SOUTH AUSTRALIAN SUBMISSION ON CGC STAFF DISCUSSION PAPERS PREPARED FOR THE 2015 REVIEW

Commission staff discussion papers
CGC 2013-05, CGC 2013-06S, CGC2013-07S and CGC2013-08S

SUBMISSION BY SOUTH AUSTRALIAN DEPARTMENT OF TREASURY AND FINANCE

JANUARY 2014

MEASURE OF FISCAL CAPACITY AND THE "SIMPLIFIED AND INTEGRATED" FRAMEWORK

South Australia continues to favour the Simplified and Integrated operating statement framework on the basis of transparency and accessibility. That framework allows for an upfront assessment of population dilution needs in respect of earnings on legacy net worth on the income side, and in respect of the expenses side, allows for depreciation needs to be augmented by a time value/holding cost adjustment.

However, given that the Commission is disinclined to adopt the holding cost model - it is a matter of judgement on weighing the possible advantages (see Attachment A) - South Australia supports proposals suggested in the Discussion papers to improve the coherence and persuasiveness of the Commission's capital assessment in its current form. These are

- to include non - commercial subsidised Public Non-Financial Corporations (PNFCs) in scope of the investment assessment; and
- to present the investment assessment in gross terms.

In its first submission, South Australia sought to engage with the Commission on a simplified approach in an operating statement context which is the natural home for a depreciation based assessment. If the framework is to remain a net lending one, South Australia now focuses on a gross investment approach with no reference to depreciation. Further comments on the investment assessment are provided in the Infrastructure section below.

In its first submission, South Australia also sought to open up a discussion on the *positive* role of higher population growth on the generation of net worth per capita. Taken together, the Commission's assessment of population growth needs in respect of the physical asset stock in the Infrastructure assessment and in respect of net financial worth in the net lending assessment constitutes an assessment of the adverse (arithmetic) impact only of population growth on net worth per capita. In this submission the positive fiscal impact of population growth is taken up in the section on the net lending assessment below.

IMPLEMENTATION ISSUES FOR WHAT STATES COLLECTIVELY DO

South Australia strongly supports the "what states collectively do" principle rather than the use of subjective/value based standards.

Revenue and expense standards

South Australia supports the continued basing of revenue and expense standards on revenue and service base weighted averages of what states do.

Determining average policy

South Australia is generally supportive of the proposed revised approach whereby every tax imposed by one or more states is potentially subject to differential assessment, subject to materiality, rather than determining average policy based on a majority of states and majority of revenue base rule.

However, this proposal has to be implemented with care. South Australia has concerns with the proposal to merge unique or not generally applied taxes into a similar tax base assessment as interpreted in respect of insurance duty on workers compensation premiums. It is one thing to add a small amount to standard revenue with no change to the existing measure of an existing tax base. It is another thing to add a tiny amount to standard revenue but add substantially to the existing tax base measure, and potentially disturb a fit for purpose assessment of the tax base. This is further discussed below.

In the case of duty on workers compensation premiums, it might be the case that the tax base aligns better with payroll tax than other forms of insurance which are more aligned to fixed and mobile property ownerships and values.

Equalisation of interstate costs on a "spend gradient" basis

South Australia supports the staff recommendation that interstate costs should not be equalised using a spend-gradient approach.

IMPLEMENTATION ISSUES FOR POLICY NEUTRALITY

Elasticity adjustments

South Australia commends the Commission for its investigation and examination of this issue. It is important to note that assessments are only potentially affected insofar as individual state tax rates vary from other states.

South Australia agrees with the proposal not to reintroduce elasticity adjustments in the 2015 Review. However, this is an issue which should be monitored at Methodology Review intervals, or in the event of major new developments occurring non-uniformly in the composition of state taxes.

IMPLEMENTATION ISSUES FOR PRACTICALITY

Materiality thresholds

South Australia has been opposed to the four-fold increase in materiality thresholds proposed by the GST Distribution Review on the basis that such a large arbitrary increase has no conceptual basis, created winners and losers and undermines the achievement of equalisation objectives.

Commission staff are proposing that the category total and category redistribution thresholds be removed and a three-fold increase in the disability and data adjustment materiality thresholds be introduced in the 2015 Review.

As a general principle, South Australia supports adjustments to materiality thresholds to maintain values in real terms but believes that the Commission needs further justification for any increases beyond this level. An increase from $10 per capita to $30 per capita in the disability factor threshold is well above general price movements.

South Australia is also concerned that the extent of disaggregation within revenue and expense categories could preclude appropriate redistribution. The proposed Assessment Guidelines state:

The commission will include the disability in its final assessments if:

- *it redistributes more than $30 per capita for any State in the assessment period (the materiality test will be applied to the total impact the disability has on the redistribution of funds across all revenue or expense categories in which it is assessed)*
- *removing the disability has a significant impact on the conceptual rigor and reliability of assessments.*

South Australia considers that the Commission should wait and consider the possible cumulative implications of threshold levels before finalising their levels. Further analysis is also required on the aggregate impact of both the existing and proposed materiality thresholds. As this can only be done once all assessments have been settled, South Australia reserves its position on the proposed increases to the thresholds.

In any case, the same quantum of materiality threshold for a disability factor should not apply to a decision on the degree of age stratification in an assessment. The motivation for materiality thresholds is simplification/reduction in number of factor assessments. It has a conservative bias in outcome but there should be no positive goal of conservative bias per se. An assessment with 10 age groups is equally deliverable as one with 5 age groups. An age stratification decision has to be fit for purpose often by ensuring appropriate disaggregation at the extremes of an age distribution. Further, if an assessment is proceeding, no harm is done by stratifications 'excess to requirements', whether or not they result in redistributions, say in the middle age bands. See further comments on population bands in the section on the health assessment.

Materiality thresholds for Commonwealth payments

South Australia does not support applying a materiality threshold to Commonwealth payments. A materiality threshold could result in funding arrangements being developed and structured in a manner to remain under the threshold (ie splitting funding into several smaller agreements rather than one). This could lead to further proliferation of funding agreements, already a well-documented concern with the current Intergovernmental Agreement on Federal Financial Relations.

Discounting

South Australia has concerns about the proposed approach to discounting as discussed in the Proposed Assessments paper and the proposed Assessment Guidelines.

Paragraph 3 of the Assessment Guidelines proposes the following:

When the assessment is to be discounted, a uniform set of discounts is used, with higher discounts being applied when there is less confidence in the outcome of the assessment or more uncertainty attached to the information. The discounts are:

- *12.5 per cent, if there is not full confidence about the size of an effect because of a low level of uncertainty around the information on which it is based*

- *25 per cent, if there is a medium level of confidence about the size of an effect or a medium level of uncertainty about the information*
- *50 per cent, if an effect on States is known to be large and there is confidence about its direction but there is limited confidence in the measurement of its size due to a high level of uncertainty in the information*
- *if there is little confidence in the direction of an effect or its size, no differential assessment would be made.*

The Commission often uses survey data with large confidence intervals in its assessments. Typically, the Commission would take the midpoint of the confidence interval as the data point. Under the criteria set out above, the assessment would be discounted by 50%, "if an effect on States is known to be large and there is confidence about its direction but there is limited confidence in the measurement of its size due to a high level of uncertainty in the information".

There may be merit in a more sophisticated approach to the use of problematic data in some situations (such as the sample survey data for private sector wages for comparable employees by region used in Fig 28-10). An alternative would be to choose the end point of the 95% confidence interval in the direction of the null hypothesis, rather than the mid-point.

IMPLEMENTATION ISSUES FOR CONTEMPORANEITY

Backcasting

South Australia is generally supportive of backcasting major changes in Commonwealth-State relations as a general principle. However, backcasting should only be undertaken when the Commission is satisfied that reliable estimates of all relevant factors (including costs, activity levels, participation) are available, and a genuine step change is occurring in the application year in respect of the roles and responsibilities of Commonwealth and State Governments.

South Australia believes that changes occurring in health funding arrangements do not meet these tests. Under the National Health Reform Agreement signed in 2011, the Commonwealth and the states agreed to jointly share the cost of the efficient growth of public hospital based services and that the base funding in the National Heathcare Agreement would continue under the reforms.

The efficient growth of public hospital services will ultimately be equally funded by the Commonwealth and the states. The Commonwealth will gradually increase its contribution to efficient growth funding for public hospitals over time from 45 per cent from 1 July 2014 to 50 per cent from 1 July 2017.

Although the introduction of an efficient growth funding component is a new development, the actual impact from a total funding allocation perspective does not constitute a "step" change.

Also the estimates on which the back-casting would be based for National Health Reform are not reliable.

The use of National Health Reform funding estimates contained in the 2013-14 Commonwealth budget papers as a basis for back-casting would not be reliable or appropriate. The Commonwealth's forward estimates, for the growth funding component, are largely based on historical spending patterns and not on expected activity. As such, the estimates incorporate past policy decisions on funding levels made by jurisdictions. In reality, the growth funding component will be based on actual activity.

Use of non-annual and lagged data

As a general principle, the Commission should attempt to use the latest available data that best reflects states' circumstances in the year of application. The use of updated data in the latest assessment year but not in the two prior assessment years would result in data that is not aligned and inconsistent across all assessment years. It is also not consistent with the general contemporaneity principle and may restrict the Commission from correcting known data errors or issues.

South Australia supports the staff recommendation to continue to use data which best reflects States' likely circumstances in the year of application.

A GLOBAL REVENUE ASSESSMENT

South Australia supports the staff recommendation not to adopt a global revenue assessment as no one indicator reflects a state's capacity to generate revenue from multiple tax bases.

The use of global indicators (including household disposable income and adjusted Gross State Product) could not produce an outcome that is consistent with the "what states collectively do" principle. States do not levy taxes on a global basis, they levy individual taxes.

Revenue raising capacities differ between taxes and assessments that consider legislative bases (including thresholds, exemptions and progressive rates) are able capture these differences. This is not the case for a global assessment.

The use of household incomes confuses households' capacity to pay with States' capacities to raise revenues. As the tax bases available to, and used by States, are not directly related to incomes then neither is their ability to raise revenues from them. The use of global indicators to measure revenue capacity is likely to simply create winners and losers without achieving any significant simplification, and at the expense of a less equitable and efficient HFE outcome.

The revenue assessments are not complex and South Australia sees no practical benefits from a shift in assessment methodology from one which is based on indicators of actual "what states do" tax capacity to one which uses global indicators.

BROAD INDICATOR ASSESSMENTS

South Australia is opposed to the use of broad indicators where they do not reflect "what States do". The use of broader indicators to measure revenue capacity at a global level is likely to simply create winners and losers without achieving any significant simplification, and at the expense of an appropriate HFE outcome.

Assessments should reflect the structure of state taxes including arising from progressive tax rates, exemptions and thresholds.

South Australia strongly endorses the "what states do" principle in respect of tax design as well as mix of taxes.

TREATMENT OF COMMONWEALTH PAYMENTS

South Australia supports consideration of all in scope Commonwealth payments on a case-by-case basis using the Commission staff's proposed guidelines. As previously discussed, we do not support the application of a materiality threshold to Commonwealth payments.

The approach of assessing of Commonwealth payments in areas where there is a deliberative equal per capita assessment was not articulated in the previous guidelines developed for the 2010 Review. Explicit reference to deliberative equal per capita assessments improves transparency and wider understanding.

South Australia seeks a response to the suggestion in its first submission that Commonwealth payments, if any, to commercial PTEs, should be treated by exclusion, if it can be demonstrated that the payments flow to the benefit of user charges/ services funded by user charges. The upfront dilution assessment of net financial wealth is in lieu of an interest/dividends received assessment over time, and in the circumstances described there is no effect on interest/dividends received.

The analogy is with Commonwealth assistance to a private sector owned electricity or ports entity.

Water for the Future National Partnership

In the 2010 Review, the Commission considered the Water for the Future omni-bus National Partnership (NP) and concluded that the majority of these programs were for irrigation and urban water supply rather than for protection of the environment.

From reviewing South Australian sub-program data for the S*ustainable rural water-use and infrastructure* component of the Water for the Future NP, it is clear that a number of these programs are more focused on protection of the environment than irrigation and urban water supply.

Funding from the S*ustainable rural water-use and infrastructure* component has been used for the Murray Futures program which is primarily focused on a sustainable river system. Funding has been used for environmental recovery programs in the Coorong and Lower Lakes and for improvement of wetlands and floodplains from the South Australian border to Wellington. In recent years, it would appear that around half of the funding under this component has been for protection of the environment. Other funding has been used for water supply pipelines and irrigation investment.

In the 2011 Update the Commission concluded that the Living Murray program was focused on the protection of the environment. The Murray Futures program has a similar objective.

South Australia believes that the Commission needs to reconsider its blanket treatment that all Water for the Future funding (to states) is for irrigation and urban water supply.

ASSESSMENT GUIDELINES

South Australia's comments on the proposed guidelines for applying materiality thresholds and discounting have already been outlined in the relevant sections.

PROPOSED ASSESSMENTS

STAFF DISCUSSION PAPER CGC 2013-07S

PAYROLL TAX

South Australia supports continuation of the current assessment method. The adjustment for the tax free threshold should be retained as it reflects the way all jurisdictions tax payrolls. Not recognising the tax free threshold would overstate the revenue raising capacity of states that have proportionally more small firms.

LAND TAX

South Australia supports the staff position to not use a global revenue assessment that incorporates land tax. The value of land in ABS National Accounts does not correspond to the taxable base used by jurisdictions to assess land tax liabilities and does not reflect aggregation of land holdings.

South Australia supports the staff recommendation to continue the 2010 methodology and to incorporate revenue from metropolitan levies into the assessment.

STAMP DUTY ON CONVEYANCES

South Australia supports the staff recommendation to continue the assessment method adopted in the 2010 Review.

INSURANCE TAX

The statement at paragraph 9 of the *Proposed Assessments* paper that South Australia imposes a tax on workers compensation is not correct. Although the *Stamp Duties Act 1923 (SA)* does impose duty on workers compensation premiums (with an exemption for employees under 25 years of age), Section 27 of the *WorkCover Corporation Act 1994 (SA)* exempts the Corporation from insurance duty completely.

This is not reflected in the NSW *Treasury Interstate comparison of taxes 2012-13*.

This means that only Queensland imposes duty on workers compensation premiums.

South Australia does not support inclusion of duty on workers compensation premiums into the insurance tax base. It is one thing to add a small amount to standard revenue with no change to the existing measure of an existing tax base. It is another thing to add a tiny amount to standard revenue but add substantially to the existing tax base measure, and potentially disturb a fit for purpose assessment of the tax base.

Also, workers compensation premiums are based on payrolls – there is a closer resemblance to the payroll tax base than the largely property based insurance premiums.

MOTOR TAXES

South Australia supports continuation of the current assessment methodology.

MINING REVENUE – PRIORITY ISSUE

Commission staff have asked States whether GST distribution impacts have determined or influenced recent decisions to adjust mining royalty rates.

From a South Australian perspective, the HFE implications of all taxation rate adjustment decisions (including mineral royalty decisions) are considered but we do not believe there have been any instances where these impacts have driven or significantly influenced an ultimate decision.

It is noted that South Australia is not in the position of dominating the base of any revenue head, and rate adjustment decisions are unlikely to have significant positive or negative HFE implications.

As discussed in our initial submission, royalty rates across commodities are, to a large degree, set with regard to what the market will bear or expected profitability. Royalty rates themselves contain information about expected profitability. If a commodity by commodity approach is ruled out, this gives conceptual support to an assessment using profitability weights based on royalty rates.

A single category assessment would need to reflect that some minerals attract significantly higher royalties than others. This could be achieved by developing an assessment that uses rates of royalty relative to the overall average. This would avoid problems when commodities shift between royalty level categories.

Consistent with the current methodology, a tiered approach that aggregates commodities by rate of royalty is probably a reasonable alternative.

The three tiered approach contemplated in the 2014 New Issues paper would appear to be a practical approach. Although grouping of minerals does not fully address policy neutrality issues, it does to some degree lessen the impact of a single jurisdiction dominating policy if more than one mineral is in each group.

Accordingly, South Australia sees some merit in the Commission considering adding a third category of minerals that separately assesses iron ore (both lump and fines) and coal together.

A possible classification structure could be:

- High royalty group – onshore gas and oil, bauxite
- Medium or special royalty group – iron ore (lump and fines) and coal
- Low royalty group – all other minerals.

South Australia does not support the use of external standards based on international experience. Such an approach would not be consistent with the “what states do” principle. In particular, international standards that do not reflect the Australian mining environment would not be appropriate.

The Commission’s primary role is to equalise fiscal capacity in Australia and assessments should be based on what states do in Australia. The use of Australian historical standards would be an internal standard but not especially consistent with contemporaneity objectives.

South Australia also does not support the application of any discount to this assessment as there are insufficient concerns about the quality of data that the assessment is based on. A discount makes little impact on policy non-neutrality.

OTHER REVENUE

Gambling taxes

South Australia believes that a differential assessment could be undertaken for gambling revenues. Although policy differences still remain, the regulatory landscape of gambling in states has become much more consistent than at the time of the 2010 Review.

Based on the literature review already undertaken, it is unlikely that available research will be able to identify reliable drivers of a jurisdiction's propensity to gamble. Propensity to gamble is likely to be driven by a complex interaction of factors that would include income, age, socio-economic background, ethnicity and local/ unique preferences. In any event there is a significant gambling export sector.

Every jurisdiction is able to collect player loss and taxation revenue data (by gambling type) and this could be used as the basis for constructing an assessment along similar lines to other revenue assessments.

In addition, the Queensland Government Statistician prepares an annual publication titled *Australian Gambling Statistics* which provides state-by-state gambling turnover and expenditure data. Although there are some lags in the data, this could be used as a data source.

An extract from the 28th edition of the Australian Gambling Statistics publication (December 2012) showing per capita gambling expenditure for each jurisdiction is provided in Attachment B.

The issue of Western Australia not having gaming machines (outside of its casino) could be overcome by deriving an average tax base based on data from other jurisdictions or assigning Western Australia with a neutral revenue raising capacity (ie 1.000). In any event, the assessment is not substantially affected by Western Australia's tax base.

Discounts or other adjustments could be applied to the assessment to allow if necessary for possible other policy differences.

A gambling revenue assessment would need to incorporate lump sum capitalised revenue streams as well as regular annual gambling taxes.

Fire and Emergency Service Levies (ESL levies)

South Australia has previously stated its view that it considers ESL levies to be taxes rather than user charges. They are in the nature of property taxes but are not comparable to state land tax as currently applied. The main distinguishing features are:

- ESL is comprehensively applied and includes principal place of residence which is exempt from land tax, and
- ESL is levied on improved capital values.

ESL should be assessed as a separate tax to land tax. All States have data from Valuer-Generals which would allow an assessment. Such an assessment could be merged with an assessment for other broad based metropolitan rates type taxes if they develop in significance. An example may be a 'State's component' of ACT rates which constitutes the replacement (on a phased basis) of conveyance duty and insurance duty in that jurisdiction.

User charges

Road toll revenue should be offset against roads expenditure assessments. This should include income items in respect of recognition (often phased) of the reversion to state balance sheets of concessions such as City Link.

School fees should be offset against expenditure assessments in the same way as are hospital charges.

SCHOOLS EDUCATION

As there has been standardisation of state policies for school starting and finishing ages, South Australia is comfortable for actual enrolments to be used for all school age groups as its broad measure of use in the Schools education assessment. However, the CGC will need to take into account that 2014 will be the first year that South Australian government schools have had one intake for students starting school. In previous years there were four school intakes with government school students starting school the term after turning 5 years of age.

South Australia has some concerns about the MySchool data being used to derive cost weights, should cost weights be based on what States do form part of the Schools education assessment. The MySchool data is based on reporting by schools that could be problematic. It is not clear that the data is consistent between schools and there are policy differences between schools in the application of programs such as school card. South Australia considers that results of analyses of MySchool data from the initial years of the data collection should be treated as preliminary or exploratory until the data collection is considered to be mature.

South Australia supports the proposal that Commonwealth payments for non-government schools under NERA continue to be assessed as not affecting the relativities.

Prior to the implementation of the Better Schools funding model, South Australia adjusted and determined the total allocated funding amount to non-government schools each year based on the following parameters:

- an annual adjustment for increases/decreases in student enrolment numbers;
- 25% of an agreed salary movement based on salaries awarded in the Department of Education and Child Development; and
- a Department of Treasury and Finance determined inflation allowance on the goods and services component.

The funding formula for distributing the state government funding to non-government schools quarantines funding for special schools before allocating 47.5% of the remaining funds as a per capita grant for primary and secondary students. The remaining 52.5% of funding is distributed in accordance with a schools entitlement to any of the following needs:

- Index of disadvantage;
- Interest subsidy;
- Index of Rurality;
- Social equity;
- Special needs students;
- Indigenous students and Language other than English students;
- Fee remissions (to offset some of the loss of income arising from fee remissions given for economic hardship and sibling concessions); and
- Boarding (offset cost of increased pastoral care).

South Australia considers that the commission should continue to assess non-government schools based on the average State policy for funding non-government schools after the introduction of NERA.

NATIONAL EDUCATION REFORM AGREEMENT (NERA) – PRIORITY ISSUE

In principle, South Australia believes use of the NERA loadings would be consistent with the 'no unwinding' clauses.

South Australia supports the interpretation of the 'not unwinding' clause that the recognition of educational disadvantage relates to SRS loadings, not to base funding, and that 'not unwinding' related to the fiscal impact of SRS loadings in Commonwealth payments for government schools and not the loadings used by States in their own allocation models.

All Commonwealth payments should be fully included on the revenue side.

It is South Australia's view that third option for implementing the 'no unwinding' clause most appropriately achieves HFE and satisfies the requirement of the terms of reference. The NERA model based on the SRS standard should be augmented by adding extra disabilities not recognised in the SRS funding model such as administrative scale, interstate location costs and student transport.

South Australia recognises that the NERA model based on the SRS standard might not reflect what States do. For example, there is an assumption in the NERA loadings that money allocated for Indigenous students has a relationship to Indigenous spend. It is not clear that this is what States do.

POST-SECONDARY EDUCATION

South Australia supports the proposal to move all VET expenses in the Services to industry category to the Post-Secondary education category. Under the VET Reform National Partnership Agreement States are introducing demand-driven VET systems with an increasing role for the private RTOs. All VET providers in receipt of public funds are obliged to provide their publicly-funded VET delivery data to NCVER.

Table 10.1 is misleading as data for all privately funded VET delivery is not included in the data collection used to derive Table 10.1. While the scope of the NCVER data collection is to be expanded to include all VET activity this is not the situation at present.

In terms of determining cost weights for training provided by private RTOs, most States publish the amounts they will pay to private providers for contested training delivery on a course by course basis. The amounts paid by training hour by States to private providers for User Choice courses for apprenticeship and traineeship training is available on the websites of State public training authorities. Often States will pay a lower hourly rate to enterprise training providers who deliver training in-house.

PUBLIC HOSPITALS

At this point in time, South Australia has reservations about the currently proposed assessment categories for health expenditure. At this stage, it is our view the data required for such an assessment will not be sufficiently mature to undertake a robust assessment until at least the 2020 Review.

However, South Australia will provide further comments when the Commission comes back to States with a more developed proposal prior to the release of the draft report.

South Australia has a number of concerns about the IPHA methodology and data being proposed for the Public Hospitals assessment.

- IPHA based Commonwealth funding does not equate with total health expenditure including from State sources.

- The IPHA data is still being developed and States data sets are at a different stage of development. Those States that previously had systems based on case mix models are more advanced with their data sets than States that are still developing their case mix models.

- The data for outpatient services is the least developed of all data sets and 'occasion of service' data is inconsistent across jurisdictions. In South Australia outpatient services are funded on the basis of the clinic, not on the basis of the individuals using the clinic.

- Diagnosis Related Groups are not a cost weight but are funding allocations of 'like' procedures.

- An adjustment to the national efficient price for private patient revenue (see para 24) already exists, however the CGC is proposing to do its own adjustment which would result in a double adjustment. IHPA has made adjustments for private patients, locality, indigenous status and major paediatric hospitals. The IPAA model doesn't recognise private outpatients. Any component of an episode of care that is charged to Medicare is not included by IPHA.

- It is not clear what price weighting would be used to obtain "national average costs to the number of people in the corresponding population groups in each state" as individuals cannot be identified in the data.

- The discussion paper does not mention the effect of block funded rural hospitals on the admitted patients category. Block funded rural hospitals are not funded on an activity basis. States and Territories do, however, report patient level admitted activity data for block funded hospitals. It is not clear whether the CGC have proposed to only take into account the effect of block funded hospitals for Emergency Department and outpatients because they already have activity data available for admitted activity.

South Australia does not support the disaggregation of age into 5 groups instead of 7 groups. Age classification in a given assessment should be fit for purpose in that assessment. In health, spending against age has a very steep gradient for those over 80 years of age. People 85 years of age and over have different service delivery needs to the age group who are under 85 years of age. With healthier lifestyles and improvements in medical care, the elderly tend to experience poor health at older ages.

Emergency department services

South Australia does not agree that the most appropriate assessment for an economic environment factor for emergency departments would be the number of GP-type services provided in each state. This assumes that emergency department services are substitutable for GP services.

- We do not agree with the assumptions made by the Commission in regard to the substitutability of ED services for GP services. The Australasian College for Emergency Medicine have been publicly critical of the figures reported by the AIHW. If the CGC propose a methodology for identifying GP type patients, we could calculate this figure for South Australia relatively easily. However the current methodology employed by the AIHW is flawed. There was a workshop conducted by the AIHW in April 2013 seeking to explore new methodologies.

- The statement that 55% of Emergency Department attendances are for GP type presentations seems too high. A recent study published in the Medical Journal of Australia estimated the proportion of general practice-type patients attending the Emergency Departments of Perth's major hospitals was 10%–12% https://www.mja.com.au/journal/2013/198/11/quantifying-proportion-general-practice-and-low-acuity-patients-emergency

- We are concerned about the assumption that 60% of both activity **and** cost in emergency departments are for GP substitutable services. There is an implicit assumption in para 45 and 46 that 60% of Emergency Department activity (GP substitute) equates to 60% of Emergency Department expenses – this is not correct as the Emergency Department activity that could be substituted by GPs is much lower in cost. This assumes that all triage 4 and 5 is GP substitutable and costs the same as triage 1 to 3.

Outpatient services

Public outpatient services are high volume, low margin services that typically cater for the more complex patients with co-morbidities.

South Australia does not support the proposal for outpatient services that an economic environment factor is calculated based on the raw volume of specialist type services provided in each State with the factor applied to 60% of outpatient services.

The economic environment factor has to 'net off' the demand drivers of GP-type services and obtain the same type of outcome as is currently achieved by the subtraction method. Drivers of a high demand and supply of for GP-type services include communities with a relatively high proportion of people from a low socio-economic status background and an older population.

COMMUNITY HEALTH

South Australia does not support the adoption of a direct assessment approach instead of a subtraction model approach unless the new methodology achieves the same outcome as was achieved by the subtraction method.

A direct assessment approach would need to be capable of 'netting off' the demand drivers of GP-type services and obtain the same outcome as is currently achieved by the subtraction method. As previously stated, the drivers of a high demand and supply for GP-type services include communities with a relatively high proportion of people from a low socio-economic status background and an older population.

South Australia does not agree with the Commission that there are similarities in the services provided by GPs and those provided in community health centres as stated in the discussion paper, "given the similarities in the services provided by GPs and those provided in community health centres" (para 21). Community health includes dental health, home nursing, domiciliary care, alcohol and drug rehabilitation, well baby clinics. The user profile is quite different and perhaps the only components that are similar to GPs are family planning and immunisation.

Some data collections for community health data will be robust, such as SA Dental Service and Community Mental Health. However, there is general difficulty in measuring community health services arising from the lack of definition of what constitutes a service event. This issue occurs both across different types of services and also across jurisdictions. Cost would be harder to determine as States do not fund community health services on activity or episodes of care.

WELFARE

South Australia continues to support the use of Commonwealth income support recipients as the main driver for determining a socio-demographic factor for state welfare services. This approach was considered in the 2010 Review and available data supported the correlation between the receipt of Commonwealth income support payments and state service use. Commonwealth income support payments are a reliable, policy neutral indicator of relative state need.

Aged care services

South Australia supports the staff recommendation to assess Western Australia's aged care expenses and related Commonwealth payments equal per capita.

Disability services

South Australia supports retaining the current disability services assessment (adjusted to remove the impact of users aged over 65) that calculates national average use rates of disability services by disability pensioners and applies these use rates to the interstate distribution of Indigenous and non-Indigenous disability pensioners.

Family and child services

South Australia supports Commission staff investigating the use of Australian Institute of Health and Welfare (AIHW) child protection data unit record data to derive a location breakdown of service users and linking this data to ABS SEIFA data to estimate an SES breakdown of family and child service use.

General welfare services

South Australia supports as assessment of concessions based on concession card holder numbers and the balance of general welfare services expenses being based on the relative proportion of people in the bottom quintile of the ABS's SEIFI.

Fly-in fly-out workers

South Australia believes that there is insufficient evidence to support the case that differences in the cost of living result in additional spending on welfare services by states.

DISABILITY CARE AUSTRALIA – PRIORITY ISSUE

As discussed in our initial submission, South Australia proposed that the current methodology for assessing disability services needs should be retained until the time of full implementation of Disability Care Australia (DCA) or when DCA is fully functioning (ie 2018 or 2019).

South Australia continues to hold this view and believes that this approach is appropriate from both a conceptual and data reliability perspective.

When DCA is fully functioning and applying uniform national standards of service, horizontal equity is effectively being achieved within the operations of a national scheme.

The main issue for consideration is the assessment of disability services during the transition period. Commission staff have proposed two approaches, a "blended" assessment or a "switch' approach.

The use of a blended assessment approach during the transition period would be a departure from the Commission's usual "average policy" approach. The Commission's usual approach would be the "switch" approach which would see DCA become average policy when the majority of disability clients are covered by the new arrangements. On current trajectories this would occur around 2017-18 or 2018-19.

The "blended" approach proposes an assessment of state contributions to DCA based on each state's proportion of the total number of people ultimately to be covered by DCA. Therefore this component of the assessment would be based on estimates. The remaining disability services would be assessed using the existing methodology.

South Australia believes that the assessment for state contributions to DCA should not be based on "ultimate" participation <u>estimates or projections</u> that are likely to vary right up until full implementation. Accordingly, we do not support the blended approach or any backcasting of this approach. Any backcasting of this approach, especially from the 2016 Update, would have to be based on estimates with questionable reliability.

South Australia supports a "switch" approach but for data reliability purposes we think the switch point should be fixed at 1 July 2019 – the year in which most jurisdictions fully transition. This would mean that the 2020 Update would be the first update to reflect the transfer of disability services to DCA and the assessment would be based on actual participation data, by jurisdiction. The existing methodology should be maintained up until the 2019 Update.

At this point, the transfer of responsibilities could be backcast as reliable participation data would be available, but not beforehand.

HOUSING

South Australia supports the proposal to assess housing services, including capital stock usage, as a separate category. Use of Census social housing household numbers as the primary indicator of service demand burden on state budgets is also supported. However South Australia queries why only social housing households with equivalised income below $600 per week should be included in the assessment. Security of tenancy commitments tend to mean that 'what states do' in respect of the stock of tenants is not restricted in the way that income eligibility limits for new tenants would suggest.

Further South Australia notes that community housing tenants tend to place a lower burden on state budgets than public housing tenants, reflecting the self-funded nature of community housing arrangements with the support of Commonwealth Rental Assistance.

South Australia favours functionalisation of the capital assessment generally and notes that because of the importance of capital stock expenditures/expenses in housing it would assist transparency if the capital assessment for this area were not merged into an aggregate assessment- including in respect of revenue assessments being seen to offset capital expenditure/expenses assessments, as well as operating expense assessments.

SERVICES TO COMMUNITIES

South Australia is comfortable with water and electricity subsidies being part of the same broad assessment category, but we do not support combining the water and electricity subsidy assessments into one assessment as the water assessment should also reflect water availability and water quality.

South Australia does not support the staff recommendation to no longer recognise water availability and quality as having an impact on water subsidies. Distance from water source is a significant cost factor due to the requirement to operate an extensive pipe network.

South Australia is heavily reliant on the River Murray for water which is problematic from a cost and supply security perspective because the Murray is slow flowing, saline, turbid and subject to shortages created by upstream water use. The reliance on the Murray for country supplies leads to considerable investment in an extensive network of pipelines and the poor quality of the raw water necessitates significant investment in water treatment plant. Due to the South Australian topography all systems require pumping as gravity-feed cannot be relied upon. South Australian soils are typically reactive clay, which experiences significant movement depending on the weather conditions. As the majority of pipe is vitrified clay, there is a high rate of breaks as a result of this movement.

Analysis by Marsden and Pickering (2006)[1] compared water supply systems across Sydney, Adelaide, Perth and Newcastle and found that the direct cost of using groundwater for supply varied between $0.20 /KL and $1.58 /KL, using dams and surface water varied between $0.15 /KL and $3.00 /KL, and long distance pipelines varied between $1.30 /KL and $9.30 /KL.

The cost of supplying water is influenced by the:

- distance and lift between the water source and the consumption point,
- type of water source, including soil conditions and groundwater levels
- level of treatment, and
- density of development.

Although it is has proven difficult to precisely quantify these costs, there is sufficient evidence that states that have to pump water long distances from the source incur higher per capita subsidies (Table 16.1 in the Staff Discussion Paper). The three jurisdictions with high subsidy costs (Western Australia, South Australia and the Northern Territory) have extensive water pipe networks and pump water long distances from the source. The Northern Territory also has to use electronic bores in some regional centres which are expensive to operate compared to costs of obtaining water from other sources.

South Australia is comfortable with the proposed assessment approach for electricity subsidies.

JUSTICE SERVICES

South Australia supports the proposal to continue to assess 50% of police expenses on the basis of State population (community policing) and 50% on the basis of population influences linked to the increased occurrence of crime (specialised policing) due to the lack of nationally consistent data on police activity resourcing.

South Australia would need to examine the quality of the data from the upcoming AIC police custody survey before making a judgement about whether it provides an appropriate basis to update the current data and whether it is an adequate alternative to enable the 25% discount of specialised police use rates to be ceased.

Similarly, South Australia would need to examine the quality of data from the upcoming AIC survey to make a judgement about whether the data derived from the AIC survey can be used as a basis for introducing a discount or cost weight for criminal court data or as a basis for introducing Indigenous cost weights.

[1] Marsden, John and Phil Pickering (2006) *Securing Australia's Urban Water Supplies: Opportunities and Impediments.* A discussion paper prepared for the Department of the Prime Minister and Cabinet, Marsden Jacob Associates, November 2006.

ROADS

South Australia does not believe that the *Optimising GST Allocations* report (Pottinger Pty Ltd and AECOM, June 2013)(the Pottinger Report) provides a suitable basis for assessing any additional effects of the physical environment on road maintenance costs.

The Pottinger Report does not consider the impact of flooding and salinity on road maintenance costs.

In relation to salinity, there is a significant body of literature and research that has examined the impact of salinity and water-table levels on road construction and maintenance.

The NSW Department of Infrastructure, Planning and Natural Resources produced a paper in 2003 titled *Roads and Salinity* [2] that was essentially a literature review on the impact of salinity on road construction and maintenance. The report noted the following:

- increased salinity levels can shorten expected lifespans by accelerating the rate of deterioration. The impact of high salinity levels can shorten road lifespans by up to 50%;

- salinity can cause costly damage to roads but it is often difficult to separate salinity damage from other factors like poor construction or increased traffic; and

- accelerated damage to roads in areas subject to high saline water tables can increase repair and maintenance expenditure for major highways by up to $31,185 per km/year or $17,325 per km/year for main sealed roads[3];

The exclusion of salinity from the Pottinger report significantly diminishes the use that the Commission can make of the proposed cost weightings for road maintenance.

TRANSPORT

South Australia notes that analysis provided subsequent to the release of the Discussion papers on urban transport costs by single labour market area may supersede the urban areas examined in the Discussion paper. This seems appropriate.

TRANSPORT INFRASTRUCTURE – PRIORITY ISSUE

South Australia has concerns that the proposed new urban transport investment assessment is underdeveloped –particularly the reliance on the rather raw statistical analysis of asset value to population centre size relationship.

---

[2] Roads and Salinity – Local Government Salinity Initiative, NSW Department of Infrastructure, Planning and Natural Resources, 2003

[3] Wilson, S.M., Dryland Salinity – What are the impacts and how do you value them? An Ivey and Wilson Land Management Services Report prepared for the Murray Darling Basin Commission and the National Dryland Salinity Program, Canberra, 1999.

As per comments in the Infrastructure assessment section of this submission below, the role of user charges (fares) in meeting capital expenses should be recognised. An exponential, fares to population size, relationship will be contributing to a flattening relationship for *net* costs (including capital expenses) to population size. This effect seems to be partly captured in respect of a net operating cost approach (inclusive of depreciation) proposed for PNFCs; and for subsidies to private providers (implicitly inclusive of depreciation and holding cost), in this assessment.

South Australia also considers that it would be desirable for the capital assessment to be functionalised ie conducted for urban transport separately from an aggregate calculation. It is noted that the inclusion of depreciation in operating expenses (and subsidies to private providers) means that the assessment is partly functionalised. Also the roads capital assessment is conducted separately from other capital expenses.

Treatment of Commonwealth payments

An interstate spillover effects test of 'national' significance can be used as a matter of judgement for ensuring internal consistency of treatment of Commonwealth payments for rail projects (and possibly other projects) as against the benchmark of 50% exclusion for National network roads.

The Discussion paper raises the possibility of governments agreeing on payments relating to projects of national significance which should not impact on relativities and instructions included in terms of reference. Quarantining is always an option in respect of special circumstances. In this instance it may be helpful if the Commonwealth Government could endorse the general principle of 50% exclusion for National network roads payments as this treatment acts as an important benchmark for treatment of other payments.

SERVICES TO INDUSTRY

South Australia supports the proposal to make a separate assessment of mining regulation if the commission identifies other mining related expenditure assessments that in total would satisfy the commission's materiality threshold for a disability. In our earlier submission we supported an examination of the appropriate treatment of mining expenditure on a first principles basis and consistent with HFE.

South Australia supports the proposal to continue to use the 2010 Review State survey results as the basis for determining expense and disability weights and to continue to use a low level discount (12.5%) to the weights. We have noted the CGC advice that the ability of any one State to influence the weights in limited through the use of all State average expenses to calculate the weights.

South Australia supports the proposals to continue to assess business development expenses on an EPC basis, to net off mining regulation user charges from mining industry regulation expenses and to move all VET expenses from the Services to industry category to the Post-secondary education assessment.

South Australia supports the proposal to apply the general regional cost disability to regulation expenses as some regulation functions particularly those associated with agriculture and mining occur where businesses are located.

MINING RELATED EXPENDITURE – PRIORITY ISSUE

FIFO workforces

South Australia is sympathetic in principle to this issue, but has not yet been able to identify a supporting nationally consistent database. If further data becomes available from Western Australia and Queensland and is analysed by the Commission, South Australia would be in a better position to comment further.

Opportunity cost and risk

South Australia is not convinced by Western Australian arguments in respect of underutilised capital stock. We note that optimal utilisation will not be achieved in a range of circumstances (declining growth areas as well as possibly high growth areas). Similarly excess capacity will be present in new export oriented transport and supporting infrastructure in all states in respect of tourism, agribusiness, services as well as mining. It is noted that the possible high land management /environmental regulatory requirements of the mining industry should be revealed by the data request due in March 2014.

OTHER EXPENSES

South Australia is comfortable with retaining the existing assessment of other expenses.

INFRASTRUCTURE

South Australia welcomes the suggestion that the investment assessment might be revamped to a gross investment assessment approach consistent with a Net lending framework. The current infrastructure assessment is presented as a depreciation plus net investment assessment, but it can be analysed as follows:

1) Total investment @ cost disability

2) Total investment @ use disability

3) End of year Capital stock incremental population adjustment (weighted by use disabilities)

4) Interaction effects

The current presentation of the assessment is to divide each of items 1 and 2 into two parts, 'replacement' investment (based on the size of depreciation expense) and 'non – replacement' investment. The replacement parts of 1 and 2 are then combined together, as are the non - replacement (net investment) parts. The capital stock incremental adjustment is then attached to the net investment component.

There is no need for the separation of investment into replacement (depreciation) and non-replacement components.

Depreciation has no place in a Net lending framework, the essence of which is upfront full expensing of capital expenditure in the year of acquisition rather than on a deferred (matched to usage) basis. While there may be no double counting problem arising from labelling a component of investment in a time inconsistent way or in incompatible terms with a net lending framework, transparency and a comprehensible narrative is not assisted.[4]

In analytical terms, the rationale of the infrastructure assessment is as follows: Current period *cost* disabilities are indeed relevant to the cost of acquisition of capital assets. While current period *use* disabilities and population levels are *not* relevant to the planned usage of assets in the future, which is the driver of investment in the current period[5] - the application of current period information in the investment assessment is continually corrected/adjusted incrementally over time by way of a capital stock adjustment. As new population shares and use disabilities emerge, these are applied to the stock of previously acquired assets for each year in which previously acquired assets are in use.

The Commission is presumably satisfied that the incremental stock adjustment methodology is a reliable 'work-around' of the infeasibility of a direct assessment of investment needs, and that possible drawbacks of the work-around methodology are acceptable.[6]

In any event a *gross* investment assessment is readily achievable.

Adopting the above analysis allows a simplified additive version of a gross investment assessment[7] as follows:

1) Total Investment @ cost and use disabilities, *plus*

2) Average Capital stock incremental population adjustment (weighted by *use* disabilities)

The use of an *average* opening and closing capital stock balance achieves a better alignment with average populations, flow disabilities for the year, and year average price levels imbedded elsewhere in the Commission's assessment.

The total (gross) investment approach may also facilitate a more functionalised approach than just roads/non roads. Investment by function is moderately stable whereas net investment (investment less depreciation) by function is always more volatile and can even be negative. Volatility may be submerged by the lumpen

---

[4] '*Every year, State budgets record their spending on the gross acquisition of non-financial assets. This includes their depreciation expenses plus their net spending on acquiring non – financial assets.'* Para 19 p189 Staff Discussion paper.

[5] A direct assessment of investment needs would only be possible if future population shares and use disabilities for the life of physical assets were known now, or could be reliably estimated now by the CGC.

[6] It could be queried whether the incremental capital stock 'work around' will reliably achieve the goal of correcting for the use of prior period disability factors and population shares, if variation can be expected (as seems likely) in CGC methodology or in the scope or modus operandi of state governments, over 30 -50 years. It is not apparent that the investment assessment including the volatile incremental capital stock adjustment will average out the same in PV terms as a stable depreciation and holding cost assessment. The incremental capital stock adjustment seems vulnerable to changes in the mix of insourced and outsourced asset services for example, and off and on balance sheet roads provision.

[7] which is also less prone to interaction/rebalancing effects than the Commission formula.

aggregate approach to the insertion of use disabilities in the population dilution calculation, but it comes at a high price to transparency.

The preceding discussion makes some constructive suggestions as to how the current infrastructure assessment might be transparently analysed and how its separation into problematic replacement (depreciation) and non-replacement components might be avoided.

This Submission now provides a critique on the implementation of the infrastructure assessment.

1. The 50% actual per capita needs assessment on the roads expenditure side to deliver 50% 'exclusion' of National Network Roads (NNR) grants needs to be reflected not only in the current period flow component of the assessment but also in the capital stock adjustment. As with state funded investment, the driver of NNR grants is the future expected usage of national network roads not current period usage. The value of the roads stock used in the capital stock adjustment needs to be discounted by the estimated proportion by which road stock is and has been funded by 50% NNR grants. A broad rule of thumb estimate may be required as a practical matter, but if the proposition here is conceptually sound, any plausible estimate will be material.

2. At present the contribution that relevant user charges makes to the funding of capital assets is not allowed for. At present user charges which offset expenditure needs, such as hospital charges, are effectively set against only operating expenses.[8] In principle user charges should be assessed as an offset to capital costs as well as to operating expenses. Road tolls for example reduce the net scale of the burden on the budget for both maintenance and capital expenditure. It seems to follow, that asset values should be adjusted downwards to the extent of the contribution from user charges.

3. It is essential that disability assessments related to population scale operate at a contemporaneous up to date level. If administrative scale disability factors are understated and out of date, the injection of disability factors into the 'work around' will not adequately modify (mitigate) the pure population dilution calculation for the emergence of economies of scale. See also the section on administrative scale.

4. Also the capital stock adjustment is incomplete in that only the adverse arithmetic dilution effect of population growth is taken account of. Clearly there are advantages of high growth (average age of technology imbedded in the capital stock is likely to be lower). This might be hard to quantify compared with the readily computable dilution effect but in the situation of such a heavily leveraged assessment, the consequences of imbalance in the recognition of conceptual population growth effects are substantial. A discounting of the infrastructure assessment seems called for on this account.

---

[8] The exception to this may be in the urban transport area where the proposed net operating cost assessment inclusive of depreciation expense because of a lack of data to enable the hiving off of depreciation into a lumpen depreciation category, may, inconsistently with the general scheme, involve an effective pro rata offsetting of user charges against depreciation expense. (The offsetting of relevant user charges on a functional basis is a readily deliverable feature of the holding cost model).

NET LENDING

Aside from temporary fluctuations in valuations of employee liabilities and financial assets, long term public sector net worth stems from the application of accumulated operating surpluses of general government, PNFCs, and PFCs, liquidation of (upvalued) land assets; and revaluation of assets in PNFCs and general government.

Net worth equalisation can be analysed in the following components:

a) Land – general government and non-commercial PNFCs. This is excluded appropriately from a population growth disability calculation. Population growth is a generator of value for government land holdings

b) Physical assets –general government and non-commercial PNFCs – included in Infrastructure assessment

c) Borrowings – included in the NFW dilution calculation. The dilution of borrowings by population growth is a benefit. Investment funded by an increase in borrowings gives rise in the NFW dilution calculation to an offset to population growth fiscal disability initially captured in the Infrastructure assessment.

d) Net superannuation and other employee liabilities – included in the NFW dilution calculation as a form of borrowings from employees

e) Net assets (Equity) in commercial PNFCs – arises partly from retained earnings and largely from asset revaluations. It is the inclusion of net assets of PNFCs in the NFW balance for the Net lending needs calculation which overwhelms the recognition of the *positive* benefit from population growth in dilution of accumulated debt.

f) Net assets (Equity) in Public Financial Corporations (PFCs) – accumulated surpluses, including from actuarial valuation of liabilities and mark to market valuation of financial assets.

South Australia has concerns about the one sided nature of the Commission's population growth assessment. (These are taken up in this section even though they are more readily framed in terms of drivers of net worth levels including the application of annual net operating surpluses, rather than in relation to annual borrowing requirements and debt levels.[9])

South Australia proposes that it is not common sense that only fiscal *advantage* is generated by low population growth for the accumulation of net worth. Yes accumulated net worth suffers less dilution but South Australia suggests it is surely telling that Western Australia and Queensland have the highest net worth per capita (aside from the legacy effects of net worth transfers to Australia Capital Territory upon self – government).The much higher net worth per capita in those two high growth jurisdictions seems larger than explained by accumulated deficiencies in the contemporaneity of mining revenue equalisation.

[9] Borrowing for the purposes of buying long life assets for their service potential such as hospitals, police stations etc is neutral for net worth (absent unanticipated valuation effects).

For example, separation payments for redundancies have had a major adverse fiscal impact on South Australia over the last 10 years compared with a savings strategy based on a freeze or lesser rate of recruitment. A low revenue growth environment makes it infeasible to rely on recruiting freezes to achieve efficiency gains in expense ratios.

South Australia acknowledges the Commission is partly recognising the positive fiscal effects of population growth in respect of land values by excluding general government land from the net worth dilution calculation, and that recognition would now extend to land owned by non –commercial PNFCs. But land still forms part of the assets of commercial PNFCs and thus the NFW, and more generally, the 'franchise' value (cash realisable value above accounting net assets) of commercial PNFCs is enhanced by population growth.

South Australia proposes that

- only the liabilities component of NFW be assessed in respect of the Net lending deficit – this would make more transparent how population growth needs for investment are neutralised to the extent that investment is funded by net borrowings. This is (properly) a feature of the current methodology and if made more transparent may alleviate concerns about the excessive scale of the investment assessment;

- the remaining NFW balance (Equity in PNFCs and PFCs) should then be separately assessed on a substantially discounted basis; and

- the Commission seek data from the states on redundancy payments perhaps over the last 10-15 years.

INDIGENEITY (INCLUDING SOCIO-ECONOMIC STATUS) – PRIORITY ISSUE

In principle, and subject to further clarification on the application of the new methodology to relevant assessments, South Australia is comfortable with the option of replacing SEIFA with IRSEO for the Indigenous population to appropriately capture the characteristics of this population to meet the terms of reference requirements. This is supported by the evidence provided by the CGC that some of the variables used in SEIFA appear to capture aspects of disadvantage that are specific to non-Indigenous people, such as separated or divorced, one parent families, people aged over 70 with long term health conditions or disability and people employed as machine operators or drivers.

We also consider it pragmatic to use IRSEO rather than develop a new index as IRSEO was designed specifically to capture Indigenous specific measures. Our understanding from the CGC telepresence meetings with States is that the IRSEO index can be readily updated with new census data.

The CGC has commissioned the ABS to produce a SEIFA index using data for the non-Indigenous population.

The ABS comparison of SEIFA 2011 IRSD with the non-Indigenous SEIFA showed that for a large number of variables the population of non-Indigenous people in the NT has a low prevalence of highly disadvantaged variables compared to the other States.

South Australia supports replacing SEIFA with an ABS produced non-Indigenous SEIFA for the non-Indigenous population as the ABS has reported that there is a notable difference between the results from the SEIFA 2011 IRSD (which includes Indigenous people) and the non-Indigenous SEIFA.

ADMINISTRATIVE SCALE

The need to recognise the cost of providing a minimum level of administration (regardless of size/population) has been considered and debated in previous reviews. The Commission has correctly concluded that inclusion of administrative scale is a relevant disability factor and should influence relativities.

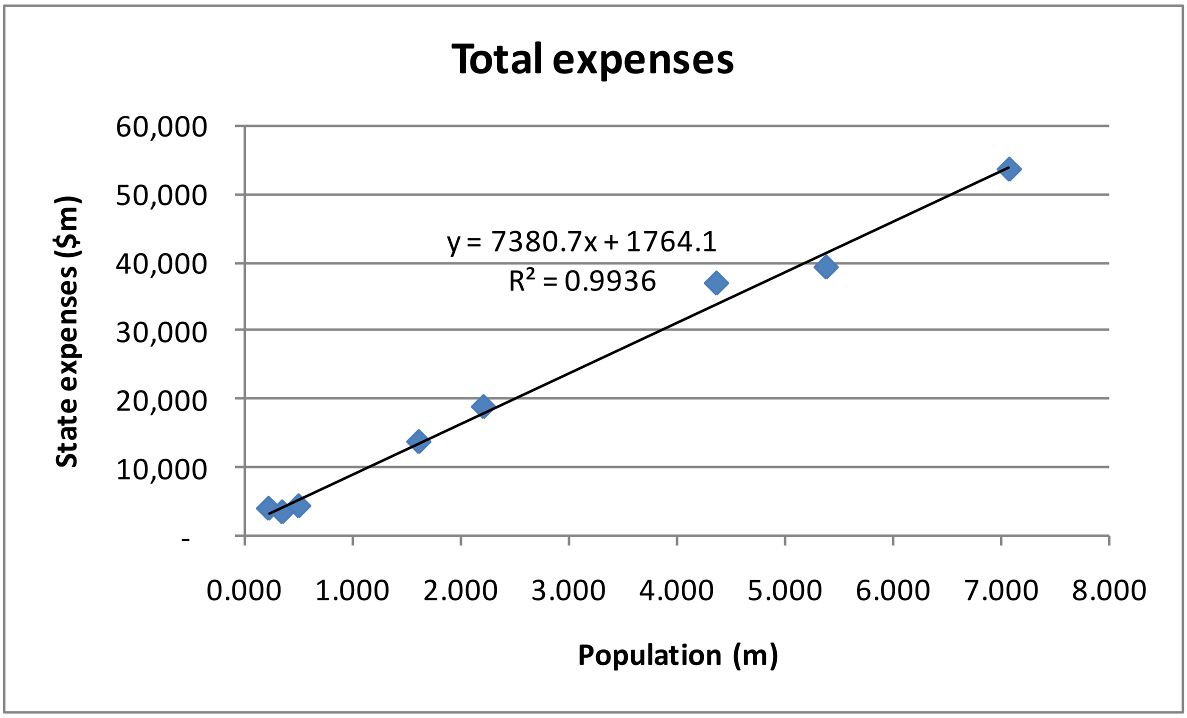
South Australia acknowledges that there are practical limitations in collecting data to support a detailed rebasing of the administrative scale quantum. However, there is sufficient data to support an upward adjustment to the current quantum.

In the Chapter 27 of the Staff Discussion paper on proposed assessments, Commission staff examined the minimum cost of providing school services ("*Regression approach using ABS GFS data*"). This produced a minimum cost estimate of $189 million per state to provide school services. This amount was considered by Commission staff as being too high.

South Australia is concerned that the results of this analysis have been dismissed on the basis of a simple comparison with the current quantum - a quantum that is based on very dated data and assumptions. This analysis appears to provide a strong case for an upward adjustment to the administrative scale quantum and appears to be based on a reliable and appropriate data source.

The use of ABS GFS school education expenditure is a more comprehensive data source than the Productivity Commission data on out-of school staff and student numbers which is the basis for the other regression approach discussed in the staff discussion paper.

There is other Commission analysis that supports an increase in the quantum. In the Data Working Party - Administrative Scale paper (CGC 2011-05, page 7), total State GFS expenses were plotted against state populations to derive a cost curve where the intercept can be interpreted as representing the total quantum of administrative scale costs. This curve (based on ABS GFS data for 2008-09) is shown below:



This analysis supports an administrative scale quantum, per state, of around $1.7 billion. Although a figure of $1.7 billion per state appears high it supports the position that the current administrative scale amounts that range from $227 million to $255 million per state (2011-12 CGC estimate) are too low and are not capturing all relevant costs.

South Australia believes that the administrative scale quantum requires a "step" increase to reflect current circumstances. There is sufficient evidence to support a significant increase (possibly a two or three-fold increase) in the quantum.

South Australia notes that the Commission has been prepared to use comparable statistical analysis in some assessments (urban public transport) in respect of an observed regression relationship of expenditure to scale of population.

The Commission should not be deterred from a step change in this assessment on account of the strong budgetary circumstances of the ACT. The ongoing strength of the ACT budget stems from the very favourable terms of commencement of self government on ACT net worth. If necessary this is appropriately addressed by a transitional adjustment in the Net lending assessment to level up the net worth starting points as between the two outlying territories.

INTERSTATE WAGES

It is South Australia's view that the interstate wages assessment should not continue. Public sector wages are clearly greatly affected by policy differences across states. The sub-set of private sector wages relevant to state government employees insofar as there is a regional labour market are also not 'policy neutral' in respect of State governments.

Should the Commission continue with an interstate wages assessment, based on either whole-of-state or capital city private sector wages, then it should be discounted by 50%.

There are analytical and data quality reasons for this view.

Analytical

The Interstate wages assessment is based on the premise that State governments face differences in public sector wage costs that are beyond the control of state governments.

In using private sector wages as the basis of estimating state differences faced by governments there is a basic assumption that the public sector is a 'wage taker', with the prevailing wage levels set by the private sector and with private sector wages being 'policy neutral' in respect of State governments.

However, if the public sector is the ‘wage setter’ for the private sector then State government policy decisions would feedback from public sector wages to private sector wages which would therefore also be state government policy contaminated.

The assumption that the public sector is a ‘wage taker’ would be plausible if public sector employment is relatively small in comparison to the private sector.

Dr Tom Karmel, has investigated this assumption empirically for the SA Department of Treasury and Finance. His work has focussed specifically on the human capital characteristics of workers employed by the public sector. What matters is the size of the public sector in that part of the labour market most relevant to the public sector. A copy of Dr Karmel’s report is provided in Attachment C.

His approach is based on the idea that the labour market comprises a distribution of human capital from which the public sector recruits, and that the public sector will recruit more actively in certain parts of that distribution.

Using data from the CURF of the 2009 Survey of Education and Training, and the results of separate logistic regressions for males and females of the probability of an employee working in the public sector, he demonstrates that the public sector is a very big employer for some groups of people. In particular the public sector is more important than the private sector for those employees with bachelor and post-graduate qualifications, particularly in the areas of health and education. Clearly in those areas where the public sector is the dominant employer it is likely that public sector wages will influence private sector wages.

Dr Karmel concludes in his report that the analysis raises an important issue in respect of the use of private sector wages as the 'policy neutral' benchmark. Specifically, for a significant part of the labour market in which the public sector is competing, the public sector has a very large if not dominant position. This means that the public sector is most likely affecting private sector wage levels. It is not true that private sector wages are a 'clean' benchmark unaffected by government recruitment, particularly at the skilled end of the labour market.

South Australia has previously submitted that the Australian labour market in respect of both public sector and private sector occupations has a partly regional and partly mobile national character, eg head office type employment. The existence of apparent interstate differentials in wages is not conclusive in favour of the view that the private sector labour market is wholly regionalised. What accounts for such differentials in an entirely integrated single capital market? Why don’t employers locate so as to eliminate wage cost differentials? It must presumably be because of unit productivity differences. There could be a number of sources for these differences but it cannot be ruled out that some element comes from labour quality differences from variables outside the SET dataset.

The wholly regionalised public / private labour market model implicitly lying behind the Commission's assessment is not empirically established in respect of 2009 SET data as can be seen in Figure 28-2 from the relationship between private sector and public sector State variations. What positive relationship there is, is much less than a 45 degree line, and more importantly, the relationship is statistically unreliable particularly with regard to the influence of the data points for the Northern Territory, the Australian Capital Territory and Tasmania.

Data quality

Due to the data quality issues, there is a case for the Commission to use a higher point in the confidence range than the mid-point (Figure 28-10). Use of a two thirds confidence interval would result in less variation away from the national average but would still be the same sign as a 50% confidence (mid point) assessment.

Capital city or whole of state.

South Australia does not support a capital city based assessment.

The significantly different results obtained from the capital city and whole-of-state assessments should be grounds for caution because of the reliance being placed on the econometric analysis of SET data without discounting or allowing for the effect of high standard errors on the confidence intervals in either the complete whole of state dataset or the capital city subset.

There seems little logic in moving away from a whole of state private sector wages based assessment for interstate wages to a capital city based assessment and then re-introducing a private sector based loading for regional intra state assessments. The result would remove any recognition of the influence of the attractiveness of some regional locations on state wages levels such as NSW coastal and Victorian regional centre locations.

INTERSTATE NON-WAGES

South Australia supports the proposals to no longer assess freight and to cease the Interstate non-wage assessments as the largest components will be captured by the Regional costs assessment. South Australia is comfortable the CGC's assessment that residual costs are adequately captured by an equal per capita assessment.

REGIONAL COSTS

South Australia supports the proposal to use ARIA as its remoteness classification.

South Australia supports the proposal to utilise the schools regional costs gradient calculated from a regression of ACARA data to assess regional costs for schools.

South Australia does not support the proposal to apply a State specific loading to those States with high regional wages based on the difference between the rest of State private sector wage level and the capital city private sector wage level.

South Australia is not convinced that public sector wage levels in regional locations reflect regional private sector wage levels. Often remote and regional locations are attractive locations to new public sector employees such as teachers and nurses who may be able to secure permanent employment not offered to new labour market entrants in capital city locations. Regional and remote locations are also attractive to public sector employees who can secure a promotion in order to move to these localities, often with a right of return to a capital city after serving a set amount of time in a remote or regional location.

There may be data available for States' regional costs that could be investigated. The Australian Financial Review quotes Western Australian state regional cost data in an article (8 Jan 2014) noting some government workers in the Pilbara are paying rent up to 70 per cent below the median rent in Perth. The Western Australian Government's regional price index underpins the district allowance paid to regional workers.

South Australia supports the proposal to extrapolate the schools regional costs gradient to those categories to which regional costs were applied in the 2010 Review with the exception of Justice Services and to apply the 2010 Review police regional costs gradient only to police.

South Australia supports revising the regional costs gradients before the next review. Our education department considers that improvements will be made to the ACARA data for some time so it will be worthwhile to regularly re-estimate the regional costs gradients that are based on the ACARA data.

South Australia supports the proposal not to apply any discount to the Schools education regional costs factor but does not support the proposal to apply a low discount of 12.5% to the regional costs factor for all other categories to which it is applied. This seems to be an arbitrary decision and it is not clear why a higher discount factor is not warranted.

SERVICE DELIVERY SCALE

South Australia supports the staff proposals.

NATIVE TITLE AND LAND RIGHTS

South Australia supports the staff proposal to include all native title and land rights expenses in the 'Other expenses' category rather than assessing them in a number of categories.

CULTURAL and LINGUISTIC DIVERSITY (CALD)

South Australia accepts the Commission's analysis which provides evidence for ceasing assessing cultural and linguistic diversity. It is our view that differences in cost and services usage between birthplace groups and conflicting data on intensity of service use mean it would be highly problematic and subjective to apply disabilities to expenditure assessments on the basis of cultural and linguistic diversity.

Further, the regression analysis conducted by Commission staff indicates that 'language background other than English' is not a statistically significant influence on the cost of public school education.

POPULATION

South Australia supports the staff proposal to use ERP for its population estimates, to use 31 December estimates for total population level estimates and to use 30 June estimates for population growth, or where disaggregated population data are required. In our view where people reside is a better measure for service use than any other data as administrative data collections are based on place of usual residence. Administrative data sets are more likely to be nationally comparable than other data sets. Survey data tends to be unreliable because of the large standard errors associated with small sample sizes, either for groups of specific interest such as FIFO workers or for the smaller jurisdictions.

South Australia does not support the staff proposal to adopt a standard approach to the selection of age groups in assessments. Data should be 'fit for purpose' and the best available data should be used. People 85 years of age and over have different service delivery needs to the age group who are under 85 years of age. With healthier lifestyles and improvements in medical care, the elderly tend to experience poor health now at older ages, are able to stay at home longer and enter nursing homes at older ages, usually around 85 years of age.

The reasoning that having a common age structure with fewer unique categories would reduce the size of data sets required, thus simplifying the assessments and reducing the prospect of errors is not a convincing argument. Disabilities in assessments should be calculated using the most appropriate data. Rather the converse should be argued as modern computing facilities allow for the use of large data sets and ensure more robust statistical analyses can be undertaken with ease.

South Australia supports the adoption of the ABS remoteness areas as the standard classification of remoteness.

South Australia supports the use of UCLs as the primary measure of assessments that relate to urban form and agrees with the staff proposals to aggregate UCLs within a Significant Urban Area for the Transport services category and the aggregation of mesh blocks for towns of below 200 people.

South Australia Department of Treasury and Finance
February 2014

Contact Officers:

Katrina Ball
Director, Intergovernmental Relations
08 8226 9698
Katrina.Ball@sa.gov.au

Robert Schwarz
Policy Advisor, Intergovernmental Relations and Revenue
08 8226 9433
Robert.Schwarz@sa.gov.au

Mark Collins
Principal Economic Analyst, Intergovernmental Relations
08 8226 3833
Mark.Collins@sa.gov.au

Attachment A

Advantages of a simplified capital assessment model

The advantages of the simplified model are considered to be:

- The depreciation plus holding cost augmentation in an operating statement framework is considered more explicable than depreciation plus net investment augmentation (in a number of respects including avoiding double count/ time inconsistency concerns).

- The Depreciation/use of physical assets assessment occurs on a functional ie expenses category basis. The complicated weighting and reweighting of physical assets to produce weighted average aggregate relativity factors to insert into the population dilution needs calculation is avoided.

- Single simple population dilution calculation based on year average net worth to align with year average population

- The upfront net worth assessment, which is in lieu of an emerging over time assessment of *income* on net worth, is kept separate from the use of physical assets *expenses* side assessment.

- A depreciation and holding cost assessment for own asset services is neutral with respect to payments for outsourced asset services eg for urban public transport, which embody depreciation and holding cost charges.

A possible disadvantage is the need to specify a holding cost rate.

Attachment B

Extract from the 28th edition of the Australian Gambling Statistics publication (December 2012)

SUMMARY TABLE E
PER CAPITA GAMBLING EXPENDITURE
2009–10

	ACT	NSW	NT	QLD	SA	TAS	VIC	WA	AUSTRALIA
GAMBLING FROM					Value ($)				
Off-course bookmaker	-	-	-	-	0.00	-	1.92	-	0.48
On-course bookmaker	2.14	4.69	1,382.45	-	1.34	0.55	3.59	1.07	16.04
On-course totalisator	0.89	6.42	17.75	-	-	3.50	18.43	7.14	7.69
TAB	95.54	141.83	130.73	103.08	104.31	237.53	134.63	137.24	130.34
Total Racing	**98.56**	**152.94**	**1,530.94**	**103.08**	**105.65**	**241.58**	**158.56**	**145.44**	**154.56**
Casino	71.51	132.31	664.87	162.21	109.72	280.62	308.93	308.85	206.26
Gaming Machines	626.87	856.78	421.87	523.47	570.18	309.26	607.81	-	599.07
Instant Lottery	7.73	2.04	9.69	26.72	9.98	11.87	3.69	21.38	10.31
Interactive Gaming	-	-	-	-	-	-	-	-	-
Keno	3.29	20.28	54.37	26.28	15.11	64.68	1.37	-	15.34
Lotteries	3.33	1.09	-	0.14	-	0.63	0.40	-	0.55
Lotto	66.71	19.22	101.52	100.85	74.82	79.77	97.87	155.68	76.13
Minor Gaming	-	-	-	-	-	-	-	11.47	1.17
Pools	0.33	0.13	0.14	0.52	0.24	0.31	0.25	0.56	0.30
Total Gaming	**779.77**	**1,031.86**	**1,252.45**	**840.20**	**780.06**	**747.16**	**1,020.32**	**497.93**	**909.13**
Bookmaker (and other) Fixed Odds	-	1.01	509.19	-	0.05	-	0.95	0.04	5.50
Bookmaker (and other) Pool Betting	-	-	-	-	-	-	-	-	-
Tab Fixed Odds	-	15.06	-	4.49	5.90	2.25	18.02	10.74	11.89
Tab Tote Odds	-	0.60	-	0.22	-	0.12	0.50	0.29	0.40
Total Sports Betting	**-**	**16.68**	**509.19**	**4.71**	**5.95**	**2.37**	**19.46**	**11.07**	**17.78**
2009-10	**878.33**	**1,201.47**	**3,292.58**	**947.98**	**891.66**	**991.10**	**1,198.34**	**654.44**	**1,081.48**

Notes: These data should be read in conjunction with the explanatory notes, and footnotes from State and Product Tables.

Attachment C

Is the public sector a 'wage taker'?

By Dr Tom Karmel and Patrick Lim

Prepared for SA Department of Treasury and Finance, January 2014

1. Introduction

In the 2010 Grants Commission review, the Commission decided that there were differences in wages across States which reflected differences in labour markets that were beyond the control of State governments. This was considered to be a factor that needed to be assessed.

Following on from the review the Commission undertook econometric analysis of private sector employees using the 2009 Survey of Education and Training as the latest available data. The analysis was based on a Mincer type wage equation in which log of wages was regressed against log hours, educational qualifications, field of study, gender (with interactions) and a number of other controls. Interstate differences were estimated by simple State dummies.

In using the private sector wages as the basis of estimating state differences in the wages there is a basic assumption that the public sector is a 'wage taker', with the prevailing wage levels set by the private sector and with private sector wages being 'policy neutral' in respect of State governments. This assumption would be plausible if the public sector were relatively small in comparison to the private sector.

The purpose of this paper is to test this assumption specifically in relation to the type of workers employed by the public sector. The approach is based on the idea that the labour market comprises a distribution of human capital from which the public sector recruits, and that the public sector will recruit more actively in certain parts of that distribution. What counts is the size of the public sector in that part of the labour market most relevant to the public sector.

Our approach is to model the probability of being a public sector employee as a function of an individual's human capital. This allows us to estimate the probability of being in the public sector for any individual, and these probabilities can be aggregated for groups of individuals in the labour market relevant to the public sector.

Our empirical analysis is based on the confidentialised unit record file from the 2009 Survey of Education and Training.

In the next section, we briefly present the specification of our model. Section 3 contains our empirical results. We end with some overall comments.

2. . Our human capital model

Our approach is to model the probability of being in the public sector as a function of a range of human capital variables. We employ a Mincer type model which regresses (logistically) whether an individual is in the public sector or not against a rich set of human capital attributes:

- education: post-graduate, bachelor, diploma; certificate III/IV, year 12 (without a certificate III/IV or higher), did not complete school (plus a final category which is difficult to interpret consisting of certificates undefined and unknown [10])
- field of education interacted with level of education for those with a post-school qualification of certificate III/IV or higher). The fields are the same as those used by the Commonwealth Grants Commission.
- experience (and experience squared) interacted with level of education, reflecting that the life time profile of being in the public sector or not may differ depending on level of education (for example, tradespeople face a very flat experience profile).
- migrant status (using a similar approach to that of the Commission).

3. Results

The model used for the predictions is for all of Australia, based on the 2009 Survey of Education and Training. The sample base for the predictions is the sample of public sector wage and salary earners for all of Australia. That is, we use the distribution of human capital in the public sector as the basis for predicting the probability that a person with a certain level of human capital is in the public sector.

Our approach allows us to estimate the probability of being in the public sector for each individual. We summarise the results by making these predictions for individual and then aggregating them. We could for example aggregate the predictions over the whole sample, but this would not take into account that the public sector will be more important for some types of human capital than for others. In order to make the predictions line up with the structure of the labour market pertinent to the public sector we make the predictions for each public sector employee and then aggregate.

This allows us to tabulate (see table 1) the probability of being in the public sector for the distribution of people in the public sector. This is a little counterintuitive because the probability of being in the public sector for a public sector employee is clearly 1. So the way to think of this is to note that our approach is equivalent to estimating the probability of being in the public sector for every possible variation of human capital allowed by our model, and then aggregating these predictions by the distribution of human capital in the public sector. That is, our predictions are relevant to everyone in the workforce but weighted to reflect the labour market relevant to the public sector.

[10] The number of public sector employees in this category is very small.

Table 7: Probability of being in the public sector, by education, weighted to reflect the public sector labour market

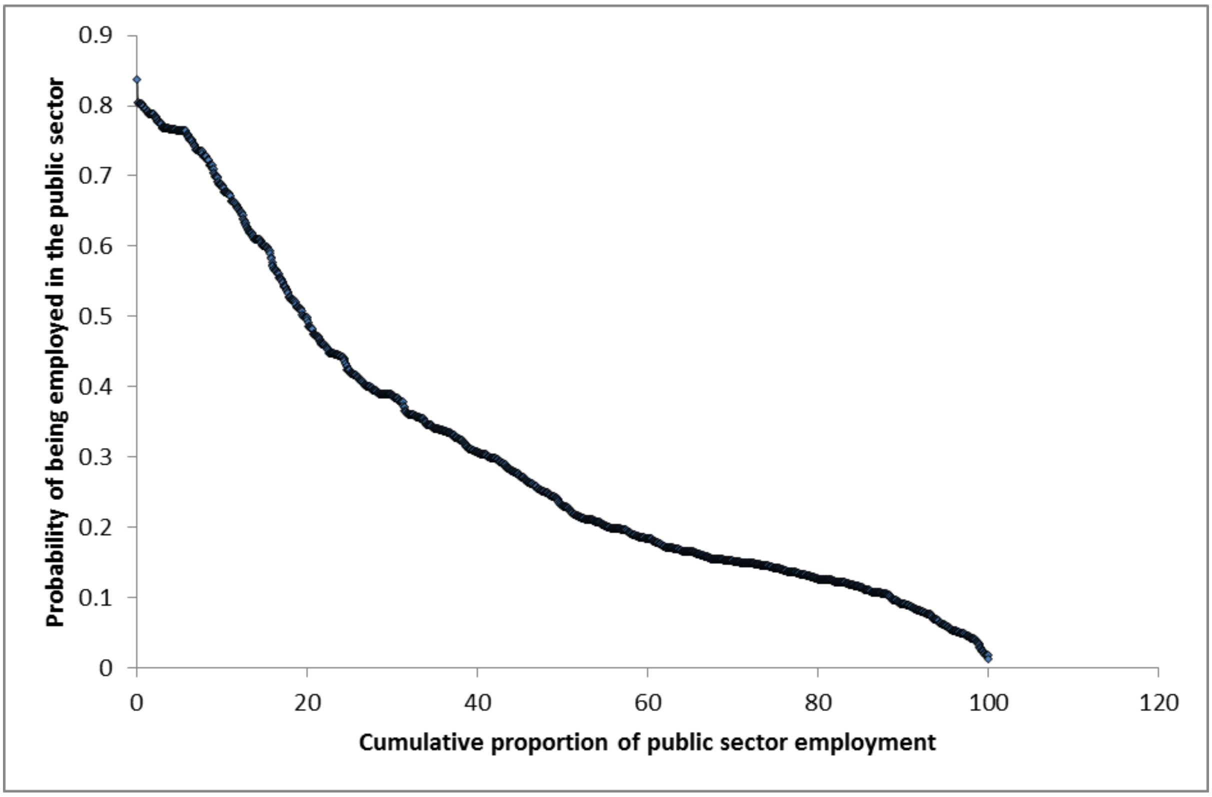
Qualification Level	Probability of being in the public sector	Share of public sector employment (%)
Males		
Postgrad	0.55	9.7
Bachelor	0.40	9.0
Dip/Advanced Diploma	0.32	5.0
Certificate III/IV	0.18	6.9
Year 12	0.16	5.6
School lower than Year 12	0.12	5.1
Other quals including Cert I/II	0.30	0.8
All Males	0.32	42.2
Females		
Postgrad	0.60	13.3
Bachelor	0.50	16.8
Dip/Advanced Diploma	0.38	8.4
Certificate III/IV	0.26	6.4
Year 12	0.17	5.6
School lower than Year 12	0.14	6.6
Other quals including Cert I/II	0.24	0.6
All Females	0.40	57.8
All persons	0.37	100.0

Source: Authors' calculations using the basic CURF of the Survey of Education and Training, 2009 (ABS 2009, cat no. 6278.0)

We see that overall the probability of being in the public sector for individuals with the type of human capital found in the public sector is around 0.37. It is higher for females (0.4) and is related to educational qualifications. In particular, the public sector is more important for those with bachelor and post-graduate qualifications, especially the latter. In this respect, the probability of being the public sector for those with a post-graduate qualification is 0.55 for males and 0.6 for females.

An alternative representation of the results is given in the two figures below. They are constructed by sorting the data from the individual with the highest probability of being in the public sector to the individual with the lowest.

Figure 1: Probability of being in the public sector, from the highest to the lowest, weighted to reflect the public sector labour market, Australia, males

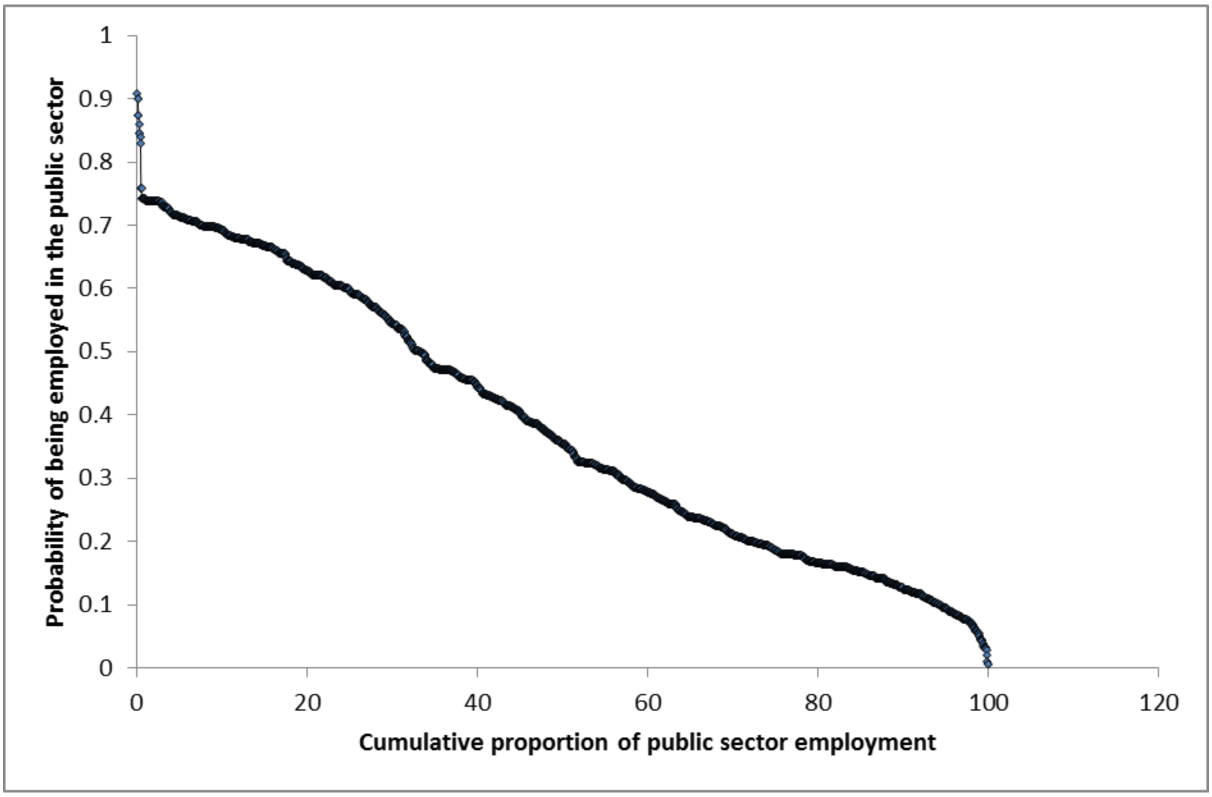


Source: Authors' calculations using the basic CURF of the Survey of Education and Training, 2009 (ABS 2009, cat no. 6278.0)

For males, we see that around 20% of public sector employees have human capital such that the probability of being in the public sector is greater than 0.5 (for that human capital), with around 10% having a probability greater than 0.7. For females the probability is somewhat higher, with over 30% having a probability of being in the public sector greater than 0.5.

Thus there is little doubt that the public sector is a very big employer for some groups of people, throwing into doubt the assumption that the private sector can be taken as the price setter. Clearly, in some areas the private sector is having to compete for labour, and therefore it is likely that public sector wages will influence private sector wages. The earlier table suggests that this tends to be in areas where people are highly qualified, for example with degrees or post-graduate degrees. In fact, the highest probabilities of being in the public sector are for those with post-graduate degrees and the model results show that the probabilities are particularly high for health, education and agricultural fields of study.

Figure 2: Probability of being in the public sector, from the highest to the lowest, weighted to reflect the public sector labour market, Australia, females



Source: Authors' calculations using the basic CURF of the Survey of Education and Training , 2009 (ABS 2009, cat no. 6278.0)

4. Concluding comments

The analysis does raise an important issue in respect of the use of private sector wages as the 'policy neutral' benchmark. Specifically, for a significant part of the labour market in which the public sector is competing, the public sector has a very large if not dominant position. This means that the public sector is most likely affecting private sector wage levels. It is not true that private sector wages are a 'clean' benchmark unaffected by gove rnment recruitment, particularly at the skilled end of the labour market.