papers 2002 Update.

14. Figure 1 shows the gross Superannuation expenses per capita for 2000-01 in terms of standardised, estimated and standard expenses.

**Figure 1** SUPERANNUATION — GROSS EXPENSES PER CAPITA — STANDARDISED, ESTIMATED AND STANDARD, 2000-2001



Source: CGC Working Papers 2002 Update.