

Victorian response to CGC Staff Draft Assessment Papers on Expenses

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1. Introduction

Victoria acknowledges the efforts of Commission staff in reviewing the methods used to assess expenses and that they have seriously examined changes to methodology that some of the states have suggested.

Victoria has examined the current methodology used by the Commission. This has led to the identification of alternative approaches which are outlined in some of the sections below. Response have also been developed to the proposals made by Commission staff in each of the expense draft assessment papers.

Victoria notes that the specifications for some of the revisions to methodology have not been finalised at this stage. Therefore, Victoria cannot express an opinion on these assessments until the methodology has been finalised, but is willing to work with Commission staff in developing the methodology.

Each of the draft assessment papers are separately discussed in the sections that follow.

2. School Education

2.1 The Regression Model

2.1.1 ACARA data quality

The ACARA data are based on the records held by individual schools and therefore, the quality of the data depends on the quality of the record keeping of schools. Although ACARA has undertaken a quality assurance exercise, this exercise was concerned with the reporting of the data and not the quality of the recording done by schools. While Victoria does not wish to imply any deficiencies in the record keeping of schools, there can be no guarantee that the data for every school in the ACARA database are completely accurate. Any inaccuracy in the recording of financial data of schools will have implications for the estimated impact of the SDC factors.

2.1.2 Model specification

The draft assessment paper indicated that Commission staff were revising the specification of the regression model used for the 2015 Review, but limited detail was provided. At a subsequent Officer Working Party (OWP) meeting details of the revised model specification were provided. This revised model omitted the Indigenous and non-Indigenous socio-economic status (SES) variables and replaced them with the proportion of Indigenous students and the proportion of students in the most disadvantaged 25 per cent. Victoria understands that Commission staff have not yet finalised the specification of the regression model. However, in the absence of any further model specification, the comments below are based on the OWP specification of the model.

This model provided results that met with prior expectations—a positive cost impact from Indigenous students and from students in the most disadvantaged 25 per cent. The

Victorian Department of Treasury and Finance (DTF) attempted to reproduce this model using 2014 ACARA data¹. As Table 2.1 indicates, results similar to those provided to the OWP were obtained, apart from the Indigenous proportion variable.

Table 2.1: Revised regression model coefficients for government schools

	OWP	DTF
Intercept	7,730	7,407
Inverse school size	195,286	182,207
Indigenous proportion	6,587	3,725
Inner regional school	-46	-582
Outer regional school	927	1,264
Remote school	4,139	5,862
Very Remote school	3,228	4,302
Students in most disadvantaged 25%	3,236	3,918
Adjusted R ²	0.45	0.64

However, the interpretation of the coefficient for the Indigenous proportion of students is different to that from the 2015 Review model. In that model, the Indigeneity variable (for each SES) was a categorical dummy variable and the coefficient could be interpreted as the additional cost to the average cost of a student to a student with Indigenous students.

The revised model has a continuous variable for Indigeneity. The interpretation of the coefficients presented to the OWP is that a government school with no Indigenous students will have a base average cost per student of \$7,730 and a school with all Indigenous students will have a base average cost per student of \$14,317. A school with 50 per cent Indigenous/non-Indigenous split will have a base average cost per student of \$11,024.

This means that with the revised model the Indigenous cost weight has to be calculated in a different way to the 2015 Review model. The same applies for the derivation of the cost weight for students in the most disadvantaged 25 per cent. Cost weights can be obtained for each remoteness classification by applying the respective coefficients to the proportions of Indigenous students and students in the most disadvantaged 25 per cent in each remoteness classification. This will produce the estimated additional costs for these students in the remoteness classifications. Table 2.2 presents the Indigenous proportion of government school students for the remoteness classifications in each state.

Table 2.2: Proportion of Indigenous government school students, 2015 (per cent)

Remoteness	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Major cities	4.1	1.2	4.9	4.4	4.7	0.0	3.5	0.0
Inner regional	12.7	3.6	10.3	7.3	4.6	8.7	84.0	0.0
Outer regional	19.0	7.5	19.5	15.6	9.7	12.3	0.0	21.6
Remote	47.2	1.1	28.2	28.7	8.6	14.6	0.0	47.6
Very remote	72.5	0.0	59.9	39.6	35.0	8.7	0.0	86.0

Source: ACARA data.

¹ DTF acknowledges the assistance of Commission staff in providing instructions for the 'cleaning' of ACARA data and for creating the variables to be used for estimating the 2015 Review model.

Applying the coefficient for the Indigenous proportion of Indigenous students from Table 2.1 to the Indigenous proportion of students in each state gives the estimated additional cost of Indigenous students for the remoteness classifications. These estimates are presented in Table 2.3.

Table 2.3: Additional cost of Indigenous government school students, 2015 (\$)

Remoteness	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Major cities	269	76	326	289	312	0	230	0
Inner regional	839	240	681	479	302	572	5,533	0
Outer regional	1,250	493	1,286	1,026	642	810	0	1,423
Remote	3,111	74	1,857	1,889	569	963	0	3,138
Very remote	4,777	0	3,943	2,608	2,305	570	0	5,664

Finally, the additional cost of Indigenous students in each remoteness classification can be converted into a cost weight. These cost weights are presented in Table 2.4.

Table 2.4: Indigenous cost weights for government school students, 2015

Remoteness	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Major cities	1.035	1.010	1.042	1.037	1.040	1.000	1.030	1.000
Inner regional	1.108	1.031	1.088	1.062	1.039	1.074	1.716	1.000
Outer regional	1.162	1.064	1.166	1.133	1.083	1.105	1.000	1.184
Remote	1.402	1.010	1.240	1.244	1.074	1.125	1.000	1.406
Very remote	1.618	1.000	1.510	1.337	1.298	1.074	1.000	1.733

By a similar method, the cost weights for the most disadvantaged government school students can be obtained. These cost weights are presented in Table 2.5.

Table 2.5: Most disadvantaged government school students cost weights, 2015

Remoteness	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Major cities	1.112	1.105	1.104	1.100	1.116	1.000	1.052	1.000
Inner regional	1.178	1.161	1.163	1.158	1.144	1.161	1.314	1.000
Outer regional	1.210	1.174	1.161	1.177	1.181	1.210	1.000	1.137
Remote	1.251	1.103	1.170	1.150	1.126	1.271	1.000	1.191
Very remote	1.285	1.000	1.209	1.190	1.173	1.149	1.000	1.325

The sector and remoteness weights implied by the coefficients in Table 2.1 are presented in Table 2.6. Only coefficients for government schools were presented at the OWP so the non-government coefficients from the DTF regressions were used. Given the low non-government sector weight this may not have a significant impact on the results. The Indigenous, most disadvantaged, remoteness and sector weights can be combined in order to calculate government funded expenses. These expenses and the difference to those from the 2015 Review model are presented in Table 2.7.

Table 2.6: Sector and remoteness weights, 2015

Sector	ARIA region	Sector weight	ARIA weight
Government	Inner regional	1.00	0.99
Government	Major cities	1.00	1.00
Government	Outer regional	1.00	1.12
Government	Remote	1.00	1.54
Government	Very remote	1.00	1.42
Non-government	Inner regional	0.25	1.03
Non-government	Major cities	0.25	1.00
Non-government	Outer regional	0.25	1.02
Non-government	Remote	0.25	1.19
Non-government	Very remote	0.25	1.09

Table 2.7: Assessed government funded expenses, 2015–16 (\$ per capita)

State	2015 Review model	OWP model	Difference
NSW	1,343.11	1,327.12	-16.00
Victoria	1,248.44	1,214.64	-33.80
Queensland	1,489.32	1,510.98	21.66
Western Australia	1,428.79	1,509.65	80.86
South Australia	1,393.73	1,346.57	-47.16
Tasmania	1,564.39	1,663.35	98.97
ACT	1,205.10	1,302.10	97.00
Northern Territory	2,205.68	2,242.86	37.18
Average	1,372.32	1,372.32	0.00

It can be seen that the two specifications of the regression model give differences that are material. This outcome does not invalidate the OWP model as the draft assessment paper infers that there are issues with the 2015 Review model. Victoria concurs that the 2015 Review specification may not be desirable.

The final specification of the model that Commission staff devise may give results closer to the 2015 Review model. Victoria's consideration of the final model presented to the states will be based more on the rigour of its specification rather than the closeness of its outcomes to the 2015 Review model.

2.1.3 Other explanatory variables

In the 2015 Review it was found that the ACARA data indicate that secondary students are about 30 per cent more costly than primary students. However, analysis by the Commission indicated that it was not material to include a loading for secondary students because state shares of these students are not sufficiently different. In paragraph 24 of the draft assessment paper it is noted that the main difference between the states in their primary and secondary school numbers is driven by South Australia including Year 7 in primary schools.

It would appear that Commission staff consider the type of school, primary, secondary and combined is driven by state policy to such an extent that it would be inappropriate to

include school type in the assessment of expenses. While this would be an appropriate approach, Commission staff also note that school type is a strong predictor of school costs. DTF have included a non-primary dummy variable in the OWP model and the results are presented in Table 2.8.

Table 2.8: OWP regression model including school level—government schools

	Coefficient	t-value
Intercept	6,979	82.6
Inverse school size	199,184	85.7
Indigenous proportion	4,622	12.1
Students in most disadvantaged 25%	2,626	10.3
Inner regional school	-505	4.8
Outer regional school	913	7.3
Remote school	4,991	20.0
Very Remote school	2,461	7.9
Non-primary school	3,095	30.2
Adjusted R ²	0.67	

The coefficient for the non-primary school variable is statistically significant and its inclusion improves the adjusted R² value. Compared with the results presented in Table 2.1 the base cost per student and the impact of remoteness has been reduced. School level should be included in the regression model as the omission of a statistically significant variable would produce biased coefficient estimates.

Including school level would be consistent with the treatment of school size, where it is included in the regression model but does not form part of the assessment of expenses (other than through service delivery scale (SDS) where Victoria has reservations about the current derivation of SDS, which are discussed later in this section).

English language proficiency, despite being recorded by ACARA, was not included as an explanatory variable. The reasons advanced for this in the 2015 Review were that students with a language background other than English (LBOTE) are more heterogeneous than other groups and that while some of these students attract higher than average state funding, others attract lower than average funding. The Commission was also concerned that including a LBOTE variable would not help in estimating the coefficients for other variables.

There are legitimate concerns about the LBOTE variable that is used in the ACARA school profile data. It captures students within a school's population who speak a language other than English at home. This may be a misleading indicator of English language ability as a student may be fluent in English but speaks another language at home due to the lack of English proficiency of the parents. In addition, if the English language data are not provided in the school census, then ACARA derives the data from NAPLAN student level data.

The ACARA data shows that there are a number of schools that have a high proportion of both Indigenous students and LBOTE students². This situation would arise from Indigenous students speaking an Indigenous language at home. If LBOTE does, in itself, lead to a higher cost per student, then some of the higher cost attributed to Indigeneity

2 ACARA data shows that in 2015 just over 800 schools had identical proportions of Indigenous and LBOTE students.

could be due to LBOTE. If this is the case, then the higher cost per student for Indigeneity may be overstated. Potentially the cost impact of non-Indigenous LBOTE students is being ignored.

The Victorian Government allocates funding to schools to provide English as an Additional Language (EAL) programs for students based on the number of students who:

- come from a language background other than English;
- speak a language other than English at home as their main language;
- have been enrolled in an Australian school for less than five years; or
- attract SRP funding.

EAL funding is based on an integrated weighted index for primary and secondary students. This is applied to a school's profile of students from language backgrounds other than English as identified in the August School census. These weighted indices ranged from 1 to 7.64 for 2016.

The ACARA data records student enrolments, but Commission staff have raised the issue of attendance. It is not clear from the discussion in paragraph 27 of the draft assessment paper where the attendance data was sourced. The results presented in paragraph 28 are quite interesting, especially the vast difference in expenditure between attending and absent non-Indigenous students. Victoria would need to better understand the underlying expense drivers before forming an opinion about the impact of school attendance on expense assessment.

Victoria considers that the assessment of expenses should be based on the variables that states use to determine the funding they provide to government schools. The Victorian Department of Education and Training uses the Student Resource Package (SRP) as the main funding mechanism. It is primarily an enrolment based funding model, but there are a range of other factors taken into account³.

Victoria supports the proposal by Commission staff to use an appropriate regression model reflecting state funding models once the model has been further developed following consultation with the states. Once the model has been developed Victoria can comment on its appropriateness.

2.2 Complementary Commonwealth Data

Paragraph 35 of the draft assessment paper notes that the Commonwealth Department of Education and Training has data on Australian schools that can complement the data collected by ACARA. Victoria looks forward to Commission staff providing more details about these Commonwealth data and how they can be used to improve the assessment of expenses.

2.3 User Charges

The nature of user charges needs to be considered in order to determine how they are best treated. In the case of Victoria, the Department of Education and Training charges tuition fees and other charges for international students, FOI requests and other

3 The 2018 version of the SRP can be downloaded from <http://www.education.vic.gov.au/school/teachers/management/finance/Pages/srpprint.aspx>.

miscellaneous charges. This revenue received from these charges should be included in the GFS figures.

However, the charges recorded in the ACARA finance data covers income received from parents for the delivery of education services to students and income received from other sources, such as donations, interest on bank accounts, profits on trading activities and profits from sale of assets. It is unlikely that these funds would be returned to the states and included in the GFS user charges.

In the case of Victoria, the *Education and Training Act 2006* allows school councils to charge parents for items that the school provides or makes available to the student. The charges are subject to a departmental parent payment policy.

In addition, a government school community may undertake fundraising activities, having as their object the establishment or augmentation of school funds or raising funds for a particular school purpose. Under the *Fundraising Act 1998* funds raised for a government school by fundraising activities must be held by the school council for the purpose for which the funds were raised.

It is not clear to Victoria that the ACARA finance data records net rather than gross funding provided to government schools. It is quite likely that schools record the funding they receive from the responsible department which would be on a gross basis. Any user charges would be paid to the responsible department, either directly or through the school.

Commission staff need to carefully consider the nature of user charges before they can be confident that the statement made in paragraph 38 of the draft assessment paper is correct. Victoria would require reassurance on this issue before it would support the proposal by Commission staff of net user charges off the state funded government school assessment.

2.4 Commonwealth Funded Government Schools

The terms of reference for the 2015 Review included the direction that the measures of educational disadvantage in National Education Reform Agreement (NERA) were not to be unwound. This direction was consistent with clause 76 of the 31 May 2013 version of the Agreement:

‘The Commonwealth Treasurer will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the NERA funding arrangements’.

By the time of the 2020 Review NERA will be replaced by Quality Schools, although currently the states are negotiating funding agreements with the Commonwealth. The Commission may decide that the funding agreements for Quality Schools differ to such an extent to NERA that without an explicit direction through terms of reference the 2015 Review direction is no longer applicable.

However, Commonwealth funding will still be based on the SRS measure of need. The Commission will need to consider whether the appropriate measure to assess the funding states should receive from the Commonwealth is the Commonwealth’s measure of need or the Commission’s measure of state funding need.

At this stage, in the absence of a signed funding agreement between Victoria and the Commonwealth, Victoria supports the Commission staff proposal to the Commonwealth's SRS to assess need for Commonwealth funded government schools.

2.5 Commonwealth Funded Non-Government Schools

Victoria agrees with the assessment of Commission staff that there is no analytic benefit to the current treatment of Commonwealth funding for non-government schools and supports the proposal to assess these payments in the same way as other Commonwealth payments that do not affect relativities.

2.6 Data Sources for Student Numbers

The assessment currently uses two sources of data for school enrolments—ACARA data and the ABS *Schools, Australia*. The assessment scales ACARA enrolments by student characteristics to agree with ABS enrolments for each state.

Table 2.9 compares the number of government school students in 2015 recorded in the ACARA data (for primary, secondary and combined schools) with the student numbers recorded by the ABS. It can be seen that the ACARA student numbers represent quite a high proportion of students recorded by the ABS, which provides a high level of confidence that the ACARA data covers most students in Australia. There is little difference in the coverage rate for Indigenous and non-Indigenous students. The only anomaly is for Tasmania where the ACARA data has more students than the ABS data.

Table 2.9: FTE government school students by Indigeneity and state, 2015

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
ACARA								
Indigenous	53,311	11,101	49,283	22,367	10,190	5,708	1,383	12,852
Non-Indigenous	713,327	553,618	470,593	254,945	157,080	53,290	36,992	15,707
ABS								
Indigenous	54,150	11,820	49,609	23,185	10,367	5,220	1,392	13,026
Non-Indigenous	717,828	565,012	475,354	257,879	158,072	51,413	37,314	15,856
ACARA proportion of ABS (per cent)								
Indigenous	98.5	93.9	99.3	96.5	98.3	109.4	99.4	98.7
Non-Indigenous	99.4	98.0	99.0	98.9	99.4	103.7	99.1	99.1

Sources: ACARA, unpublished school profile data and ABS, *Schools, Australia, 2015*, Catalogue no. 4221.0.

The current method is to determine the number of students in each state by SDC attributes by applying the ACARA shares to the ABS numbers. This approach is appropriate as long as there are no significant state variations between the states in the representativeness of ACARA data, which is the case presented in Table 2.9.

However, all that this method achieves is a scale effect as there is no change to the distribution of attributes. Scale matters if there were significant differences between the most recent ACARA data and the most recent ABS data. An analysis of the relevant data shows variations of 4.7 per cent (Victoria) to -4.1 per cent (Tasmania). If the variation is uniform between the various student groups considered then the rescaling is appropriate.

A comparison of ACARA data for 2014 rescaled to ABS 2015 state totals and ACARA 2015 data show that the distribution of students between the SES and remoteness categories for Indigenous and non-Indigenous are very similar. This indicates that while the scaling would not introduce any distribution change, it would not produce any significant difference in the assessment of expenses.

Victoria supports the Commission staff proposal to continue the 2015 method of using ABS numbers of state enrolments distributed to SES and remoteness on the basis of ACARA data. However, it is noted that this method may not result in any improvement to assessed expenses if ACARA enrolment numbers were used.

2.7 Students with Disabilities

The ACARA data do not provide any information about students with disabilities. In the 2015 Review the Commission recognised that students with a disability were more costly to educate, but did not estimate a cost weight for these students in the assessment of state funded expenses. The absence of data on students with disabilities creates the problem that an important driver of funding needs cannot be measured. The assessment of schools education expenses will, therefore, not fully represent the determinants of actual state funding of government schools.

The Victorian Program for Students with Disabilities (PSD) provides a range of supports and initiatives to assist government school students with disabilities. Schools will be funded for each eligible student with a disability at one of 6 levels, with the index level informed by the responses provided to the Educational Needs Questionnaire. The 2017 Students with Disabilities rates range from \$6,799 to \$51,902⁴.

It is noted in paragraph 49 of the draft assessment paper that the data collected on student disability may not be currently nationally consistent. Commission staff propose not to incorporate students with a disability into the assessment unless the data are nationally consistent in time for the 2020 Review. Victoria considers that the Commission needs to consider what serves HFE better—not recognising a disability because of imperfect data or recognising it imperfectly. There are examples of the Commission recognising a disability because a strong conceptual case exists but the supporting data are imperfect.

2.8 Policy Effects on Shares of Government and Non-Government Students

The existence of non-government schools could be considered in an analogous way to the non-state provision of health services, that is, the existence of non-government schools would reduce the need for states to provide government schools. However, the difference with non-government schools is that they receive funding from the states, with this funding being significantly less than that provided to government schools.

The separate assessment of state expenses for non-government schools will cover the funding needs on the basis of school and student characteristics. The consideration from the policy neutrality perspective is whether the difference between the states in funding provided to non-government schools and any other policy differences influences the number of students in non-government schools.

4 <http://www.education.vic.gov.au/school/principals/finance/pages/srpref015levels.aspx>

While there may be some policy influences on the number of non-government students in the states, it would be difficult to identify and quantify these influences. Accordingly, Victoria supports the Commission staff proposal to use the actual numbers of government and non-government students.

2.9 Student Transport

The provision of state assistance for student transport differs between metropolitan and country students. In the case of Victoria, students travelling in areas covered by the Myki smart card are eligible for the Victorian Student Pass which entitles student to be charged the child fare. Students living in rural and regional Victoria are entitled to free bus travel if they live more than 4.8km from their nearest school. Arrangements in other states may differ, but there has not been a detailed discussion of student transport services in any of the recent reviews.

The current separate assessment of student transport expenses is not material. Victoria agrees with Commission staff that these expenses should not be separately assessed. If these expenses were to be assessed with transport services as proposed by Commission staff then the expenses for metropolitan students should be assessed under urban transport and expenses for country students assessed under non-urban transport. Victoria does not support the proposal by Commission staff that all student transport expenses should be assessed under urban transport.

However, it is quite likely that adding student transport expenses to transport services expenses will not be material. Given the uncertainty regarding the split of student transport expenses between metropolitan and country students, Victoria considers that it would be more appropriate to include these expenses in other expenses and not differentially assess them.

2.10 Other Issues Considered and Settled

Commission staff propose to retain the interstate wages assessment for school education expenses. While Victoria supports this proposal, it considers that the assessment should reflect that the states are the main employers of teachers and that the flow on effects from private sectors wage pressures may be reduced.

Commission staff also propose to retain the SDS assessment. As outlined in the geography section, Victoria has concerns regarding the derivation of the SDS assessment for schools education and regarding the concurrent application of regional costs and SDS.

One issue that has not been considered is the early childhood component of schools education. While this component only makes up a relatively small proportion of expenses the service delivery and funding model is different to that for schools education. Victoria considers that Commission staff should investigate the feasibility and materiality of separately assessing early childhood education.

3. Post-Secondary Education

3.1 Indigenous Cost Loading

Victoria supports the assessment continuing to have a loading for Indigenous students to reflect that states spend a higher amount per Indigenous student than for non-Indigenous students.

However, given that the ways in which additional expenses for Indigenous students arise, for instance subsidy loadings, flat rate subsidies and funding of support services, it is critical that the Indigenous cost loading has a common basis so that it can be applied to contact hours.

3.2 Remoteness Cost Loadings

Victoria is pleased that Commission staff have developed a regional cost gradient for post-secondary education that is based on the cost loadings actually applied by the states. It is noted that, at least for Victoria, that both the NCVET contact hours and the non-metropolitan loading are on the basis of the location of the training provider. It is important that this common basis exists for all states.

It is also important that the regional cost gradient is applied to where students receive their training and not where they reside. Otherwise, if there is a mismatch between the remoteness classification of where students reside and where they study the application of the regional cost loading to the classification of residence will result in an incorrect estimation of regional cost needs. Victoria recognises that the extent of this mismatch may be small, but it is an issue that Commission staff should explore.

Subject to the above considerations, Victoria supports the proposal that the Commission adopt the category specific regional cost loadings and apply them without any discounting.

The interaction of Indigenous and remoteness loadings should be based on the operation of state funding models.

3.3 Qualification Level Loading

On the basis of subsidy loadings provided by Victoria, any difference in subsidy payments by qualification level would be the result of a combination of the following:

- certain qualifications being provided relatively more in non-metropolitan areas;
- certain qualifications being provided relatively more to Indigenous students;
- certain qualifications receiving different subsidies; and
- certain qualifications requiring more contact hours for completion.

It is noted that as VET training is demand driven the levels of training provided by qualification level should be independent of state policy influence.

Victoria supports the proposal by Commission staff to investigate the feasibility of a qualification level loading.

3.4 Course/Industry Mix

Victoria accepts that the industry structure of a state may have an influence on the fields of study undertaken in post-secondary education. The Victorian Department of Education and Training provides a list of current funded courses and the subsidy rates. If these courses can be matched with NCVET contact hours data then the costs for particular types of courses could be estimated. A complicating factor is that the subsidy amount may change from year to year and the applicable subsidy in any year will depend on the years in which students commenced their studies.

While the amount of subsidy offered may affect course choices, VET training is essential demand driven, so that the choice of courses undertaken should largely reflect the types of skills sought by employers. However, the availability of the Commonwealth VET fee help may also reflect the choice of course undertaken. Victoria considers that state policies would have only a minor impact on the choice of courses undertaken.

Victoria considers that Commission staff should assess further the feasibility of obtaining the data required before recommending to the Commission that course mix not be assessed.

3.5 Public Registered Training Organisations Loading

Commission staff note that it is not average policy to provide a higher subsidy to private Registered Training Organisations (RTOs). This interpretation of average policy does not seem compatible with how average policy is applied according to the Commission's position paper on HFE and its implementation⁵

On the basis of the Commission's position paper if one state provided a higher subsidy to public RTOs then it would be average policy. The decision whether to include public RTO loading as a disability should be made on the basis of whether a policy neutral measure can be obtained and it is material to do so.

However, if most states pay the same subsidies to public and public providers then it is likely the disability would not be material. This is the issue that should be examined by Commission staff before deciding whether or not to proceed with this loading.

3.6 User Charges

User charges include fee-for-service income from full fee paying students, fees and charges from government subsidised students and ancillary income. Table 6 in the draft assessment paper shows that Victoria accounts for 39 per cent of the national total of all fee-for-service income.

In the 2015 Review, all post-secondary education revenue was netted off. For this Review, the Commission is proposing to net off only fee-for-service revenue on the basis that this approach is more conceptually sound.

Victoria is not convinced that only fee-for-service revenue should be deducted and does not support this change from the 2015 Review assessment.

5 Commonwealth Grants Commission, *The Principle of HFE and its Implementation*, Commission Position Paper CGC 2017-21, p. 17.

As an aside, Victoria understands that the NCVET VET finance collection will be discontinued and replaced by the National VET Funding collection from 2019. It is understood that this arrangement is unlikely to have significant adverse impacts on the Commission's calculations since the new collection will better reflect activity.

4. Health

4.1 Assessment Approach

Victoria agrees with the Commission's proposal to retain the direct approach to assess all components of health expenses.

The Commission's argument that greater data is available meaning the direct approach is more useful than the subtraction approach appears reasonable. The use of the subtraction approach and broader definitions of "state like services" as put forward by WA are not generally applicable and seem unlikely to result in a more accurate picture of state health spending and the size of the state-like health service sector.

Victoria does note a shortcoming with using the Independent Hospital Pricing Authority (IHPA) National Weighted Activity Unit (NWAU) model for assessing total health expenditure. The NWAU provides a way of comparing and valuing public hospital services to determine growth funding pursuant to the National Health Reform Agreement. It is not a true reflection of the total cost incurred in delivering services.

The NWAU is based on a national average cost of in scope services (some costs excluded), averaged over several years. Expenditure deemed 'out of scope' includes expenses such as out-of-scope health programs and capital and lease payments that are associated with public-private partnership (PPP) funding arrangements used for the construction of new public hospitals.

As noted to the Commission as part of Victoria's state visit, the Commission should also be aware that the introduction of a cap on Commonwealth funding growth of 6.5 per cent for services provided under the National Health Reform Agreement and the potential for over-cap funding by jurisdictions may impact on the Commission's assessment of states' expenditure and the relevant contribution by states towards hospital funding. This will be of particular concern for jurisdictions where there may be higher use of hospital services as a consequence of decisions impacting on services funded primarily by the Commonwealth, such as primary care, disability and aged care sectors.

4.2 SDC Assessments

Victoria considers the use of the NWAU for socio-demographic composition (SDC) assessments could have the potential to distort the relative magnitude of effects for each patient component. For instance, the NWAU contains an adjustment for Indigenous status and two adjustments for remoteness, but none for socioeconomic status (SES), age, homelessness, and other drivers of costs.

Although the Indigenous and remoteness adjustments are likely to reflect the additional costs associated with these cohorts, there are other SDC components that are likely to have a significant impact but are not accounted for by an NWAU adjustment.

For example, numerous studies suggest that SES has a significant and material impact on hospital length of stay and costs^{6,7,8}, not only on usage of health services. Therefore by using the NWAU, more weighting may be placed on Indigenous status and remoteness relative to other factors.

This issue may have the potential to unduly impact on those jurisdictions with a higher proportion of Indigenous people and people living in remote and regional areas.

4.2.1 Non-admitted patient services

With regard to the data sources for assessing State spending, Victoria considers that the Commission's proposed approach to use non-admitted outpatient services (NAP) NWAU data for the SDC assessment of NAP expenses is more appropriate than the approach adopted in the 2015 Review, where admitted patient separations data were used as a proxy indicator for NAP. The IHPA NAP data, whilst not perfect, is considered the best available data source for determining the material factors influencing Victoria's spend on NAP services. Victoria notes that admission practices between states vary, and therefore the application of a single approach to the discounting of services that are substitutable may create unintended distortions.

4.2.2 Community and other health services

Victoria agrees with Commission staff's proposal to investigate whether comparable data on community health services is available from other states. In the absence of suitable data, Commission staff have suggested that ED triage category 4 & 5 data may remain the best proxy for measuring SDC disability for community health services. Victoria considers that the use of ED triage category 4 & 5 data is not totally suitable to use as a proxy measure, however, given the limited availability of more appropriate and accurate data, this may be the most sensible approach.

4.3 Remoteness and Service Delivery Scale

At a national level, the costs associated with remoteness are currently taken into account by the IHPA in both the National Efficient Price (NEP) for larger Activity Based Funded (ABF) hospitals and the National Efficient Cost (NEC) for smaller rural health services that are considered too small for an ABF funding model.

Under the NEP, additional costs related to remoteness are factored in two ways:

- (1) the application of a significant patient remoteness loading (+25% for patients living in remote areas and +29% for patients living in very remote areas in NEP 18); and
- (2) the application of a significant remote area treatment adjustment – which is based on the reported additional expenditure associated with the costs of operating a hospital in a remote or very remote area. In NEP 18 this loading was +8% for hospitals located in a remote area and +12% for hospitals located in a very remote area.

⁶ Epstein, A., Stern, R. and Weissman, J. (1990). *Do the Poor Cost More? A Multihospital Study of Patients' Socioeconomic Status and Use of Hospital Resources*. New England Journal of Medicine, 322(16), pp.1122-1128.

⁷ Perelman, J. and Closon, M. (2011). *Impact of socioeconomic factors on in-patient length of stay and their consequences in per case hospital payment systems*. Journal of Health Services Research & Policy, 16(4), pp.197-202.

⁸ Pirson, M., Dramaix, M., Leclercq, P. and Jackson, T. (2006). *Analysis of cost outliers within APR-DRGs in a Belgian general hospital: Two complementary approaches*. Health Policy, 76(1), pp.13-25.

These loadings are likely to vary from year to year in line with updated reported expenditure.

Under the current NEC, hospitals located in very remote areas are treated differently to hospitals in inner and outer regional and remote areas. The rate applied to hospitals in very remote areas is related to their reported costs, and in most NWAU categories, is higher than the rate applied to hospitals in the other areas. It can therefore be said that the higher costs of operating a health service in very remote areas is considered at the moment.

It should also be noted that the IHPA is currently considering potential alternative ways of developing the NEC—all of the options have a greater focus on the NEP, which already takes into account the relatively higher costs of operating a hospital in a remote area (see discussion under NEP above).

In relation to block-funded hospitals, Commission staff note that the NWAU data for block-funded hospitals may not reflect all the remoteness and service delivery scale costs IHPA measures for these hospitals. Victoria agrees that there are likely to be broad issues with completeness and accuracy of the dataset, as well as inconsistencies between states in the types of services included.

Victoria notes that the data is based on the most recent hospital expenditure information supplied by states and territories and should therefore capture all remoteness and SDS costs. Victoria cautions against potential double counting by including additional remoteness and SDS costs for both block-funded and ABF funded hospitals above those captured in the data, particularly as remote loadings are already included in the NEP and NEC methodology.

In terms of community and other health services, Victoria agrees with Commission staff's proposed approach to ensure that all remoteness and SDS costs are recognised in the community health assessment and to consider the materiality of splitting the remote and very remote areas in the SDC assessments.

Victoria also considers Commission staff's proposed approach to re-test the materiality of splitting the 75+ years age group reasonable. The current single 75+ cohort is likely to underestimate the impact of differences in the older 85+ age group between states. Victoria suggests that Commission staff may also wish to investigate whether the costs associated with particular social groups such as the indigenous population and migrant groups should be disaggregated at a younger age due to the earlier onset of significant health events.

4.4 Substitutability

Victoria generally supports the proposed approaches for assessing the influence of the non-state sector (substitutability) on health spending, and for further investigation by the Commission staff to determine the best available data.

Victoria is open to further consultation and looks forward to contributing to the development of this work. Victoria will provide further comments when Commission staff conduct further investigation and analysis.

4.4.1 Admitted patient services

With regard to admitted patient expenses, Victoria notes that the IHPA data are likely to be the best available. However, there may be opportunities to re-examine the influence of the non-State sector. For example, Victoria understands the IHPA collects cost information for the private sector, therefore an adjusted NWAU for the private sector could be used instead of public NWAU.

4.4.2 Emergency department services

With regard to emergency department (ED) services, Victoria supports additional investigation of the relationship between GP- and State-provided ED services, and between private and State ED services.

While GPs have some capacity to provide emergency services, the level of substitutability of emergency services and GP services is unlikely to be high, with GPs increasingly less likely to provide the same kind of services as EDs.

For example, a University of Melbourne study⁹ of 1,150 children who attended hospitals for a low-urgency condition found only 43 per cent of parents had attempted to see a GP first. Of the 320 who did see a GP first, two thirds of them (212) were instructed by their GP to go to hospital. GP-type problems include vomiting and diarrhoea without severe dehydration, sprained ankles and mild asthma.

With regard to private hospitals, further to the comments in the staff paper, Victoria notes that the level of ED services provided by each private hospital is likely to vary. While some level of substitutability is present, access is determined by the level of private hospital cover that each patient has, the level of out-of-pocket expenses, the capability level of each ED, and individual patient/family preference.

4.4.3 Non-admitted patient and community health services

With regard to non-admitted patients and community health services, Victoria notes that Commission staff propose to investigate if service bundling or non-State allied health services have any implications for State-provided NAP services. Victoria also notes that staff propose to re-estimate the substitutability level for community health using a bottom-up approach. Given a lack of detail, Victoria seeks further consultation with the CGC as these new methodologies are developed, before possible implementation in 2020–21.

Finally, it should be noted that footnote (b) under Table 7 in the CGC staff paper should include a reference to Victoria, as this State also provides public dental services through private dentists using a voucher scheme.

4.5 Cross-Border Service Use

Victoria supports the proposed approach regarding community health services.

9 Freed et al, *Parent perspectives and reasons for lower urgency paediatric presentations to emergency departments*, Emergency Medicine Australia, April 2016.

4.6 Non-Hospital Patient Transport

Victoria agrees with the Commission's proposal to retain the current method for assessing non-hospital patient transport expenses and the collection of new data to benchmark patient transport expenses and re-calculate the remote patient cost loading.

4.7 Other Health Expenses

Victoria agrees with the Commission staff's proposal to consider whether expenses for pharmaceuticals, medical aids and appliance and health administration not elsewhere classified (n.e.c.) should be included in the community and other health component or admitted patients.

4.8 Component Expenses

The Commission staff's proposal to consider options for deriving annual estimates of ED and NAP expenses appears reasonable. Both options described in the assessment paper should provide more accurate estimates than the current assumption of a 50:50 split between ED and NAP expenses.

4.9 User charges

Victoria considers the proposed approach to continue to offset all user charges against expenses to be reasonable. Victoria questions the terminology used by Commission staff in terms of private patients being less costly than public patients. Private patients are not less costly in a general sense but are less costly to the taxpayer as their services are partially subsidised by private insurance.

4.10 Category Structure

Victoria considers the proposed approach to assess all hospital services in a single component to be reasonable, if IHPA's NWAU data for NAP services is considered sufficiently reliable by the time of the 2020 Review and provided that there is stability in the classification and NWAU price weight models. Changes in classification affect NWAU and there have been changes to the price weights over time.

If all hospital services are to be assessed in a single component (NWAU), care should be taken to ensure substitutability of private services can be determined accurately. Earlier parts of the draft assessment paper note that the impact is not likely to be consistent across the different components of hospital services.

4.11 Other Issues Considered

4.11.1 Cultural and linguistic diversity (CALD)

Victoria considers the proposed approach to not include a cost adjustment for culturally and linguistically diverse (CALD) to be unreasonable.

Victoria notes that it incurs additional costs associated with delivering targeted and responsive services and programs to meet the needs of large numbers of people seeking asylum, refugees and migrants. This is a result of 33 per cent of the national refugee intake and 38-40 per cent of the national intake for people seeking asylum settling in Victoria. Furthermore, Melbourne has the highest international migration of Australian cities.

Victoria notes that there are significant additional costs associated with treatment of some CALD patients, this includes the provision of:

- specialised refuges health and human services each;
- language services for provisioning of interpreting and translating services for people with no or low English language proficiency; and
- major initiatives and programs for CALD communities.

The National Health Costs Data Collection treats these costs as an overhead across all patients. However, in Victoria these costs are incurred at a patient level but there is not a consistent approach applied across health services in terms of reporting these costs.

5. Housing

5.1 Census data versus AIHW data

Commission staff have concluded that AIHW data provide a more accurate representation of the total number of social housing dwellings, whereas, the Census data provide more detailed breakdowns of socio-economic characteristics of households in social housing.

Therefore, Commission staff propose to combine the 'more reliable features of both data sets'. Specifically, it is proposed to develop an approach whereby Census data are scaled with AIHW data for each State on households in State and community housing.

Victoria sees merit in what has been proposed by Commission staff and supports the approach to develop and investigate scaling of Census data with AIHW data, whilst noting that there are gaps in both data sets.

5.2 The Impact of the Cost of Land

Commission staff propose not to pursue a differential assessment of housing related land costs because recurrent expenses would not be affected by land prices and net investment in land is too small for an assessment to be material. Furthermore, as the paper explains, the user costs of capital is a notional amount not reflected in the States' actual expenses and land is not depreciated.

However, Victoria argues that high land prices increase the cost of housing which in turn increases the demand for social housing and homelessness services from lower income households.

The cost of responding to this increased demand, including the assessment of applications for priority assistance and the provision of homelessness services for people unable to

access social housing, is likely to have an impact on the overall cost of providing social housing and other housing services in the State, relative to other jurisdictions where demand is not as prevalent.

5.3 The Impact of Policies on Affordable Housing

Due to a lack of information on state spending on affordable housing and the assumption that any spending would be small, relative to spending on social housing, Commission staff propose not to pursue a separate assessment of affordable housing. Victoria supports this recommendation.

5.4 The Assessment for First Home Owner Grants and Stamp Duty Concessions

Commission staff recommend the retention of the EPC assessment of FHOGs and stamp duty concessions expenses. Under this method, assessments do not affect the GST distribution. Victoria supports this proposal as there is no better alternative.

5.5 Updating Weights Ahead of the Draft Report

Victoria agrees with Commission staff's proposal to update the Indigenous cost weight and the location factor using the latest available data.

6. Welfare

6.1 Family and Child Services

Victoria agrees with the Commission staff's proposal to retain the current assessment methodology of family and child services, noting the significant over-representation of Aboriginal children in Victorian out of home care. Commission staff state that Indigenous children were seven times as likely as non-Indigenous children to have received Child Protection services and 10 times as likely to be in Out of Home Care. However, in Victoria this number is higher. For children in out of home care, a rate ratio of Indigenous to non-Indigenous children in Victoria is 15.9 (AIHW Child protection Australia 2016–17).

Victoria notes that the Commission will stay in contact with the AIHW on developments concerning its unit record database.

6.2 Aged Care

As Commission staff note, HACC and specialist disability services for older people are no longer a State responsibility in Victoria. Therefore, Commission staff propose to recommend to the Commission that residual aged care expenses be merged with other general welfare expenses and assessed using a general low SES measure.

Victoria agrees that any residual expenses would be minimal by the implementation year and agrees with the Commission staff's proposal.

6.3 Disability Services

6.3.1 NDIS

Commission staff propose to assess NDIS expenses APC at full implementation in the 2020 Review, subject to decisions on this issue taken in the 2019 Update. Victoria supports the Commission staff's proposal to assess NDIS expenses APC at full implementation in the 2020 Review.

6.3.2 Non-NDIS disability services

Staff propose to re-allocate non NDIS expenses to the other general welfare component and assess them using the same measure of low SES, as that used for other general welfare expenses after the full implementation of NDIS, subject to decisions on this issue taken in the 2019 Update.

General welfare services include concessions, homeless persons' assistance, prisoners' aid, care of refugees, Indigenous welfare services, women's shelters, and information, advice and referral services; services which are directed to people of low SES status.

Victoria questions whether SES is in fact the appropriate disability to assess non-NDIS disability services. It is not clear whether people who cannot access NDIS or experience gaps between NDIS and mainstream services will be of low-SES groups.

6.4 General Welfare Services

6.4.1 Concessions

Victoria agrees with the recommendation to retain the current assessment methodology for concessions.

6.4.2 Other general welfare

Victoria agrees with the recommendation to retain homelessness related expenses within the other general welfare component of the Welfare category and the most appropriate assessment is to use a low SES measure.

Further, Victoria supports the proposal to use an updated ABS SEIFI to measure needs for other general welfare expenses. If an updated SEIFI is not available for the 2020 Review, Victoria recommends an equivalent measure be used, noting the Commission staff's proposal to use the relative proportions of State populations in the bottom quintile of the 2016 Census individual income.

7. Services to Communities

7.1 Utilities Expenses

Utilities subsidies include both electricity subsidies and water and waste water subsidies. The assessment paper shows that in 2016–17, the Victorian government provided \$6 million towards water and wastewater subsidies but no electricity subsidies. By contrast other state governments collectively provided almost \$1.7 billion.

Victoria supports the proposal to split the utilities component into electricity subsidies and water subsidies, as the Commission staff have stated, the average subsidies for these services are likely to be different. Victoria also welcomes the proposal to update the split between electricity and water subsidies annually using data already available from the States.

7.2 Electricity Subsidies

The draft assessment paper notes that fewer than one per cent of the Australian population reside in “off-grid” regions. Most of the electricity subsidies, however, are provided to regional areas in Queensland and Western Australia where the cost of transmission and distribution is higher than in more densely populated areas reflecting diseconomies of small scale.

Victoria notes that the Commission’s analysis of state electricity subsidies is incomplete and will be informed by further data analysis over coming months. In particular, it is important to identify the point at which full cost recovery of electricity provision is not feasible. Victoria believes that it is important that electricity subsidies are not differentially assessed when the decision not to fully cost recover is due to a state policy choice.

Victoria agrees with the Commission staff’s proposal to determine the full cost recovery point of electricity provision and to differentially assess only those subsidies which are the result of unavoidable (non-policy related) costs.

7.3 Water Subsidies

Water services are generally provided by state-owned utilities. Water subsidies mostly benefit regional households where tariffs are not fully cost-reflective due to the high cost of service provision.

Victoria notes that the Commission staff will commence analysis of state water data to determine cost drivers later in the year. Victoria believes that it is important that water subsidies are not differentially assessed when the decision not to fully cost recover is due to a state policy choice but should be instead be the result of unavoidably high costs.

Victoria agrees with the Commission staff’s proposed recommendations to determine the full cost recovery point of providing water services and to differentially assess only those subsidies which are the result of unavoidable (non-policy related) costs.

7.4 Community Development and Amenities

7.4.1 Indigenous community development

The assessment of Indigenous Community Development is based on the State's share of 'Indigenous people living in discrete communities' (defined as ABS SA1 with a population of Indigenous people over 50 per cent). In 2016–17, Victoria had a population of 37 that fell within the discrete communities category. The assessment is relevant as it will redistribute GST from Victoria.

General revenue grants to local councils with a high indigenous population are proposed to be included in the scope of this category. As noted in the draft assessment paper, these grants cannot be disaggregated by purpose. Including the full amount may overestimate the expenses for indigenous community development. Furthermore, these grants should be considered in light of grant funding to all councils, who may also receive revenue grants. This suggests a base level of funding required irrespective of indigeneity. Victoria therefore does not support expanding this category.

Victoria agrees with the Commission's staff proposal to:

- collect for indigenous community development expenses to evaluate the quality of GFS data;
- assess indigenous community development expenses in a separate component of the Services to communities category;
- continue to use the indigenous population living in these communities as the disability for the indigenous community development, and applying wage costs and regional costs disabilities; and
- continue to define discrete indigenous communities as SA1s with populations that are more than 50 per cent indigenous.

7.4.2 Other community development and amenities

Other community development expenses are currently assessed using the population living outside discrete indigenous communities. Community amenities expenses are assessed EPC. Wage costs are regional disabilities are applied to recognise the differences in wage costs.

Victoria agrees with the Commission's staff proposal to:

- collect for indigenous community development expenses to evaluate the quality of GFS data; continue to assess community amenities expenses EPC;
- assess other community development expenses EPC because these services apply to all communities including discrete Indigenous communities;
- continue to apply wage costs and regional costs disabilities to other community development and community amenities expenses; and
- include other community development and amenities expenses in the Other expenses category because this is where most other State expenses which are assessed on the basis of population are classified.

7.5 Environmental Protection

In the 2015 Review, environmental protection services were assessed on an EPC basis as the expenses covered a wide variety of services and cost drives could not be identified.

Victoria notes the assessment paper's observation that wages costs have a differential effect on the costs of providing services. The proposal to examine whether a regional costs disability should be applied to national parks and wildlife expenses is supported.

Victoria agrees with the Commission's staff proposal to:

- continue to assess environmental protection expenses EPC because it is not practical to disaggregate expenses or possible to identify a single broad indicator for assessing spending on this function;
- continue to apply a wage costs disability;
- consider applying the regional costs disability to some or all environmental protection expenses, especially in light of changes to the scope of these expenses, which now include national parks and wildlife expenses; and
- include environmental protection expenses in the service expenses component of the Other expenses category because this is where most other State expenses which are assessed on the basis of population are classified.

7.6 User Charges

Most of the user charges for the existing Services to communities category are regulatory charges related to community development and environmental protection functions. Currently environmental protection user charges are netted off expenses but community development user charges are not. The assessment paper points out this consistency and proposes a presentational change to simplify the calculations which will have no effect on the redistribution.

Victoria agrees with the Commission's staff proposal to include all user charges for the activities covered by the existing Services to communities category in the Other revenue category and assess them on an EPC basis.

7.7 Location, Service Delivery Scale and Wages

The assessment paper notes that staff intend to develop a cost gradient for electricity subsidies that includes the influence of remoteness and community size, based on actual subsidies. Therefore, the electricity subsidies assessment will no longer require an additional regional cost weight or service delivery scale factor.

Victoria agrees with the Commission's staff proposal to:

- discontinue the regional cost weight and service delivery scale factor for electricity subsidies;
- ensure that regional costs and service delivery scale costs are captured in the water subsidies assessment; and

- retain the 2015 Review assessments of wage costs and regional costs for the remaining components and consider applying a regional costs disability to environmental protection expenses.

7.8 Other issues considered

7.8.1 Non-State sector provision for electricity and water

The Commonwealth funds some electricity generation projects such as for renewable energy which may allow states to reduce their subsidies. The draft assessment paper notes that while non-state sector spending is likely to influence the level of state spending on electricity and water, it would be difficult to quantify the effect.

Victoria agrees with the Commission's staff proposal not to assess the effect of the non-state sector on the level of electricity, water and wastewater subsidies.

7.8.2 Private provision of environmental protection services

The activities of some non-government groups such as Landcare and Coastcare may reduce state costs in the provision of environmental protection services. The assessment paper notes that assessing the influence of such groups on state government service provision is unlikely to be reliable.

Victoria agrees with the Commission's staff proposal not to assess the effect of the non-state sector on the provision of environmental protection.

8. Justice

8.1 Police

Victoria understands that Commission staff are investigating changes to the assessment methodology that removes the current split of police services into 'community policing' and 'specialised policing'. While some progress was presented to the OWP, there has been no final methodology presented to the states. Commission staff are awaiting data from some states and Victoria is working on providing the data requested.

State police services generally have difficulty in viewing their activities in terms of the Commission's typology of 'community policing' and 'specialised policing'. The Victorian Police consider that their activities can be broadly categorised as reactive or proactive.

Reactive policing includes:

- First responders;
- Investigation;
- Bail compliance and custody; and
- Court and judicial process.

Proactive policing includes:

- Policy and strategy development;
- Partnerships with other government agencies and service providers;
- Community partnerships; and
- Building Community Trust and Cultural understanding.

Victoria supports the Commission's work in modelling drivers of offences and developing a geographic based model of cost offence. However, it should be noted that offences recorded are not the only output of police services and that there are difficulties in allocating costs on a geographic basis. As a final assessment methodology has not been specified Victoria is not in a position to have an opinion on an offence cost based assessment.

In the event that an offence cost based approach does not result in a reliable assessment, then Victoria supports the retention of the current approach, subject to the split between 'community policing' and 'specialised policing' being reviewed.

8.2 Courts and Legal Services

8.2.1 Elements within the legal cluster

The staff draft assessment paper recognises the other areas of spending outside of courts that was not recognised in the 2015 Review assessment. Victoria is supportive of the proposal to change the name of this component from 'courts' to 'legal services'.

In determining the split of expenses, Victoria considers that the Commission should undertake a data request to the states to determine spending on each component rather than relying on the estimates discussed in paragraph 49.

8.2.2 Civil court use drivers

Victoria considers that there may be a variety of drivers for civil courts use, not all associated with SDC factors as civil matters includes commercial disputes. However, Victoria agrees with Commission staff that the data required to make a differential assessment is lacking. Accordingly, Victoria supports the Commission staff proposal to continue the EPC assessment of civil courts expenses. Victoria also supports the proposal to that the remaining expenditure identified in paragraph 53 also be assessed EPC.

Victoria supports the allocation of 40 per cent of legal services expenses to this category, subject to the data collected from the states confirming this split.

8.2.3 SDC assessment of criminal courts

An implicit assumption of the current assessment methodology is that the cost per finalisation of each socio-demographic group is the same. For this assumption to hold each demographic group should be equally represented in higher and lower courts. The RoGS data shows that the cost per finalisation for Magistrate's Courts is around five per cent of that for higher courts, so that if there are differences in the socio-demographic distribution between the two court levels then there will be implications for the distribution of total expenses to each socio-demographic group.

ABS data on defendants finalised from *Criminal Courts, Australia, 2016–17* show that the types of offences dealt with differs between higher and lower courts. Higher courts are

more likely to deal with homicide, sexual assault and robbery offences, although these offences account for only around two per cent of criminal court defendants. If the type of offences committed varies according to SDC then there could be cost implications. If certain SDC groups are more likely to commit offences that are dealt with in higher courts then they have higher costs associated with them.

Victoria supports Commission staff requesting data from the states that would enable a disaggregation of offenders by type of offence and/or level of court where the defendant appeared. Given the cost disparity between higher and lower court costs per case, it is important that these are recognised in the assessment.

Victoria is not convinced that the gathering of data from the states on the age, Indigeneity and SES of defendants is so complex that it could not be undertaken annually, it is recognised that the distributions may not change significantly over a five year period.

Commission staff have proposed that cost weights not be applied to the SDC groups. Victoria recognises that the data required to do this may be lacking. However, as an alternative Victoria considers that a separate assessment of higher and lower courts expenses be undertaken. Calculations undertaken by Victoria indicate that a separate assessment would be material for the 2018 Update. Victoria can provide details of its calculations to Commission staff.

8.3 Prisons

In the 2015 Review the Commission used the terms 'prisons' and 'corrective services' interchangeably, but tended to use the term 'prisons'. The 2015 Review defined 'corrective services' as including '...the administration, support and operation of prisons and other places of secure detention' as well as 'Community-based corrective services are also offered by the States to provide a non-custodial sentencing alternative'¹⁰

Commission staff claim in paragraph 19 that the corrective services assessment focuses solely on prisons as they make up the bulk of the expenses. Paragraph 61 notes that Productivity Commission data indicates that 85 per cent of net expenditure on corrective services is on prisons. These data also show that people on community corrections account for 63 per cent of corrective services clients and the cost per community correction is 10 per cent of the cost per prisoner.

ABS data from *Criminal Courts, Australia, 2016–17* show that only 8.4 per cent of defendants found guilty were sentenced to custody in a correctional institution. There was also a difference in the age distributions of those sentenced to custody in a correctional institution compared with other sentencing outcomes, with those sentenced in the 25 to 44 years age group being more likely to be sentenced to custody in a correctional institution than other age groups.

The ABS data also show that the principal offence of defendants found guilty has an influence on whether the outcome is custody in a correctional institution. Those found guilty of the more serious offences, such as acts intended to cause injury, sexual assault and robbery are much more likely to be sentenced to custody in a correctional institution. On the other hand, offences such as traffic and vehicle regulatory offences are much more likely to result in a non-custodial sentence.

10 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities 2015 Review: Volume 2—Assessments*, pp. 304–305.

Victoria examined the impact of separately assessing prisons and community orders expenses. Productivity Commission *Report on Government Services* (ROGs) data were used to split corrections expenses between prisons and community orders and to scale up prisoner numbers (by Indigeneity but not age group) ratios of prisoner to community orders numbers. These calculations indicate that a separate assessment would be material for the 2018 Update. Victoria can provide details of its calculations to Commission staff.

8.4 User Charges

Victoria agrees that justice user charges should continue to be assessed EPC and, accordingly, supports the proposal by Commission staff to include justice user charges with other revenue.

8.5 Other Issues Considered

Victoria supports the proposal by Commission staff to continue to apply an interstate wage costs assessment to the justice expense category, subject to the appropriate determination of these costs.

While Victoria supports the proposal by Commission staff to continue to apply a regional costs assessment, it has a number of concerns, outlined in the geography section, regarding the current determination and application of regional costs, as well as the concurrent application of regional costs and SDS assessments.

Victoria supports the proposal by Commission staff to continue the national capital allowance for police services.

9. Roads

9.1 Rural Road Length

The two are two competing principles involved in the consideration of Commission staff on the determination of rural road length—what states do and policy neutrality. The current assessment places policy neutrality above what states do, but it is a particular form of policy neutrality in that it relates to policy decisions made some time ago.

In other assessments the Commission has taken past policy decisions as a given and the focus is on the current situation. A consistent approach for the roads assessment would take the current rural road network, appropriately measured and defined, as a given. What states do is maintain the rural road network they currently have.

Victoria supports Commission staff undertaking further work to enable them to base the rural road length on the actual rural road length, with a consistent definition of state roads.

9.2 Urban Road Length

Victoria supports the proposal by Commission staff to retain the current definition of urban areas as this definition is consistent with the definition used by the agencies that provide data used in the assessment.

Victoria also supports the use of state actual lane kilometres for urban roads, with a consistent definition of state roads, as the basis of determining urban road length. Victoria considers that the electronic pavement datasets should be used to estimate urban road lengths, lane kilometres and traffic volumes for urban areas.

There may be merit in disaggregating road length by type of road — freeways, major arterial roads and minor arterial roads — as there is evidence that traffic volumes vary between these types of roads.

9.3 Local Roads

Victoria also supports the use of state actual kilometres for local roads, with an appropriate and consistent definition of local roads, as the basis of determining local road length.

9.4 Road Use

Commission staff propose to remove light commercial vehicles from the definition of heavy vehicles. One of the reasons given for this proposal is that the average weight of light commercial vehicles is similar to heavier passenger vehicles. However, the average weight of light commercial vehicles will still be higher than that of passenger vehicles.

Some of the ways in which traffic volumes are measured include:

- Average annual daily traffic, which can be used to indicate the proportion of traffic that are heavy vehicles; and
- Passenger car equivalent units (PCEU), which measures the road space taken up by traffic.

In many instances the decision to expand road infrastructure is determined by the PCEU capacity of roads, especially roads carrying large volumes of heavy vehicles, in order to maintain the functionality of the road network.

Commission staff also propose to combine rigid and other trucks with buses. As the trend AGM of these vehicles is similar Victoria supports this proposal.

Victoria notes the examination by Commission staff on the impact of urban population density on spending. Unless the ACT is forthcoming with further evidence on this issue Victoria supports Commission staff not pursuing this issue.

9.5 Bridges and Tunnels

Victoria supports Commission staff exploring the issues associated with the expense drivers for bridges and tunnels. The Victorian Government is currently undertaking a project (as part of the Heavy Vehicle Road Reform Agenda) to revise the current cost allocation weighting used by the National Transport Commission in allocating the cost of maintaining bridges and tunnels to heavy vehicles.

Should no satisfactory options be found, Victoria supports the bridge and tunnel expenses being reallocated to the relevant urban and rural road components.

9.6 Other Services

Victoria does not consider that there is a direct relationship between corporate services expenses and the components of roads expenses. These expenses should continue to be assessed on an EPC basis. If regulation type expenses are to be differentially assessed then they should be done on a whole of state basis of road use.

9.7 National Network Roads

9.7.1. Overview

Commission staff have requested the views of the states as to whether the 50 per cent discount applying to national network road and rail projects should continue.

Victoria's position in regard to the national network discount can be summarised as follows:

- the conceptual case for the discount is unsound;
- the existence of the discount could influence state policy;
- the existence of the discount has influenced update and review terms of reference; and
- the discount should be discontinued.

9.7.2. The national network discount

The Commission introduced a 50 per cent discount for Commonwealth payments for national network roads in the 2010 Review. The reason for this discount was that the Commission considered that Commonwealth support for investment in these roads is influenced by Commonwealth considerations which are not captured in the State-based disability measures (such as, the need to develop an efficient national transport network to facilitate national economic growth and productivity gains in the long-term)¹¹. In the 2015 Review this 50 per cent discount was extended to Commonwealth payments for national network rail investment¹². This extension is consistent with the recommendation of the GST Distribution Review that Commonwealth payments for nationally significant road and rail projects be treated in the same way.

9.7.3. The National Land Transport Network and Commonwealth infrastructure funding

The National Land Transport Network (the national network) is a defined national network of important road and rail infrastructure links and their intermodal connections. The Network is determined by the relevant Commonwealth Minister under the *National Land Transport Act 2014*. Schedule 1 of the Minister's determination lists existing and proposed roads forming part of the National Land Transport Network and Schedule 2 lists existing

11 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2010 Review Volume 2—Assessments of State Fiscal Capacities*, p. 444.

12 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2015 Review Volume 1—Main Report*, p. 61.

and proposed railways forming part of the National Land Transport Network. It is interesting to note that in some cases only a portion within one state of a national highway is determined to be on National Land Transport Network. It is also interesting to note that cities that are on the national road network are not on the national rail network, and vice versa.

The stated objectives of the National Land Transport Network are¹³:

- improves national and inter-regional connectivity for people, communities, regions and industry.
- improves national, inter-regional and international logistics and trade.
- enhances health, safety and security.
- is consistent with the obligation to current and future generations to sustain the environment.
- is consistent with viable, long-term economic and social outcomes.
- is linked effectively to the broader transport network.

The *National Partnership Agreement on Land Transport Infrastructure Projects* was signed by all jurisdictions in October 2014. The objective of this Agreement is a safe, sustainable national transport system that enhances the interconnectivity of corridors (networks) of significant economic opportunity across Australia. [p. 3]. The role of the Commonwealth under this Agreement includes ‘...assessing and determining which Projects are to be funded under this Agreement, in consultation with the States...’. [p. 3]. The role of the states includes ‘ providing a financial or in-kind contribution...’. [p. 4.] In the Agreement the Commonwealth and the states ‘...agree that the National Land Transport Network is a joint responsibility...’. [p. 5].

There is a difference between the ownership of national road and rail networks. While the states own the roads on the national network, a large component of the national rail network (Kalgoorlie to Brisbane via Melbourne/Broken Hill and the Hunter Valley) is owned by the Australian Rail Track Corporation (ARTC) Ltd which is in turn is owned by the Commonwealth. This means that the states are only responsible for the national rail network that is not part of the ARTC network.

9.7.4. The conceptual case

The national network discount is provided as the Commission considers that the Commonwealth may provide road funding on a basis that includes factors other than road length, road use, population growth and construction costs. As a consequence some of the infrastructure expenditure by the states is driven by factors other than those considered in the assessment of road construction expenditure. The national network discount reflects the Commission’s judgement that half of Commonwealth funding for national network road construction is determined by factors other than those used by the Commission in its road construction assessment.

A report by the Grattan Institute¹⁴ provides support for the notion that some Commonwealth funding is not related to factors included in the Commission’s assessment. This report claims that Commonwealth funding for road projects can be influenced by electoral

¹³ Department of Infrastructure and Regional Development, accessed from http://investment.infrastructure.gov.au/whatis/obj_and_key_features.aspx.

¹⁴ The Grattan Institute, *Roads to Riches—Better Transport Investment*, April 2016.

considerations and that there has been a bias towards funding projects in those states with more swinging seats.

There are a number of factors to consider with the Commission's conceptual case. The Grattan Institute report claims that electoral considerations are also important at the state level which suggests that factors determining the expenditure of states themselves on road construction may not fully align with the factors used in the Commission's assessment. To the extent that this exists there may not be a divergence between the motivation for Commonwealth and state funding for road construction, weakening the conceptual case for the national network discount. It also suggests that there may need to be a reconsideration of the factors used for assessing road construction expenses.

While a road being on the national network may impose funding obligations on the Commonwealth relative to other roads, this does not necessarily mean that Commonwealth funding for other roads is not influenced by factors other than those used for the Road construction assessment. The Grattan Institute report notes that some roads on the national network better meet the criteria for being on the national network than other roads. This indicates that if the Commission considers that a discount is to be applied to Commonwealth road construction funding then it should be applied to funding for all road construction.

The value of the discount to be applied is quite difficult to determine. The 50 per cent value used by the Commission cannot be regarded as anything but a guess. Victoria does not consider that HFE is advanced by using guesses. The Commission needs to undertake more analysis of the rationale for Commonwealth funding of individual projects to determine the extent to which this funding is in line with what would be expected from its assessment of expense needs. If the Commission is unable to do this, then the imposition of an arbitrary adjustment cannot guarantee that HFE is better achieved.

The provision of Commonwealth funding that differs to expense needs is not confined to road construction. Some of the major SPPs are allocated to the states on a population share basis while the associated expenses are differentially assessed. States that received Commonwealth funding in excess of their assessed expense needs are assessed as having a reduction in their GST requirement and vice versa. It is not clear that this is any conceptual difference between this Commonwealth funding and road construction funding. States that receive Commonwealth road construction funding in excess of their assessed needs have a greater fiscal capacity than states that receive funding that is below their assessed needs. It is not clear why some of this greater fiscal capacity needs to be discounted in order to be consistent with HFE.

In light of the discussion above, Victoria concludes that the conceptual case for the national network discount is weak at best and should be discontinued.

9.7.5. New projects not on the national network

In one of its submissions to the 2015 Review Victoria raised concerns about Commonwealth funding for a new road or railway line that may not be declared as part of the national network until it is fully completed. Although the Ministerial determination does include proposed projects, projects may arise since the issuing of the last determination. Also, as inclusion of a road or track on the national network commits the Commonwealth to contribute to maintenance funding, there may be a reluctance to include new roads or tracks on the national network, either at all or in a timely manner.

In the 2015 Review's final report the Commission stated that it would ensure payments are treated appropriately and consistently with its understanding of the national networks¹⁵. However, it would be difficult for the Commission to make such a decision as it is unlikely that it would have all the advice that the Minister would have in making a determination. This was born out in the 2016 Update in regard to the Western Interstate Freight Terminal project where the Commission stated that 'Our preference is to rely on the advice of [the Department of Infrastructure and Regional Development] as to what is a network project'¹⁶.

The conclusion that can be drawn about new projects not on the national network is that the Commission will not consider them to be on the national network until they are declared to be on the national network. It is entirely likely that by that stage the relevant assessment years are no longer part of the current assessment so that the discount is not applied. This is a further illustration of the problems associated with using the national network as the basis of applying a discount.

9.7.6. Policy neutrality

One of the supporting principles that the Commission has adopted to assist in the achievement of HFE is policy neutrality. One aspect of policy neutrality is that '...the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another'¹⁷. However, there is evidence that states are responding to the incentive of the national network discount. States have an incentive to have road and rail projects declared to be on the national network or to seek Commonwealth funding for national network projects in preference to other projects.

Alternatively, states are requesting that terms of reference specify the treatment of particular projects as if they were national network projects. For instance, the supplementary terms of reference for the 2015 Review required that the 50 per cent discount should be applied to Commonwealth payments for a number of specified road projects.

The possibility that the 50 per cent national network discount is leading to these situations should be of concern to the Commission. As well as the discount affecting assessments, applying it to projects that would otherwise not have received the discount compromises the achievement of HFE.

This is a further illustration that the national network discount is not achieving its stated aims and adds strength to the argument for its removal.

9.7.7. The Grattan Institute report

The Grattan Institute report mentioned above discusses the GST treatment of Commonwealth infrastructure funding. It argues that this funding should be treated consistently, either fully including them or fully exempting them from the determination of GST shares. The latter treatment is to be preferred once Commonwealth funding decisions are made on the basis of a rigorous independent evaluation and a supporting business case.

¹⁵ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2015 Review Volume 2—Assessments*, p. 413.

¹⁶ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2016 Update*, p. 48.

¹⁷ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2015 Review Volume 1—Main Report*, p. 30.

Victoria considers that the rationale for these options reflects a lack of understanding by the Grattan Institute of the principles of HFE. However, Victoria would agree that there needs to be a consistent treatment of Commonwealth infrastructure funding and this should be by inclusion.

9.7.8. Conclusion

To conclude, Victoria considers the conceptual case to be weak and is concerned that the value of the discount has been arbitrarily determined without any analysis of the impact on HFE. Even if the national network discount was soundly based, Victoria is concerned that it is having an influence on state behaviour and the framing of terms of reference which work against the rationale for the discount.

Victoria considers that the whole national network discount is so fraught with problems that HFE would be better achieved by the Commission discontinuing the discount.

9.8 Physical Environment

Victoria supports the proposal by Commission staff not to pursue the development of a physical environment assessment.

9.9 Location Factor

Victoria supports the proposal by Commission staff to continue the application of instate wage costs factor. Victoria supports the proposal to apply a regional costs factor, provided that it has an appropriate basis.

9.10 User Charges

Victoria supports the proposal by Commission staff to continue to assess roads user charges on an EPC basis in the Other revenue category.

10. Transport

10.1 Data Sources and Assessment Methods

10.1.1 Net urban transport operating expenses

The draft assessment paper notes that consultants engaged for the 2010 Review found public transport operating subsidy per capita rises as city size increases because a greater quantity of travel per capita is made by public transport. This rises even faster in growing urban centres.

It is also relevant to acknowledge that large scale (and expensive) public transport infrastructure investments are necessary and viable in large and dense cities due to worsening congestion on the road network. This is another factor that explains increased use of public transport when city size increases.

Conversely, in low density and low population areas there is significantly less benefit from both using and providing public transport as car use is more efficient. The main motivation for public transport in smaller areas is equity of access.

The draft assessment paper shows the relationship between per capita net expenses and per capita passenger-km by city size (Table 4 and Figure 1). Paragraph 37 notes that Melbourne's per capita net expenses may be artificially low. However, the lin-log relationship and the diminishing increase in per capita net expenses may not be appropriate were Melbourne dropped from the regression. Our analysis shows that the relationship appears to look more linear. Melbourne is the only large city data point that has net expenses lower than the transport task.

One of the practical issues is that there are a lot of data points for small cities, but very few for large ones (five for population over one million, only two for populations over two million). If Melbourne were removed from the sample the curve could look very different, such that that scaling factor (beta in the equation) would be significantly lower. At the same time, the presence of data for Sydney in the regression raises the value of the scaling factor. Victoria suggests that there would be some value into exploring the reasons for the large difference in net expenses between the two capital cities.

10.1.2 Investment and depreciation

The urban transport investment assessment allows for the impacts on investment in transport infrastructure of city size through a capital stock factor which is calculated from a population model, reflecting the effects of city size on the need for assets per capita. While the assessment paper notes that the population model is predicated on a linear relationship between city size and assets per capita, the relationship between net operating expenses and city size is not. Assets are increasingly more expensive to build in dense urban environments while operating expenses are less affected by density and land use.

The investment model adopted by the Commission includes a 50 per cent discount due to concerns over data and the model itself. Given that that large cities have high infrastructure costs, such as tunnelling, high land values and disruption issues, Victoria believes that the discount is worthy of further examination.

10.2 Urban Transport

Victoria supports the proposal by Commission staff to retain the current population-based approach to the assessment of recurrent and infrastructure urban transport expenses.

As noted above, the assessment paper shows that Melbourne's per capita net expenses are low compared to other capital cities. Victoria agrees that V/line's commuter services to Geelong, Bendigo, Ballarat and the La Trobe Valley should be included in Melbourne's expenses.

Additionally, it may be that Melbourne's geography and development over time have resulted in fewer trips taking place *along* a regional route, with many regional trips ending in inner Melbourne. This contrasts with Sydney where there are more population and employment centres along a route, such as the Newcastle line, where commuters are more likely to end their trip outside inner Sydney.

Victoria will consider the issue of satellite cities when the consultancy stage 2 report is received. In Victoria's experience a high proportion of rail travel is from regional centres to Melbourne, while most of the intra-urban transport in regional centres is provided by buses.

Victoria looks forward to receiving the report on stage 2 of the consultancy and will provide feedback to Commission staff.

Victoria supports the proposal by Commission staff to retain the 2015 Review definition of urban areas.

Victoria supports the inclusion of Significant Urban Areas that have public transport services in the assessment of urban transport.

10.3 Non-Urban Transport

Victoria considers that Commission staff need to give more consideration to the nature of non-urban transport, particularly the split between passenger and freight transport and whether they have the same expense drivers.

If the Commission were to retain the current assessment methodology then populations included in the urban transport assessment should be excluded from the assessment.

Victoria is not convinced that the current regional cost factor is the appropriate one to apply to the non-urban transport assessment. Subsidy payments are likely to reflect the costs faced by regional operators, rather than costs faced by states in providing schools education and police services.

Regardless of the conceptual case of regional costs for non-urban transport, the regional cost factor has not made a material difference to assessed expenses for the assessment years of the 2018 Update. The impact of the regional costs factor has been declining over time so it would not be expected to be material on the assessment years of the 2020 Review.

Accordingly, Victoria considers that the regional cost factor should not be applied to non-urban transport due to its immateriality.

11. Services to Industry

11.1 Business Development Expenses

Business development expenses are defined as state grants, subsidies or government services intended to assist or benefit businesses or industry.

In the 2015 Review the Commission assessed business development expenses EPC as population seemed to be the most appropriate driver. The wage cost disability was applied to business development expenses as was an administrative scale allowance in recognition of minimum fixed costs associated with this activity.

Victoria agrees with the Commission's staff proposal to continue to:

- assess business development expenses EPC;
- apply the wage costs disability to state business development expenses; and

- recognise that there are minimum fixed costs associated with the normal range of states' business development activities.

11.2 Estimating Business Development and Regulation Expenses

Conceptually, the drivers of business development and regulation are likely to differ. However, the current data collection system is not sufficiently granular to distinguish between these activities. The assessment paper discusses the Commission's attempts to obtain data from states and proposes further collection exercises.

Victoria agrees with the Commission's staff proposal to:

- use state data on business development expenses and GFS data to estimate business development and regulation expenses for agriculture and other industries;
- continue to assess agriculture and other industries regulation separately because the way States regulate these sectors is different, but only if a separate agriculture assessment remains material;
- send final data requests to the states in September 2018 to collect the final data for three financial years from 2015-16 to 2017-18; and
- retain the business development and regulation weights obtained from data for 2015-16 to 2017-18 for the period of the 2020 Review.

11.3 Weighting the Drivers of Regulation Expenses

For the past two reviews, data from the 2010 Review state collection has been used to assign weights to the different drivers of regulation expenses. This approach has required judgements about hundreds of individual line items in state budgets. The assessment paper proposes a simpler approach for the 2020 Review whereby the Commission use informed, high level judgement to determine the disability weights for regulation expenses.

Victoria agrees with the Commission's staff proposal to continue to differentially assess industry regulation expenses and to use information from state agencies to inform the decision on the relevant drivers of state spending on industry regulation.

Victoria agrees with the Commission's staff proposal to recommend not to use a regression approach to determine drivers and associated weights due to the nature of the available data and initial regression results lacking statistical significance.

11.4 Planning and Regulation for Major Infrastructure Projects

There is a conceptual case that states with high levels of private sector investment incur higher planning and regulation costs. The disability applied to this spending was based on state shares of private non-dwelling construction expenditure.

Victoria agrees with the Commission's staff proposal to:

- continue to assess planning and regulation expenses for major infrastructure projects in this category using state shares of private non-dwelling construction expenditure as the disability; and
- collect data from States to update the current spending estimate.

11.5 Other R&D expenses

Commission staff propose to continue to assess industry R&D expenses on an EPC basis. The assessment paper notes that the new classification of the functions of government – Australia (COFOG-A) classification identifies R&D spending within each 2-digit division (such as health and education). For simplicity reasons, the Commission is unlikely to remove the 3-digit R&D groups from each function of government division.

Victoria agrees with the Commission's staff proposal not to remove R&D expenses identified in the new COFOG-A classification from the relevant functions on simplicity grounds, unless it is material.

11.6 User Charges

The ABS identified \$1.6 billion in user charges to industry in 2015-16, including those relating to agriculture (\$659 million), mining (\$171 million) and labour and employment affairs (\$169 million). For the 2020 Review, Commission staff are proposing to net off all user charges except for agriculture so as to identify agricultural levies.

Victoria agrees with the Commission's staff proposal to:

- deduct all user charges from expenses because most relate to regulation activities and the same disabilities apply to expenses and revenue; and
- collect data on State agricultural levies to confirm they are not material.

11.7 Administrative Scale

This issue is covered in the administrative scale section.

12. Other Expenses

12.1 Natural Disaster Relief

Victoria notes ACT's observation that there are policy differences between States in relation to insurance and natural disaster mitigation measures. Victoria does not believe that the NDRRA Determination 2017¹⁸ includes sufficient safeguards to prevent significantly different insurance and mitigation measures between States.

In 2012, the Review of Insurance Arrangements¹⁹ found that both Victoria and ACT had the strongest arrangements; however, there is no mechanism to determine what constitutes sufficient as insurance arrangements are no longer reviewed by Emergency Management Australia.

VicRoads recently improved its insurance arrangements with the Victorian Managed Insurance Agency and now have an insurance deductible of \$500,000 per event (reduced

18 Attorney-General's Department, *Natural Disaster Relief and Recovery Arrangements, Determination 2017*.

19 Department of Finance and Deregulation, *Review of the Insurance Arrangements of State and Territory Governments under the Natural Disaster Relief and Recovery Arrangements Determination 2011*.

from \$3 million). This coverage also allows for some betterment of assets where there has been previous damage history.

The Productivity Commission Inquiry on natural disaster funding arrangements²⁰ found that some state governments were only self-insuring their assets and relying on the NDRRA to fund core response activities such as fire suppression. Victoria considers this to be inequitable as our response and mitigation activities include fire suppression and planned burning. The recent development of Floodzoom (a web-based tool to assist agencies' response for the September/October 2016 Floods and Storms) also assists to mitigate the impact of floods on communities, resulting in a reduction in the amount Victoria claims under the NDRRA.

Victoria disagrees with the Commission's staff proposal to assess natural disaster relief expenses on an APC basis and supports assessing these on an EPC basis.

Victoria supports the current EPC assessment of mitigation expenses.

Victoria agrees with the Commission's staff proposal to continue to make adjustments to the adjusted budget to ensure:

- natural disaster relief expenses under the NDRRA framework are only assessed once;
- net natural disaster relief expenses funded from local government revenue are not included in the assessment; and
- Commonwealth NDRRA assistance payments through States to local government are not included in category expenses.

12.2 Capital Grants to Local Government for Community Amenities

The assessment of capital grants to local governments recognises the impact of state population growth on the level of support for cultural and recreation facilities and community amenities. The draft assessment paper points out that grants are generally part of regional economic development programs and it is not apparent how states determine their level of support for these programs. The drivers of expenses for this category are therefore unclear.

Victoria agrees with the Commission's staff proposal to cease assessing the capital grants to local governments for community amenities component.

12.3 National Park and Wildlife Services

Expenses for national parks and wildlife services were approximately \$1 billion in 2016-17. The new COFOG-A classification will make it difficult for the Commission for this category as it will be combined with other environmental protection expenses.

Victoria agrees with the Commission's staff proposal not to assess national parks and wildlife services, due to uncertainties surrounding the policy influences and difficulty in obtaining reliable data to measure cost influences and expenses.

20 Productivity Commission, *Inquiry on Natural Disaster Funding Arrangements*, December 2014.

12.4 Cross-Border Expenses

For this Review, the Commission does not intend to take into account additional expenses that the ACT incur in providing library, sports ground and other cultural and recreational services to New South Wales residents.

Victoria agrees with the Commission's staff proposal to not assess a cross-border disability for library, sports grounds and other cultural and recreational services provided to New South Wales residents unless the ACT is able to provide current data to substantiate an assessment.

12.5 Other Issues Including Location

Victoria agrees with the Commission's staff proposal to include most state expenses which are assessed EPC in this category and to continue to apply location disabilities to the same expenses as the 2015 Review.

13. Physical and Financial Assets

13.1 Functionalising the Investment Assessment

Victoria has considered the arguments presented by Commission staff regarding assessing the investment needs for each component separately rather than as a composite for those components other than roads and urban transport. This would appear to provide a higher degree of transparency without an onerous increase in data requirements or introducing data quality concerns. Accordingly, Victoria supports the proposal to separately assess investment in all category and component service areas.

Victoria considers that the issue discussed in paragraphs 34 and 35 of the draft assessment paper is due to net investment expenses being assessed rather than to the use of a composite component.

13.2 Averaging Disabilities

The investment assessment uses a three year moving average of the stock disability factors so as to smooth out fluctuations. The rationale advanced for doing this in the 2015 Review was to reduce the volatility in the year to year changes in the disabilities and to recognise that states do not necessarily respond immediately to changing circumstances.

Commission staff are now reconsidering the value of averaging the stock disability factors. Table 13.1 presents a measure of volatility for the raw and moving average stock disability factors used for rural roads, urban roads, other services and urban transport. It can be seen that, generally apart from rural roads, the moving average stock disability factors is less volatile than the raw factors. However, both exhibit relatively low volatility, and the gains from using a three year moving average may not outweigh the disadvantages identified by Commission staff.

Table 13.1: Standard deviation relative to mean for stock factors, 2012–13 to 2016–17 (per cent)

Component	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Raw factor								
Rural roads	0.27	0.68	0.07	0.52	0.75	1.33	0.51	1.32
Urban roads	0.18	0.16	0.15	0.02	0.18	0.28	0.28	0.85
Other services	0.12	0.12	0.08	0.11	0.30	0.44	0.28	1.71
Urban transport	0.17	0.24	0.27	0.57	0.87	0.35	0.49	0.44
Moving average factor								
Rural roads	0.42	0.39	0.14	0.41	0.80	1.46	0.14	0.88
Urban roads	0.13	0.13	0.09	0.04	0.14	0.16	0.25	0.58
Other services	0.08	0.06	0.05	0.07	0.24	0.19	0.14	1.48
Urban transport	0.21	0.19	0.26	0.33	0.83	0.36	0.44	0.22

Source: CGC 2018 Update.

Where volatility does exist is in investment expenditure, both for the individual components and in total, as illustrated in Table 13.2 for the years of the 2018 Update. Averaging stock disability factors will have no impact on the extent of the volatility in expenditure. It is doubtful that averaging the stock disability factors would greatly improve HFE.

Table 13.2: Annual growth in net investment expenditure by component (per cent)

Year	Roads	Other services	Urban transport	Land and other	Total investment
2014–15	-37.4	-44.7	-43.9	144.5	-35.8
2015–16	31.3	-95.0	40.8	67.6	23.7
2016–17	9.2	5,842.9	108.1	-74.4	71.1

Source: CGC 2018 Update.

Victoria supports the proposal by Commission staff not to continue the three year averaging of the capital stock disabilities.

13.3 Capturing Changes in State Circumstances

This section of the draft assessment paper presents an argument for a separate disability factor to capture ‘changes in circumstances’. The main reason advanced is that the variation over time in a state’s capital needs may reflect factors such as data improvements rather than changes in underlying capital needs. However, the section contains much speculation and little in the way of hard analysis of the data.

It is not clear how the figures were derived for the example of the capital needs of Indigenous students in the Northern Territory. However, the 2018 Update shows that for the Northern Territory its need for schools education capital, before the application of the SDS factor (it is not apparent why a cost factor should be applied to a capital needs factor) was 34 per cent above average for 2013–14, falling to 32 per cent in 2015–16 and then rising to 34 per cent above average in 2016–17. The application of the SDS factor causes more volatility in the capital stock factor.

It is claimed that changes in circumstances, such as student to population ratios, should not have an impact on capital needs for Schools education. However, it is not clear that the student to population ratio does have an impact on assessed capital stock needs. Consider the assessed opening capital stock needs for a particular state for Schools education. For simplicity only the current, rather than the three-year average, capital stock factor is used.

$$K_i^A = \frac{K}{P} \times \frac{S_i^W}{S^W} \times \frac{P}{P_i} \times P_i \times \alpha_i \quad [1]$$

Where: K is the capital stock;

P is population;

S is students enrolled;

α are the other components of the assessment (SDS factor, administrative scale factor and cost factor);

the superscript A denotes assessed;

the superscript W denotes weighted; and

the subscript i denotes state.

Equation [1] can be reduced as follows:

$$K_i^A = \frac{S_i^W}{S^W} \times K \times \alpha_i \quad [2]$$

It can be seen from equation [2] that (weighted) student to population ratios have no impact on the assessed capital stock for a state. The relevant factor is a state's share of weighted enrolments, which reflects its need for capital based on recurrent needs. It is unclear how a state's circumstances come into consideration, unless it is through the SDS factor or administrative scale factor.

It may be the case that Victoria has misconstrued the argument that is being put in this section, but to a certain extent that reflects the limited information presented to develop the case being presented.

13.4 Category Specific Measures of Growth

The 2015 Review stated that investment assessment estimates the amount extra infrastructure each state needs to acquire to ensure it finishes the year with the per capita stock of infrastructure needed to provide the average services given its circumstances. The assessment assumes that, if states were alike, they would need the average per capita stock of infrastructure if they were to provide the average level of services under average service delivery policies.

The implication in the staff assessment paper is that states are not alike in the sense that population is an appropriate indicator of investment needs. The equation for assessed net investment presented on p.2 of the paper indicates that a state with a higher share of the national population at the end of the year than at the start will be assessed as requiring more net investment than a state with a constant or falling share of the national population.

However, as equation [2] above shows, where a capital stock factor is derived, in part, by each state's share of an indicator of recurrent need relative to its population share,

population falls out of the assessment. For Schools education a faster growing population will only have an impact on investment needs if that faster growing population translates into a faster growing share of the weighted student enrolments.

In the case of Victoria its population grew between 2015–16 and 2016–17 by 0.21 percentage points, the highest growth of any state. However, its share of the weighted student enrolment grew by only 0.16 percentage points. This resulted in its investment needs (before applying the SDS and administrative scale factors) falling from 92.6 per cent of the national average in 2015–16 to 92.5 per cent in 2016–17.

The material provided by Commission staff to the OWP concedes the point that there would be no change to the current method, but states that the move to a user population is required for the proposal to have the disability component of the opening capital stock factor being the same as that for the closing stock factor.

It is claimed that freezing disabilities will remove volatile and unreliable estimates of change in relatively stable circumstances. However, no information has been provided to support this assertion. It could be regarded that the end of period capital stock factors based on recurrent cost capture financial flows across the financial year and are appropriate to use for both the opening and closing capital stocks.

Victoria considers that more detail needs to be provided on this issue before it can be in a position to express an opinion of the proposals.

13.5 Private Provision of Assets

Some state infrastructure, predominantly but not exclusively, roads are provided by the private sector under public-private partnerships (PPPs). Some infrastructure is directly funded by users, such as toll roads, while other is funded by payments by the state for the use of the infrastructure.

PPPs are used to provide value for money outcomes through private sector design and service delivery innovation. Private finance through PPP projects is not considered an additional funding source for infrastructure projects. Most PPPs are financed by the private sector. Government funding is through availability payments, which are recognised as a finance lease in the governments accounts.

There are a number of factors leading to the public provision of infrastructure through toll roads. The costs of congestion have to be sufficiently high to motorists for them to be willing to pay a toll for road usage. This situation is only likely to be the case in the major capital cities. Another factor is the capacity for governments to fund this infrastructure given the needs for other infrastructure and borrowing constraints.

As noted in the draft assessment paper, the absence of privately provided infrastructure in the smaller states may be a reflection of a lack of need for such infrastructure. Victoria is willing to provide further information if requested by Commission staff, but its current position is that the private provision of infrastructure should not be a factor considered in the assessment of infrastructure needs.

13.6 New and Old Assets

Victoria has examined the discussion in the staff draft assessment paper and agrees that it would be difficult to quantify the impact of the age of the asset stock on the expense needs to acquire additional assets.

13.7 Under-Utilisation of New Assets

Certain types of infrastructure, such as roads, are typically built to accommodate future needs due to the additional cost of expanding insufficient capacity in the future. However, experience has shown that future growth can be higher than anticipated. Other types of infrastructure are built to meet current demands, which can result in the infrastructure coming under stress when demand grows in the future.

States face a trade-off of spending more on current infrastructure to accommodate future needs and the availability of funding for infrastructure.

To include the utilisation of assets as a disability, a measure of capacity utilisation would be required for each component of infrastructure and a relationship with investment expenses developed. If states considered that this disability should be investigated then they would have to assist Commission staff with the provision of relevant data and the development of the conceptual case.

Given the fluctuation on investment expenditure from year to year, the current investment assessment aims to provide sufficient funding over a period of time for states to meet their infrastructure needs.

Victoria is not convinced at this stage that this particular disability should be pursued in the current review.

13.8 Treatment of Land

Victoria agrees with Commission staff that the urban roads disabilities do not reflect the higher costs for large urban areas. However, urban land costs affect more than just roads infrastructure. In cities with rapidly growing population, such as Melbourne, land costs become significant for infrastructure, for both brownfield and greenfield projects. Examples of rising land costs in the outer areas of Melbourne were presented to Commissioners during their visit to Victoria.

Victoria is willing to work with Commission staff in the consideration of including the cost of land in the infrastructure assessment.

Victoria supports the EPC assessment of land in the other investment components.

13.9 Net vs Gross Investment

In the equations presented at the top of p. 23 the delta terms would be the same in the investment and depreciation equations if the assessment was done on an expense category basis. However, under the current assessment the investment delta terms are investment share weighed sums of the category stock factors and the depreciation delta terms are depreciation share weighted.

In paragraph 87 it is stated that gross and net assessment produce similar outcomes. Victoria undertook some calculations which showed that the differences between the current sum of assessed net investment and depreciation for other services and the assessed gross investment would be material (for the Northern Territory) for the assessment years of the 2018 Update. It would be useful if Commission staff could present the materiality outcomes for all the components of investment.

It is unclear whether a gross investment assessment would improve transparency as the depreciation assessment would no longer be separately presented. It would not be removing moving parts, only changing where they are used. Arguably the number of moving parts would be increased with the addition of a further depreciation term—the third term in equation (1).

As depreciation is currently determined and presented separately from the category expenses this would not necessarily create a difficulty for the presentation of assessed recurrent expenses. Depreciation could be regarded as a notional expense that represents the consumption of capital. Subsuming depreciation in a gross investment assessment would be consistent with that concept of depreciation.

Victoria can see the advantage of the proposed gross investment assessment as the current investment assessment based on the net acquisition of non-financial assets gives rise to negative amounts of investment for some components in some years and net investment tends to fluctuate more than gross investment.

However, if there are material differences between the gross investment assessment and the current net investment and depreciation assessments then the cause of these differences need to be understood. A decision would need to be made as to which assessment would give the better HFE outcome.

13.10 Recurrent vs Capital Disabilities

In the 2015 Review the investment assessment assumed that factors affecting the quantity of services States provide also affect infrastructure needs. If a state needs to provide a ten per cent above average quantity of services per capita then it is also likely to need ten per cent above average infrastructure. It is also assumed that changes in infrastructure needs are proportional to changes in service use.

Victoria has no objection to Commission staff investigating the possibility of capital specific disabilities, although the nature of these disabilities is unclear at this stage.

13.11 Net Borrowing

The net borrowing assessment could be regarded as being analogous to the investment assessment, with the stock variable being financial assets rather than non-financial assets and there being no stock disabilities.

However, net borrowing can also be regarded as a residual after all sources of revenue have been applied to recurrent expenses and net acquisition of non-financial assets. States with higher needs for infrastructure investment will tend to apply their net operating balance to the net acquisition of non-financial assets rather than to debt reduction.

States also have targets for net debt as a proportion of GSP which can operate as constraint on the value of net acquisition of non-financial assets in a year or over a period of years.

The current assessment methodology gives the states with relatively higher population growth relatively more GST through the investment assessment, but relatively less GST through the net lending assessment. It is not apparent that this is a desirable outcome. It might be more appropriate to assess net borrowing on an EPC basis. An EPC assessment would be appropriate if there are no material disabilities between the states and any differences reflect differences in State policies.

13.12 Cost Factors

Victoria acknowledges that the 2015 Review undertook significant work in developing a construction cost index to measure capital costs. This index was a combination of capital cost disabilities, interstate wages costs and regional costs.

Victoria considers that it would be worthwhile to devote some effort in refining the regional cost factors to ensure that the costs relevant to infrastructure provision are being captured.

Victoria considers that Commission staff need to consider the adequacy of the Rawlinsons construction cost index in light of the issues raised during the Commission's visit to Victoria. The Commission's attention was drawn to the additional costs involved with working on brownfield sites. For example, site contamination can be a significant issue, increasing costs for environmental clean-up. There are also higher costs associated with latent conditions, such as old foundations, interface issues with other infrastructure and difficult geotechnical conditions in the Melbourne CBD. Brownfields development increasingly involve below ground or vertical builds.

The capital cost factor for urban transport could be developed to take into account that the different forms of urban transport (heavy rail, light rail and other) have different cost implications. It is considered that states with a large urban rail network will require more funds for investment than other states due to the relatively higher cost of rail investment.

Victoria is currently collecting data on the costs of brownfield construction projects to provide information for Commission staff to consider in deriving cost factors.

13.13 Other Issues

The capital stock factors are probably the least well understood component of the assessment methodology and the Commission has not devoted much discussion toward the conceptual case for their derivation. There are a number of aspects regarding the derivation of the capital stock factors that could be better explained by the Commission.

For instance, the capital stock factors for each expense category contain a component related to administrative scale. There has been no explanation of the reason for the inclusion of these costs in assessing capital stock needs. It may be the case that the Commission considers that states may need a minimum amount of capital stock to deliver services. However, the determination of administrative scale is based on recurrent costs and it is not readily apparent how these costs would translate into infrastructure costs.

Another aspect is the implicit assumption that increases in resources required for service delivery translate directly into increases in infrastructure. For instance, while

disadvantaged Indigenous school students may require more teaching resources it does not necessarily follow that these resources require additional infrastructure.

Some capital stack factors also have a SDS factor applied to them (for instance, Schools education and Justice). It is not clear that factors relating to the cost of service delivery should be included in a measure of infrastructure needs when there is a separate capital costs factor. While it might be the case that the cost of providing infrastructure does increase with the remoteness of where the infrastructure is located, it needs to be demonstrated that cost weightings derived from service provision are appropriate for infrastructure.

13.14 Way Forward

Commission staff have proposed a number of revisions to the methodology used to assess the needs for physical and financial assets. While some additional information has been provided through the officers working party, these proposals have not been sufficiently well developed for Victoria to have an unequivocal opinion on them. Victoria encourages Commission staff to continue to develop and refine their proposals so that states can be in a better position to have informed views on the proposals.

14. Geography Used by the Commission

14.1 Regional Costs and Service Delivery Scale

14.1.1 Regional costs

The conceptual case for assessing regional costs is considered to be well developed. However, Victoria has concerns about its application, which are discussed below.

As the staff draft assessment notes, there are two aspects associated with different regions—differences in the usage of services and differences in the cost of delivering services. These are claimed to be related concepts, but the evidence presented is considered to be weak in regard to the use of services aspect.

The major concern that Victoria has regarding the regional costs assessment, other than the determination of the regional cost gradient (discussed later) is the application of the regional cost gradient in the determination of regional cost factors. The separation between use and cost is not recognised, that is, the implicit assumption made in the assessments is that services are provided in the same ARIA region as where the users of these services reside.

This correspondence of location of user and service provision may be appropriate for school education and police where schools and police station are numerous and widespread. Such a consideration might be thought to apply to health services, but a person from a remote location with a complex health issue is likely to receive treatment from a health service in an inner regional or major city location.

In order to explore this issue of location of user and the location of service provision, Victoria obtained information from its court services which enabled the correspondence

between the region of user and the region of service provision to be examined. These data are presented in Table 14.1.

This table indicates that for defendants who live in major cities, inner regional areas and remote areas, the majority, or close to a majority, attend a court located in a major city. For defendants living in an outer regional area the majority attend a court located in a less remote area. Victoria acknowledges that its data are limited as it does not have any very remote areas, but the indications are that the current regional cost factors overstate the disability associated with the more remote locations.

Table 14.1: Remoteness distribution of Victorian lower courts defendant by court remoteness, 2014–15 (per cent)

Residence of Defendants ^a	Court location				
	Major cities	Inner regional	Outer regional	Remote	Very remote
Major cities	95.8	3.6	0.6	0.0	0.0
Inner regional	48.2	47.7	4.0	0.0	0.0
Outer regional	16.2	36.1	46.6	1.2	0.0
Remote	66.5	15.1	17.4	1.1	0.0
Very remote	0.0	0.0	0.0	0.0	0.0

^a This table only includes Victorian resident defendants and excludes interstate resident defendants.

Source: Court Services Victoria.

The disparity between location of residence and location of service delivery is likely to be more marked for another component of justice services—corrective services. The Victorian data on prisoners and people on community orders are presented in Table 14.2. The service delivery location refers to the location of the prison or Corrections Victoria office supervising community orders.

Table 14.2: Remoteness distribution of Victorian corrective services clients by service delivery remoteness, 2014–15 (per cent)

Residence of clients ^a	Service delivery location				
	Major cities	Inner regional	Outer regional	Remote	Very remote
Major cities	91.6	8.2	0.3	0.0	0.0
Inner regional	25.6	55.0	19.4	0.0	0.0
Outer regional	14.2	23.6	62.2	0.0	0.0
Remote	11.1	27.8	61.1	0.0	0.0
Very remote	0.0	0.0	0.0	0.0	0.0

^a This table only includes Victorians in prisons and on community orders and excludes interstate residents.

Source: Corrections Victoria.

The issue of the disparity between location of residence and location of service delivery needs to be explored other expense categories to determine the extent and whether the impact on regional cost factors is material.

14.1.2 Service delivery scale

As was the case for regional costs, the conceptual case for assessing SDS is considered to be well developed. The staff draft assessment paper does not discuss the definition used to determine SDS areas. The 2010 Review defined SDS areas to be more than 50 km from a town of 5 000 people and this definition was retained in the 2015 Review.

In some of the preliminary work undertaken for the 2015 Review the R² statistic from regressions based on ACARA data were used to analyse the impact of varying the distance from a town of 5,000 people. Advice on this analysis was sought from the Commission's econometric consultant. The consultant's response was "This method is not appropriate. There is no appropriate technique for this purpose as it is a conceptual, rather than data, question"²¹ While the consultant was correct in his assessment of the appropriateness of the use of the R² statistic, there are other empirical techniques which could have been applied to examine various distances a school is from a town of a specified size. There is scope for Commission staff to re-examine the definition of SDS areas. However, for reasons discussed below Victoria considers that the SDS assessment is problematic and may not be worth devoting resources to it.

A major concern of Victoria is that the assessment of regional costs and SDS does not recognise that the geographic classifications of remoteness and SDS are not mutually exclusive.

As Table 14.3 illustrates, that for government schools there is an overlap between the remoteness areas and SDS areas for remoteness areas other than major cities. Similar outcomes can be found in the location of police stations in Table 14.4. This overlap between regional areas and SDS areas will result in the regional cost gradient including the impact of SDS costs. To avoid the double counting of SDS the costs due to SDS need to be deducted from the costs base for the determination of the regional costs gradient for the relevant remoteness areas.

Table 14.3: Distribution of government schools by remoteness and SDS classification, 2015 (per cent)

Remoteness areas	Students		Schools	
	Non-service delivery scale	Service delivery scale	Non-service delivery scale	Service delivery scale
Major cities	100.0	0.0	100.0	0.0
Inner regional	97.6	2.4	96.3	3.7
Outer regional	69.6	30.4	54.9	45.1
Remote	34.4	65.6	18.9	81.1
Very remote	5.5	94.4	3.0	97.0

Source: ACARA 2015 My Schools data 'cleaned' for the Commission's regression model.

The issue arises as to whether a separate SDS assessment is material given that currently costs due to SDS are implicitly included in the regional costs gradients.

21 Commonwealth Grants Commission, *Report on econometric work conducted by CGC*.

Table 14.4: Police stations by remoteness and SDS classification (per cent)

Remoteness classification	Non-SDS areas	SDS areas
Major cities	100.0	0.0
Inner regional	95.5	4.5
Outer regional	47.0	53.0
Remote	12.5	87.5
Very remote	1.9	98.1

Source: Based on post codes of police stations in each state.

The issue arises as to whether a separate SDS assessment is material given that currently costs due to SDS are implicitly included in the regional costs gradients. For the 2018 Update, the SDS was immaterial for the services to communities assessment and for the other assessments that included SDS it was only material for the Northern Territory.

Victoria also has concerns regarding the calculation of the SDS for schools education. The 2015 Review stated that the ‘... ACARA regression showed that in addition to an average cost of \$7,941 per student... there was a fixed cost of \$186,734 per year per government school’²². Apportioning these fixed costs to the students according to SDS area resulted in the average cost per student in an SDS area to be 11 per cent higher than in non-SDS areas.

Victoria is concerned about the interpretation of the ACARA regression results. The value of 186,734 represents the coefficient on the inverse of school size. School size is based on student numbers and does not include staff numbers, so that the value of the variable represents a scale effect rather than a fixed cost per school.

It would be expected that if schools in SDS areas are smaller on average than schools in non-SDS areas then, based on the regression results, their costs per student would be higher. However, this higher cost would be reflective of scale only and would not incorporate directly the impact of factors directly related to SDS, such as higher staff to student ratios. This is because a school of a given size would have the same cost per student regardless of whether it was in a SDS area or not.

Victoria considers that as the ACARA data can identify those schools that are in SDS areas that it would be preferable to directly estimate the impact of SDS through the regression model by including a dummy variable for SDS areas. This variable should estimate the addition cost per student for schools located in SDS areas.

Victoria considers that including the SDS variable in the equation is the more appropriate way of incorporating the impact of SDS than the current method which does not adequately capture the impact of influences associated with SDS and results in the double counting of SDS costs.

The models based on the OWP specification including the SDS dummy are presented in Table 14.5 for government schools and non-government schools as estimated by DTF using 2014 ACARA data. The extended model estimates that for government schools the additional costs per student by remoteness classification are less than when the SDS

22 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities: 2015 Review, Volume 2—Assessment of State Fiscal Capacities*, p. 499.

dummy is not included (refer to Table 2.1), but estimates that there is a significant additional cost per student for schools in SDS areas.

The impact for non-government schools is somewhat different. The coefficients on the remoteness variables (other than inner regional) are higher, but generally still not statistically significant. However, costs are reduced for schools in SDS areas.

Table 14.5: Regression model for government schools, 2014 ACARA data

Variable	Government schools		Non-government schools	
	Coefficient	t-value	Coefficient	t-value
Intercept	7,417	83.4	1,927	72.9
Inverse school size	180,722	74.8	19,785	7.4
Indigenous proportion	3,878	9.5	337	1.6
Students in most disadvantaged 25%	3,876	14.4	1,981	12.5
Inner regional	-618	5.5	59	1.5
Outer regional	686	4.4	88	1.6
Remote	4,802	15.9	498	4.0
Very Remote	2,995	8.0	354	1.9
SDS	1,315	7.3	-202	2.4
Adjusted R ²	0.64		0.25	

Victoria considers that including the SDS variable in the regression equation is the more appropriate way of incorporating the impact of SDS than the current method which does not adequately capture the impact of influences associated with SDS and results in the double counting of SDS costs.

14.2 Geography for the Regional Costs Assessment

Victoria has noted the analysis undertaken by Commission staff in regard to using the Modified Monash Model (MMM) regional classification as an alternative to the ARIA classification. On the basis of this analysis, Victoria supports the Commission staff proposal that the Commission continue to use the ARIA regional classification.

14.3 Broadening the Evidence Base on Regional Costs

14.3.1 Overview

Victoria supports the Commission staff determining regional cost gradients for the expenses categories for which regional costs are applied. There are a number of concerns regarding the current application of the general cost gradient.

The general cost gradient calculated as the average of the schools and police gradients. While averaging the two regional cost gradients may appear to be appealing, each is calculated on a different basis. The schools regional cost gradient measures the increase in costs per student with increasing remoteness, while the police regional cost gradient measures the increase in costs per staff. It is not clear that an average of these two differently based measures makes conceptual sense.

The result from the determination of a cost gradient for post-secondary education shows that the general cost gradient did not provide a close approximation of the actual cost

gradient. However, it is recognised that the difference in the amounts redistributed from the post-secondary specific and general cost gradients were immaterial. This is may not necessarily be the case for other expense categories.

14.3.2 Post-secondary education

The determination and application of the post-secondary education specific regional cost gradient has been discussed in the chapter on post-secondary education. As noted by Commission staff the regional subsidies provided by staff may reflect more than just cost factors. Unless it is possible to determine and quantify these other influences the national average cost loadings can be regarded as representing what states do average.

14.3.3 Hospitals

Cost loadings for admitted patients are presented for both patient residence and hospital location. Commission staff state that it is not clear whether a patient address or hospital location loading is the appropriate indicator of regional costs.

Victoria considers that it is clear that the hospital location is the appropriate indicator of the regional costs associated with service delivery. The SDC used to assess health expenses takes into account the location of the patient. The conceptual case for regional costs is focussed on the costs involved in delivering services in different locations. This indicates that the location of the hospital should be used to determine regional costs.

If regional costs were to be based on patient residence then location should be removed from the determination of the SDC assessment.

14.3.4 Police

Victoria is interested to see the outcome from the new approach that Commission staff are proposing. Data from Victoria Police indicate that it may be difficult to determine a regional cost gradient consistent with the conceptual case in the situation where a number of resources are centrally located and deployed across the state as required.

Victoria considers that service delivery for courts and corrective services is sufficiently different to policing services, and from each other, to warrant separate cost gradients.

14.3.5 Potential for simplification

While Victoria supports the Commission staff proposal to develop a regional cost assessment using data from schools, police, post-secondary education and hospitals, as indicated above Victoria considers that regional cost gradients should be expense category specific.

The assessments that the Commission applies should be material, so if there were to be immaterial assessments between certain cost gradients then Victoria would support the staff proposal to use a common cost gradient for those particular assessments.

14.4 Extrapolation

Victoria, as outlined above, supports the proposal by Commission staff to request data from states that would enable expense category specific regional cost gradient to be

estimated. It is unclear how data would be used to test the validity of an extrapolated regional cost gradient without providing a specific regional cost gradient.

Victoria would be reluctant to support the Commission staff proposed use of an extrapolated regional cost gradient for those services where a conceptual case has been developed. It would appear that where little direct evidence exists the Commission's supporting principles, particularly practicality, would preclude an assessment regardless of the strength of the conceptual case. In such a situation the Commission could not be confident that making an assessment would improve HFE.

14.5 Measure of Indigenous Socio-Economic Disadvantage

Victoria notes that another measure of Indigenous socio-economic disadvantage, IRSEO+ is being developed. Victoria supports Commission staff investigating IRSEO+ to determine whether it is a better measure of Indigenous socio-economic disadvantage than IRSEO.

14.6 Other Issues Considered and Settled

14.6.1 Service delivery scale

Victoria has outline above its concerns regarding the application of a SDC assessment in conjunction with a regional cost assessment and the derivation of the school education SDS assessment.

The need for a separate SDS assessment needs to be carefully considered. Victoria doubts that this assessment, if properly applied would be material.

14.6.2 SEIFA and NISEIFA

Victoria supports the Commission staff proposal to continue to use SEIFA and NISEIFA for the total and non-Indigenous populations, respectively.

14.6.3 Interstate non-wage costs

Victoria is not fully convinced of the conceptual case for interstate non-wage costs. However, if the Commission were to retain this assessment its determination would have to be rigorously undertaken. Victoria has doubts about the validity of using the regional cost gradient for this purpose.

15. Wage Costs

15.1 Background

In the 2015 Review, the Commission committed to a comprehensive review of the wage costs assessment. It subsequently provided a work program for this review:

- the distribution of a staff discussion paper on the wage costs assessment;
- the receipt of state submissions in response to this paper;
- new data received and results of model presented;

- presentation of consultant's findings at the Labour Market Research Workshop;
- the receipt of final state submissions; and
- the Commission decision regarding the assessment methodology announced in the 2016 Update report.

For a variety of reasons there were several unanticipated delays beyond the Commission's control so that there was insufficient time for the Commission to consider any major revisions to the wage costs assessment methodology. The Commission stated that the methods used in this assessment were to be reviewed in consultation with States once the ABS Characteristics of Employees survey data become available. In the 2016 Update the Commission essentially left the methodology unchanged and did not accept the arguments made by the states.

15.2 Summary of Required Changes to the Methodology

As a result of comments on the Commission's current methodology the states and of the findings of the consultants engaged by the Commission there are a number of issues which have to be addressed in revising the wage costs assessment methodology:

- national market factors for public sector workers;
- institutional factors in public sector wage setting;
- appropriate treatment of public sector wages outside of major cities;
- appropriate specification of the wages regression model; and
- appropriate interpretation of regression model results.

15.3 The Need to Revise the Methodology

The Commission engaged consultants to examine the determination of private and public sector wages. The consultants made a number of findings that have implications for the current wage assessment methodology:

- there is evidence of a national market for public sector workers;
- state wage setting mechanisms respond to theoretical pressures, but with a lag; and
- average wages are higher in major cities than elsewhere, in both the private and public sectors.

It is clear that the Commission's current methodology for the wage costs assessment needs to be revised. The premise that state-specific factors in the determination of private sector are the sole cause of wage pressures beyond the control of states can no longer be sustained if a national market for public sector workers exists.

However, the estimates of the consultants were obtained for a dataset, HILDA, that differs to the Compensation of Employees (CoE) survey that the Commission will be using for the wage cost assessment. As well as differences in explanatory variables the consultants used a combined time series and cross section data. The findings of the consultants need to be confirmed with the CoE data to ensure that they are contemporaneous and can be applied to the Commission's assessment methodology.

15.4 The Need to Revise the Model

The current econometric model used by the Commission contains a large number of explanatory variables. At this stage it is open as to the model that will be required, but consideration should be given as to its specification and the explanatory variables chosen.

Although information on education was not available from the 2014 CoE survey due to processing error, it will be available for later surveys. The Commission's consultants did not include occupation in their preferred model as they considered that qualification and occupation are correlated and so the independent effects of each are difficult to identify. They also considered that there is no theoretical reason why a given level of qualification should be differently rewarded in different occupations. Given that qualification and occupation were specified at a highly aggregated level, the consultants may be overstating their case.

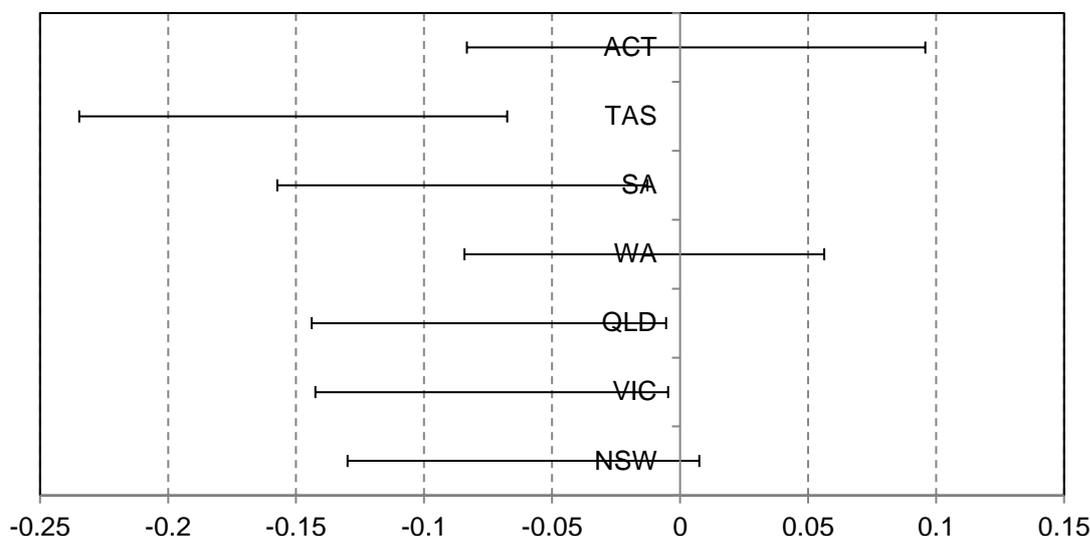
However, the Commission used occupation at the 3-digit level in its model for the 2016 Update, along with industry at the 3-digit level. Introducing educational level variables will lead to a large number of explanatory variables. While it may appear that the explanatory power of the model has improved it may produce a number of statistically insignificant parameter estimates. It would be preferable if the Commission undertook statistical tests to see whether groups of variables actually make a statistically significant contribution to the model.

The Commission's model, with such a large number of explanatory variables, risks falling into the category of 'kitchen sink econometrics'. While on the surface including every variable that seems relevant should overcome omitted variable bias, it can create a bias of its own due to the correlation between the explanatory variables. While a regression with many explanatory variables may result in a higher R^2 than one with fewer explanatory variables, the true model may be the one with the fewer explanatory variables. An F test should be used to determine which variables or groups of variables should remain in the regression model.

15.5 Interpretation of the Model Results

Victoria considers that a more extensive analysis of the results from the wages models should be undertaken before they are translated into interstate wages factors. As Figure 15.1 indicates for the CoE data used for the 2018 Update, the 95 per cent confidence intervals for the state dummy variables overlap.

Figure 15.1: 95 per cent confident intervals for CoE private sector wage equation



Source: Commonwealth Grants Commission.

There appear to be two findings that can be made on the basis of the results from the current wages model:

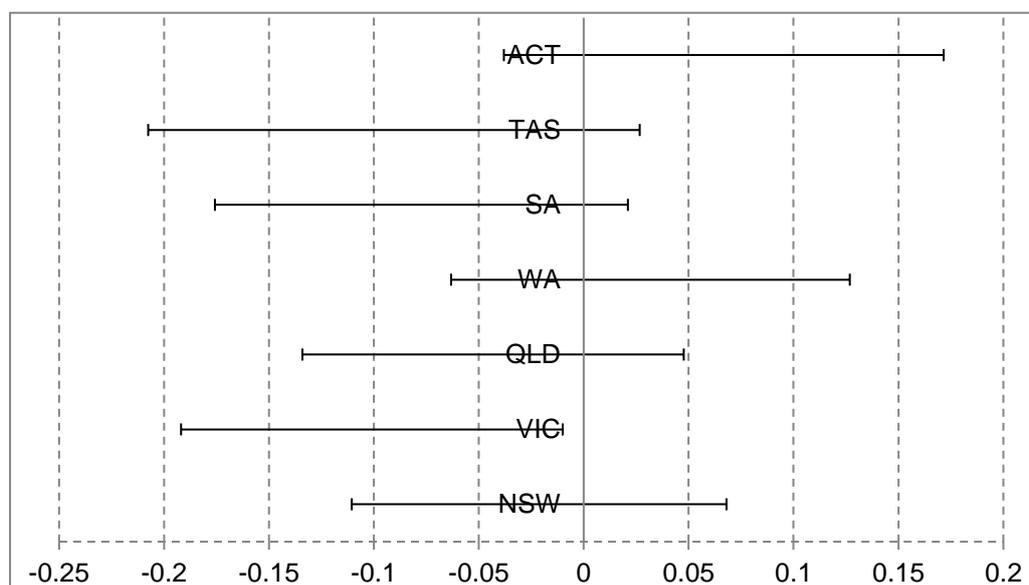
- there is no statistical difference between the private sector wages paid in Western Australia, the ACT and the Northern Territory for workers with the same characteristics; and
- the states that pay differential private sector wages (compared with the Northern Territory) for workers with similar characteristics, do not pay significantly different wages between them.

Therefore, in regard to private sector wages, states can be grouped in two ways. The first grouping is Western Australia, the ACT and the Northern Territory which have no significant difference in wage pressure between them. The second grouping is all the states except the Northern Territory which have no significant difference in wage pressure between them. The underlying causes of these outcomes need to be examined and the corresponding implications for the current methodology need to be explored.

Figure 15.2 illustrates that for public sector wages (based on the regressions for the 2017 Update and the public sector regression results were not provided for the 2018 Update) when the 95 per cent confidence intervals for the state dummies are considered, there is no statistical difference in the coefficients for any of the states other than the Northern Territory. This outcome in accordance with the findings of the Commission's consultants that the Northern Territory be treated as a special case²³.

23 Kostas Mavromaras, Stephane Mahuteau, Sue Richardson and Rong Zhu, *Public-private sector wage differentials in Australia: What are the differences by State and how do they impact GST redistribution decisions*, National Institute of Labour Studies, 2015.

Figure 15.2: 95 per cent confident intervals for CoE public sector wage equation



Source: Commonwealth Grants Commission.

The inference that can be drawn is average state policy is not to pay differential wages in the public sector for workers with similar characteristics. One of the Commission’s guiding principles is that equalisation should reflect ‘what states collectively do’²⁴. The evidence from the regression results is that states collectively do not pay differential wages for similar workers in response to community wage pressures. If equalisation implies a state should pay differential wages based on private sector wage differentials then effectively an external standard is being applied. While the Commission will consider the use of an external standard when there is extreme policy non-neutrality, it is not apparent that any non-neutrality in regard to public sector wages is ‘extreme’²⁵.

Victoria considers that the Commission needs to apply a more extensive analysis of the regression results from the wages models to demonstrate that the current interstate wages assessment remains justified. The special situation of the Northern Territory could be addressed by other means.

15.6 Conclusion

On the basis of the arguments presented above, Victoria does not support the proposal by Commission staff that the Commission retains its current approach to estimating differences in interstate wage costs.

24 Commonwealth Grants Commission, *The Principle of HFE and its Implementation*, Commission Position Paper CGC 2017-21, p. 14.

25 Commonwealth Grants Commission, *op cit*, p. 15.

16. Administrative Scale

16.1 The Conceptual Case for Administrative Scale and its Definition

The administrative scale disability recognises the costs incurred in delivering services which are independent of the size of the service populations. In the 2015 Review, the Commission deemed that the appropriate treatment was an equal per state assessment, which implies a greater per capita cost for the smaller states.

Victoria agrees with the Commission's staff proposal to retain the 2015 Review definition of administrative costs.

16.2 Re-estimating the Administrative Scale Costs

In its response to the Commission's Staff Research paper on Administrative Scale, Victoria stated that it should be a priority to update the administrative scale assessment for the 2020 Review. Victoria has assisted the Commission by providing data to enable the assessment to be re-estimated.

Victoria also considers that a separate assessment should be made for each primary department's administrative scale, rather than using a few key department's data to approximate other functions of government. It is not obvious that the minimum functions required in Education and Health are appropriate approximations of other agencies.

Victoria agrees with the Commission's staff proposal to re-estimate administrative scale expenses for each expense category using the bottom-up and top-down approaches outlined in the assessment paper.

16.3 Adjustments for the Northern Territory and the ACT

Victoria agrees with the Commission's staff proposal to continue to adjust the ACT's scale expenses to reflect its minimal spending in certain categories and to decide whether to retain the NT adjustments following examination of evidence about dual service delivery models.

16.4 Wage Cost Adjustment

In its response to the Commission's Staff Research paper on Administrative Scale, Victoria indicated that the proportion of administrative scale expenses to which wage costs factor applies (currently 80 per cent) should be reviewed.

The Commission has subsequently indicated that it intends to review the preliminary estimate by collecting state data on labour and non-labour costs for head office and whole of state agencies.

Victoria agrees with the Commission's staff proposal to re-estimate the proportion of administrative scale expenses to which the wage costs factor should apply through the collection of state data for all the Commission's categories.

16.5 Other Issues

Victoria agrees with the Commission's staff proposal to keep the expenses up-to-date following the 2020 Review by indexing them using the ABS state and local government final consumption expenditure deflator.

Victoria is in favour of the status quo by keeping all administrative scale expenses in the "Other expenses" category.

In Table E-2 it should be noted that energy should be included as a function of the Department of Environment, Land, Water and Planning (DELWP). DELWP works with the renewable energy industry, electricity networks and retailers, and consumer groups to attract and facilitate investment in renewable energy, support the development of low emission technologies and provide energy services to consumers at least cost. It provides policy advice to government on the delivery of reliable, sustainable and affordable energy services to households and business consumers.

17. Other Disabilities

17.1 Cross-border

Cross-border costs are incurred when residents of one state use the services provided by another. In the 2015 Review, the Commission determined that needs should be assessed only for the ACT and New South Wales as there was no evidence that cross-border use between other states was material.

The focus of the assessment paper is on cross-border flows between the ACT and New South Wales.

Victoria agrees with the Commission's staff proposal to:

- retain the 2015 Review approaches to cross-border disabilities for schools, post-secondary education, roads and hospitals;
- retain a cross-border assessment for community health expenses;
- collect updated evidence on cross-border use of ACT community health services by residents from NSW and the use of NSW community health services by ACT residents; and
- not apply a cross-border factor to residual state disability expenses, other general welfare expenses and recreation and culture expenses, unless ACT provides evidence of significant cross-border use and that use leads to identifiable costs for the ACT

17.2 National capital allowances

National capital allowances recognise the unavoidable extra costs incurred by the ACT because of Canberra's status as the national capital or because of legacies inherited from the Commonwealth at self-government.

In the 2015 Review, the Commission recognised three types of national capital allowances, planning, police services and roads.

The Commission notes that many states (in addition to the ACT) face circumstances outside their control in relation to planning and management such as the management of world heritage sites which are governed by Commonwealth legislation. Further, the ACT's circumstances have changed since self-government almost 30 years ago and since the planning allowances were first introduced in the 1999 Review.

Victoria agrees with the Commission's staff proposal to discontinue all planning allowances (unless the ACT can make a case for their continuation) and retain the police allowance.

17.3 Native title and land rights

This assessment recognises the additional costs incurred by the states due to the operation of the *Commonwealth's Native Title Act 1993* and *Aboriginal Land Rights (Northern Territory) Act 1976*.

The *Victorian Traditional Owner Settlement (TOS) Act 2010* provides for an out-of-court settlement of native title. The Act allows the Victorian Government to recognise traditional owners and certain rights in Crown land. In return for entering into a settlement, traditional owners must agree to withdraw any native title claim, pursuant to the *Native Title Act 1993* and not to make any future native title claims.

The assessment paper does not acknowledge Victoria's recent engagement to settle land rights through the TOS Act. Several settlements are expected to progress in the near future which will impact the state's land rights expenses.

In the Victorian context, the types of expenses listed in paragraph 95 includes all expenses relating to the TOS ACT. The distinction between land rights and native title expenses is therefore not relevant for Victoria as all compensation arising from TOS Act agreements is currently counted. TOS Act outcomes are also native title outcomes (Indigenous land use agreements are used).

Victoria agrees with the Commission's staff proposal to continue to assess native title on an APC basis. This can also include the land right components.

Victoria cautions against the use of alternative assessments that assume average annual costs based on past years. Victoria anticipates significant variation of expenses from year to year as native title settlements under the TOS Act are reached and settlements are made.

For Victoria, annual data collections are not onerous as reports can be generated from accounting systems.



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