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Queensland Government

Queensland Treasury Response to Commonwealth Grants Commission

Response to Terms of Reference for Commonwealth Grants Commission 2015 Methodology Review

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Contact Officer:
Frank Ravalli
Intergovernmental Relations Branch
Queensland Treasury
(07) 3035 1464
frank.ravalli@treasury.qld.gov.au

SUMMARY

Queensland welcomes the opportunity to provide a response to the Australian Government's terms of reference for the 2015 Methodology Review.

Given the limited timeframe for this Methodology Review it is appropriate that the terms of reference do not deal with the more global issues to do with the need for and the objective of horizontal fiscal equalisation but focuses on design issues of the existing assessment process. While Queensland still adheres to the positions on the higher level issues we articulated in our submissions to the GST Distribution Reviews, this response focuses on the more detailed issues relevant to the terms of reference.

Queensland considers that reform of the **mining revenue assessment** should be the priority issue of the 2015 Review. No other single assessment redistributes so much, and the GST Distribution Review called for a new mining revenue assessment to be developed at the earliest opportunity. The Commission needs to turn a fresh pair of eyes to its review of the mining revenue assessment. In particular:

- A discount needs to be applied to the mining revenue assessment to reflect the expenditures incurred by resource states that effectively offset mining revenues. To this end, Queensland considers that the Commission should develop a data request so that mining related expenditure needs can be fully examined in a way that is consistent between states.

- Further, the incentive to develop the mining industry needs to be encouraged and preserved. Queensland notes that a 50% discount applies to mining revenue in the Canadian system.

- Also, a single rate structure needs to replace the two-rate structure to both simplify and remove the grant design effects of the current assessment.

In relation to other assessments:

- Queensland does not consider that a strong case for extending the scope of the current assessment framework to include **public trading enterprises** has been made at this stage.

- The **simplified and integrated assessment framework** proposed by the GST Distribution Review is based on several misconceptions, holds no advantages over the current framework and should be rejected.

- While not opposed to the consideration of raised **materiality thresholds**, Queensland suggests that greater consideration be given to the reliability of assessments when balancing the desirability of removing certain assessments.

- Queensland proposes that the most suitable treatment of **Commonwealth rail infrastructure payments** going forward would be through the designation of

"national significance", and therefore application of concessional treatment, on a case by case basis by the Commonwealth in consultation with the State/States at the time of decision-making by the relevant governments on that project.

- Queensland believes it is important that the Commission's assessments reflect the most reliable and **up-to-date data** available and therefore does not support the GST Distribution Review's recommendation that newly available data be used only to inform changes in States' circumstances in the most recent assessment year, and not previous years.

- The investigation of **equalising interstate costs** on a 'spend gradient' basis should not be a priority of the Review. The discussion of this recommendation in the Review of GST Distribution Final Report provides little detail on how this might be done, and limited justification for equalising costs on such a basis.

- Queensland considers the Commission's suggested approach to the assessment of state disability expenses in a scenario where expenditure under the **DisabilityCare Australia** program becomes the average state policy to be generally reasonable and will provide further comments when the Commission has further developed their proposal.

- As the arrangements for states under the **National Education Reform Agreement** are still being negotiated, it is too early for either states or the Commission to reach definitive positions on how the NERA should be treated in the Review methodology. In general, Queensland considers that the Commission's primary concern should be implementing the methodology that best reflects horizontal fiscal equalisation, while being consistent with other Terms of Reference instructions.

- Queensland believes that serious consideration should be given to the use of a **broad revenue indicator**, such as household disposable income, to replace most if not all of the revenue assessments. Such an approach would result in significant simplification, have a strong economic justification and remove any grant design effects that exist with the current set of revenue assessments.

- A detailed review of the assessment of **transport services expenses** should be undertaken as part of the 2015 Review, including the methodology and data used in the assessment.

- Queensland considers that some of the **Location assessments** need to be reviewed, in particular those relating to Interstate Wages and Non-wage costs. Queensland does not believe that there is evidence that differences in the level of disadvantage of states' Indigenous populations can be explained by factors other than those already recognised.

- Given the short timeframe of this Methodology Review, lower priority should be given to issues of **Administrative scale**, **Water and wastewater** and **Roads**.

INTRODUCTION

Queensland welcomes the opportunity to provide a response to the Australian Government's terms of reference for the 2015 Methodology Review.

As you may be aware, Queensland provided a number of individual and joint submissions to the Australian Government's Review of the GST Distribution. In these submissions, we argued the need to reconsider the objective of horizontal fiscal equalisation, reform the structure of equalisation, and redesign specific assessments.

The GST Distribution Review articulated the need to reform the current system of federal financial relations, including the distribution of GST, in Chapter 12 of its final report. We understand that these higher level issues will be considered in a process separate to this Methodology Review.

Given the limited timeframe for this Methodology Review it is appropriate that the terms of reference do not deal with these global issues but focus on design issues of the existing assessment process. While Queensland still adheres to the positions on the higher level issues we articulated in our submissions, this response focuses on the more detailed issues relevant to the terms of reference.

While not generally considering the design issues in relation to specific assessments, the GST Distribution Review did make findings and recommendations in relation to several key assessments.

In particular, the Review recommended that the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. Moreover, the Review also recognised the need to compensate for the fact that some mining related needs of the resource States are not fully recognised and proposed an interim discount of the mining revenue assessment until a more appropriate discount could be ascertained in this Methodology Review.

This mining revenue issue is dealt with further below, but it is hoped that the Commission will embrace the sentiment of the Review's recommendations and show a willingness to turn a fresh pair of eyes to its consideration.

More broadly, and in the absence of more fundamental changes and given the short time for the Review, Queensland believes the starting point for the review of the current system is the existing architecture, framework and set of assessments. Queensland also supports the key pillars of the current system, namely that assessments should:

- be based on what States do
- be policy neutral
- be based on reliable data and methods while being as simple as possible
- deliver equalisation that reflects State circumstances in the year the funds are used.

Where Queensland proposes changes to existing assessments, it is to produce an assessment that better embodies these four pillars.

ARCHITECTURE ISSUES

Given the short timeframe for this Methodology Review, Queensland supports this Review's focus being on methodological issues where significant improvements could potentially be made. With this as the focus, Queensland does not consider it practical to make significant changes to the architecture of HFE. For the purposes of this Review, Queensland therefore supports retaining from the 2010 Review methodology:

- The definition of HFE;
- The supporting principles (that equalisation be implemented through methods that reflect what states do, are policy neutral, practical, and contemporaneous); and
- The scope of the assessment framework.

Scope of the assessment framework

Queensland supports retaining the current scope of the assessment framework, which is limited to general government activities, including states' subsidies to and revenues from public trading enterprises (PTEs). As part of this Review, Queensland understands that the Commission may decide to investigate extending the scope to include a detailed examination of PTEs.

Queensland does not consider that a strong case for extending the scope has been made at this stage, and is concerned that such an extension would:

- impose an undesirable data collection burden on commercial organisations;
- be difficult to implement given that:
    - much of the information the Commission would wish to collect about these organisations may be commercial-in-confidence. This may make it difficult for the Commission to ascertain details of service delivery, policies and financial information;
    - developing assessments that are consistent across states will be problematic considering the range of activities undertaken by PTEs and potential difficulties in obtaining data;
- necessitate a more fundamental review than is envisaged for the 2015 Methodology Review. If a major change is made to the assessment framework, it may not be possible to treat the current methodology as the starting point, and only revisit assessments where there is a prospect of significant improvement. A larger scale review may not be desirable given the short timeframe allowed by the terms of reference; and
- introduce significant further complexity to the assessment methodology when the Commission's aim, consistent with its Terms of Reference, should be to simplify wherever possible.

Queensland believes that a strong case needs to be made that an extension of the current assessment framework to include a detailed examination of PTE activities beyond their direct interaction with the general government sector would deliver significant enhancements to the equalisation of state and territory fiscal activities. Otherwise further work in this area may prove to be an unhelpful distraction for this Review, which has higher priority considerations.

Simplified Assessment framework

Terms of Reference 2(e)

Examine the merits of adopting a simplified and integrated assessment framework.

GST Distribution Review Recommendation 6.3

That the CGC examine the merits of adopting a simplified and integrated assessment framework in its next methodology review.

The Terms of Reference ask the Commission to give consideration to a "simplified assessment framework", as discussed in section 6.3 of the final report of the GST Distribution Review.

Queensland believes this section of the final report makes unsubstantiated assertions about problems arising from the current assessment framework. It also proposes an alternative framework that is, at best, no better and often less accurate and practical than the current framework. A number of the issues raised in the section had already been raised and dismissed in the 2010 CGC Methodology Review. Therefore, Queensland argues that the Commission should reject this recommendation of the GST Distribution Review.

It is Queensland's view that the analysis in this section of the final report is flawed and in particular that:

- the investment and depreciation assessments measure effects that are conceptually different, and therefore there is no double counting by these assessments;
- the current net lending assessment can accommodate the recognition of the capital needs of PTEs (for example, differences in states' capacities to earn a return on their holdings in PTEs). If it were shown that these exist – noting that the 2010 Methodology Review failed to identify them – measures of disabilities could be applied, in a similar way to the application of disabilities in the Investment assessment;
- the current capital assessments are, in themselves, relatively simple. Measures have already been taken to reduce their volatility and the capital assessments have, in fact, been less volatile than a number of other assessments;
- the proposed alternative framework provides no benefits beyond the current framework. Both the current and proposed alternative frameworks are consistent with the upfront inclusion of Commonwealth infrastructure payments, can

incorporate population growth needs and, through the calculation of a population growth dilution of net worth, have elements of a balance sheet approach.

- the operating balance approach of the proposed alternative framework is no more “accessible and familiar” than the balance sheet approach of the current framework. In any case, familiarity is not generally a criterion considered in methodology reviews and is therefore not relevant to this discussion.

While Queensland does not consider that it is necessary to change either the assessment framework or the capital assessments (following their recent overhaul in the 2010 Review), if the Commission wishes to revisit these areas, work should focus on:

- whether the method of applying expense disabilities to the investment assessment can be simplified without seriously compromising its accuracy; and
- whether there is a case to apply any additional disabilities within the current framework.

The Investment and Net Lending assessments are discussed further in the capital section of this submission.

SPECIFIC ISSUES RAISED IN THE TERMS OF REFERENCE

Materiality thresholds

Terms of Reference 2(a)

Consider the appropriateness of the current materiality thresholds.

GST Distribution Review Recommendation 3.1 on materiality thresholds

To ensure the system is not driven to become falsely precise, the Panel recommends that materiality thresholds for the next methodology review be set at:

• category total expense or revenue average of $200 per capita

• category redistribution $120 per capita for any State

• disability $40 per capita for any State

• data adjustments $12 per capita.

The GST Distribution Review recommended that the materiality thresholds be raised substantially to deliver greater simplicity and to deny false precision.

Queensland is not opposed to an exploration of the impact of raising materiality thresholds. However, while recognising the GST Distribution Review intention of simplifying the system, Queensland considers that the GST Distribution’s objectives can be achieved more effectively by focusing on both the reliability and materiality of the current expense assessments.

The GST Distribution Review associates the use of less material assessments with ‘false’ precision. This association is not necessarily the case since materiality is not correlated with the reliability of the assessment – an assessment may be highly reliable, but still deliver a relatively small distribution. Therefore the removal of some assessments simply because they deliver a low, though still material (at least for some jurisdictions), redistribution could risk reducing the precision of the system.

Queensland suggests that more of a case-by-case approach should be applied that considers both materiality and reliability in order to come to a determination on whether an assessment should be retained.

The current interpretation of the "what states do" principle assumes that a greater level of detail in the assessment of service delivery will necessarily result in an assessment that more accurately reflects the underlying differences in fiscal capacity. This is not necessarily the case since an unreliable assessment can lead to a lack of precision.

In the 2010 Review, materiality thresholds were defined, but reliability thresholds were not (a specific reliability threshold is more subjective and difficult to define for reliability than for materiality).

This can create a preference for making an assessment wherever there is a conceptual case, and if such an assessment is calculated to be material it is retained, despite any inadequacy of data or concerns over the reliability or comparability of data. Queensland's view is that, in effect, materiality considerations are given greater weighting in the current methodology than reliability considerations.

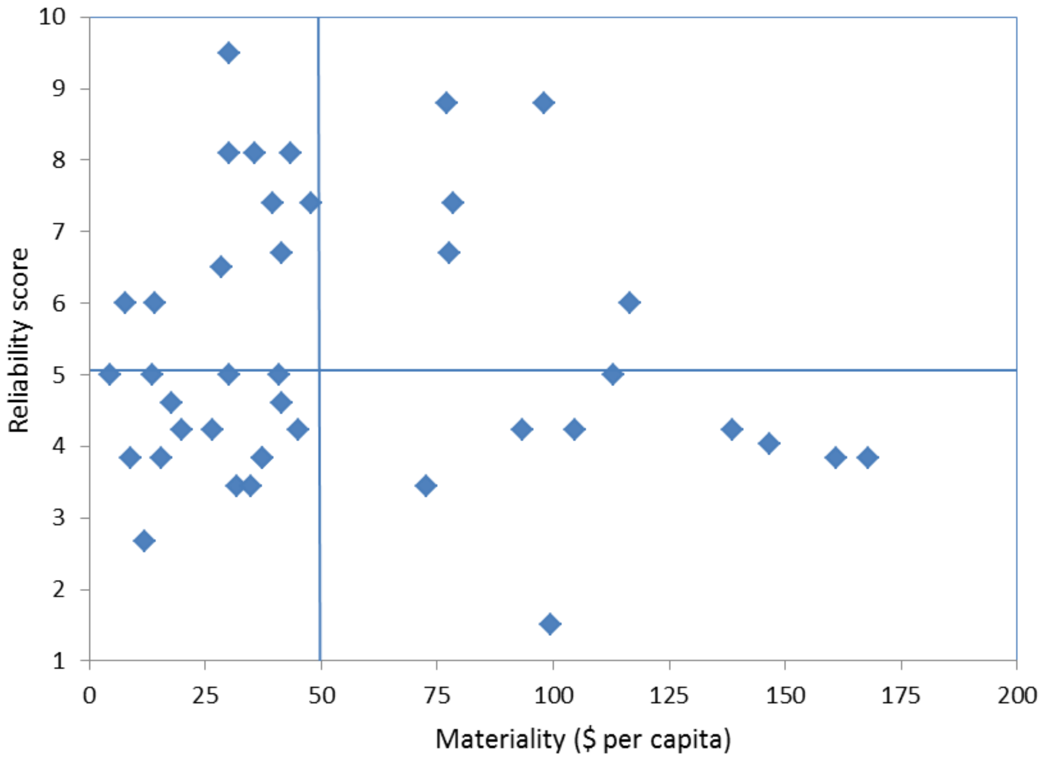
An alternative approach to simplification would be to consider materiality and reliability equally. Although a specific 'threshold' for reliability is difficult to define, it would be possible for the CGC, in consultation with states, to rate the reliability of assessments against criteria such as data reliability, comparability and robustness.

Increased simplification could then be achieved by analysing disabilities against materiality and reliability criteria simultaneously rather than simply raising materiality thresholds – for example, some disabilities may only marginally satisfy current materiality thresholds, but be highly reliable. It is appropriate for these kinds of disabilities to remain in the assessment process, but it may be preferable to remove other disabilities that are more material but less reliable.

As an alternative to simply increasing materiality thresholds or removing unreliable assessments, Queensland would also support the more frequent and increased use of discounts where it could be shown to be appropriate. In this submission, Queensland has proposed that the Commission revisit a number of assessments on the basis that they are unreliable, or the data that underpins them are not sufficiently robust. If more reliable data or methods prove unavailable over the course of this Review, Queensland would support the increased use of discounts in some of these assessments, particularly the Interstate Wages assessment and the Transport Services assessment.

Queensland's preliminary work in its submission to the GST Distribution Review suggests that a consideration of both reliability and materiality has the potential to simplify the expense assessments, while increasing the reliability of outcomes. Chart 1 compares the materiality of current disabilities with their reliability. This represents Queensland's view of the reliability of factors, and the particular factors are material but unreliable, such as urban transport and interstate wage and non-wage factors. A consultative process between the Commission and states could reach a view on the reliability levels of assessment factors.

Chart 1 – Reliability and Materiality of Assessment Factors[1]



A general approach to improve simplicity based on this kind of analysis would be to:

- remove disability factors that have both low materiality and reliability (the lower left quadrant);
- retain disability factors that have relatively low materiality, but are highly reliable (upper left quadrant); and
- focus on improving the reliability of factors that are highly material but relatively unreliable (lower right quadrant). If this is not possible, consideration may need to be given to removing these factors from the assessment.

Chart 1 uses a materiality threshold of $50 per capita as a starting point for considering the removal of factors, or identifying those that should be the focus of improvement efforts. Subject to reliability considerations, this has the potential to produce significant simplification.

Although the analysis of reliability is likely to be more subjective than that of materiality, Queensland considers that it is important to retain disabilities that are highly reliable, even

[1] Disabilities that redistribute more than $200 per capita for any state are not included in Chart 1.

while others that are more material but less reliable are removed from the assessment process.

If the Commission prefers to simply raise the materiality threshold and decides to not pursue the kind of analysis suggested above, the thresholds suggested by the GST Distribution Review may be too high, and may result in disabilities being removed that are both reliable and significant to a number of states. In this case, the Commission should give consideration to increasing the materiality thresholds by less than suggested by the GST Distribution Review.

If materiality thresholds are substantially raised, this will necessitate reviewing a large number of expense assessments to see if it is appropriate to aggregate some expenses, since aggregation will in many instances raise those expenses above the threshold. Aggregated expenses could then be assessed more broadly. This is preferable to simply removing some disabilities used in the 2010 Review Methodology, as the materiality thresholds that applied in the 2010 Review influenced decisions around the grouping of categories and expenses assessed under different category factors. This would make the simple removal of existing disabilities somewhat arbitrary if materiality thresholds are redefined.

Similarly, a significant proportion of revenue would not be assessed under the new thresholds, strengthening the case for the use of a broad revenue indicator (the issue of the use of a broad indicator is discussed later).

Rounding relativities

Terms of Reference 2(b)

Consider the appropriateness of continuing to round relativities to five decimal places.

GST Distribution Review Recommendation 3.2 on rounding relativities

To ensure the system does not appear to be falsely precise, the Panel recommends that relativities produced from the CGC's process be rounded to two decimal places in the annual Updates and Reviews.

Queensland does not have a strong view in relation to the GST Distribution Review recommendation to round the relativities to two decimal places. Queensland will not oppose the recommendation provided it does not have a material impact on any jurisdiction.

Development of a new transport infrastructure assessment

Terms of Reference 2(c)

Develop a new transport infrastructure assessment. This should include, if appropriate, a framework to identify payments for nationally significant transport infrastructure projects which should qualify for partial equalisation and options for providing that treatment.

GST Distribution Review Recommendation 6.1 on the treatment of Commonwealth payments

In recognition of the inter-related nature of transport networks and the national benefits that accrue from increasing the efficiency of these integrated transport networks, the CGC should identify all Commonwealth payments relating to national network road infrastructure and rail based transport infrastructure.

All identified payments should affect the relativities on a 50 per cent basis, to recognise their dual national/State purpose. To ensure that States that have previously received rail based transport payments are not disadvantaged, this change in treatment should apply from the CGC's 2013 Update.

The development of a new transport infrastructure assessment may not be the most appropriate method to address the treatment of rail infrastructure payments by the Commonwealth in the GST distribution.

Not all Commonwealth road payments receive concessional treatment – the Commission considers only national network road payments as deserving concessional treatment. This concessional treatment recognises the Australian Government Department of Transport assessment of State roads investment needs included broad national considerations which the Commission is unable to assess[2], including the need to develop an efficient national transport network to facilitate national economic growth and productivity gains in the long term[3]. It is important to note that the national road network has been clearly defined and designated not by the Commission, but by the Commonwealth.

In contrast, a clear national rail network does not exist. Moreover, it will likely prove difficult to develop a general rule that can be applied by the Commission to determine whether a particular rail project will facilitate national economic growth and productivity gains in the long term.

Another important consideration is that, due to the large scale funding required for some rail projects, the feasibility of a project from the point of view of a State Government will, at least sometimes, depend on the GST distribution implications of the financial arrangement with the Commonwealth. Therefore certainty of the GST treatment by the CGC is required at the time of decision-making by governments, not some time, possibly years, later.

Queensland would have concerns if the Commission sought to provide this certainty through either its determination of a blanket rule of what constitutes a rail project of national

[2] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativites – 2010 Review*, 2010, Volume 1 p.63.
[3] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativites – 2010 Review*, 2010, Volume 2 p.444.

significance or much earlier consideration of the national significance of individual projects. Not only would this be conceptually difficult since such determinations would be both complex and, to a degree, subjective, but it would be an extension of the Commission's current responsibilities and be inconsistent with the treatment of Commonwealth road infrastructure payments where national significance is essentially defined by the Commonwealth through its designation of the national road network.

The Commonwealth in consultation with states is best placed to determine the intention of these payments, and the national significance of individual projects. In the absence of a Commonwealth designated national rail network, Queensland proposes that the most suitable treatment of Commonwealth rail infrastructure payments going forward would be through the designation of national significance, and therefore application of concessional treatment, on a case by case basis by the Commonwealth in consultation with the State/States at the time of decision-making by the relevant governments on that project. The Commonwealth would then issue a direction to the Commission on the application of the concession.

These determinations by the Commonwealth should be made in a consistent manner across projects and states. This methodology allows the GST distribution's treatment of infrastructure payments to be flexible, reliable and reflective of the original intention of the payments.

Use of updated data

Terms of Reference 2(d)

Consider the use of data which is updated or released annually with a lag, or updated or released less frequently than annually

GST Distribution Review Recommendation 6.2 on data revisions

Where data are updated or released annually with a lag, or updated or released less frequently than annually, the CGC should allow the newly available data to only inform changes in States' circumstances in the most recent assessment year and not be used to revise previous estimates of earlier inter-survey years.

Queensland does not support recommendation 6.2 of the GST Distribution Review. It is important that the Commission's assessments reflect the most reliable and up-to-date data available. This includes updating previous single year relativities where relevant data was not available at the time they were originally produced. Updating relativities for data that is lagged or updated less frequently than annually does not produce sufficient volatility in the assessment to justify a less reliable or accurate outcome.

Equalisation on a "spend gradient" basis

> **Terms of Reference 2(f)**
>
> **Investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis**
>
> *GST Distribution Review Recommendation 6.4 on cost equalisation*
>
> *That the CGC investigate whether it is appropriate and feasible to equalise interstate costs on a 'spend gradient' basis. This investigation should occur in the context of the assessment of other cost disability factors including costs of remote locations, and administrative scale.*

The investigation of equalising costs on a 'spend gradient' basis should not be a priority of this Review. The discussion of this recommendation in the Review of GST Distribution Final Report provides little detail on how this might be done, and limited justification for equalising costs on such a basis.

The suggestion that reducing equalisation for intrastate costs such as remoteness will encourage more efficient population settlement patterns implies that there is a direct link between, for example, the level of services states provide in remote areas (relative to regional and urban areas) and the state's level of GST funding. For that to be the case, it would need to be shown that:

- governments take into account GST distribution impacts in establishing the relative levels of services between remote, regional and urban settlements; and
- the provision of additional public services in remote areas is a major inducement for settlement there.

Queensland is not aware of any evidence for either premise and, regarding the second, other factors, such as the availability of employment, are likely to have much greater influence on settlement patterns than the level of service provision (above a minimum standard).

If a major objective of this Review is to more effectively provide states with a similar capacity to provide the same level of service to its citizens, strong justification would need to be provided before taking this approach.

The Review Report notes that Murphy[4], who proposes the spend gradient basis for interstate costs, supports full equalisation for intrastate costs such as remoteness, but only partial equalisation for interstate wage levels.

In light of the issues with the wages assessment outlined in this submission and given the short timeframe for the 2015 Review, it may be more useful to consider the cost equalisation issues raised in the Review of the GST Distribution Final Report in the context of

[4] Murphy, C, Independent Economics, *Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*, Report prepared for the South Australian Department of Treasury and Finance, February 2012.

the wages assessment, including consideration of less than full equalisation for interstate wage levels.

The Assessment of Mining Revenue

Terms of Reference 2(g), (h)

(g) develop a new mining revenue assessment

(h) consider the appropriate treatment of mining related expenditure.

GST Distribution Review Recommendations

Recommendation 7.1 on the mining revenue assessment

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- *continue to ensure that Western Australia's removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years*
- *consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia's decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.*

Recommendation 7.2 on the mining revenue assessment

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- *avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment*
- *treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.*

Recommendation 7.3 on mining related expenditure needs

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.

Queensland considers that reform of the mining revenue assessment should be the priority issue of the 2015 Methodology Review. Given that no other single assessment impacts on the redistribution of GST to the same degree, and the GST Distribution Review identified a need for a new mining revenue assessment to be developed at the earliest opportunity, Queensland believes this issue should be addressed urgently. The Commission is well placed to turn a fresh pair of eyes to this issue, with a view to rectifying this assessment as soon as possible, in particular, addressing the need to set a discount beyond the 3% suggested by the GST Distribution Review as an interim measure.

This Review should focus on improving the policy neutrality of the assessment and removing the potential for grant design, as well as investigating the appropriate level of discount to be applied to the mining assessment.

Mining revenue is different from other state revenue sources

Every jurisdiction has industries to regulate and manage. However, the mining industry and the state revenue generated from the industry have unique attributes that should be recognised in the Commission's mining revenue assessment.

The mining industry is concentrated in a few states

When an assessment has a common base in every state it can be assumed that where there are costs arising from the required development and maintenance of associated economic and social infrastructure, each state will have incurred these costs. In these cases, it is not material whether the assessment process considers these costs as the treatment will be consistent across states. However, it is material in cases such as the assessment of mining revenue, where only two or three states have significant costs from associated economic and social infrastructure and regulation. If the assessment process does not consider these costs, as is currently the case, these states are effectively treated inconsistently.

The mining assessment redistributes a State asset

As Pincus and Ergas[5] point out, royalties are payments for the extraction of an exhaustible resource, whose offset is a reduction to the jurisdiction's assets. In redistributing the financial benefits of the royalty through the GST, a State asset is also being redistributed. If the redistribution were to be limited to the income component, then only the revenue associated with indefinitely holding the asset intact should be redistributed, which is likely to be less than the royalties revenues. This is fundamentally different from the rest of the revenue assessments, which deal predominantly with state taxes. Conceptually, mining revenue may be more similar to the proceeds of asset sales (which are not redistributed) than to state taxes.

It may be argued that mineral deposits represent a windfall gain to the owning states and that their ownership was not 'earned'. However, this argument could apply to other state assets – for example, roads and buildings in the more established, wealthier states were acquired before the current system of HFE commenced and represent a 'windfall' to the current generation, and assets such as real property may have acquired a large 'windfall' increase in their value since their acquisition.

Mining development can be problematic

The existence and scale of most state revenue sources are not subject to difficult policy choices by government. The economic bases of payroll tax, conveyance duty, land tax and motor vehicle taxes – paid employment, property market values and activity, and vehicle ownership and use – are accepted as part of modern life. There are choices to be made that

[5] Pincus, J and Ergas, H 2011 *Reflections on Fiscal Equalisation in Australia*, Submission to the GST Distribution Review, 2011.

can affect the size of these bases – for example, restrictions on pollution emissions by factories near residential areas or waterways, or zoning of land. But in the main, these decisions have impacts only at the margins of the relevant economic bases.

In contrast, the development of the mining industry often requires difficult policy choices to be made. Mining operations can have large environmental and social impacts and often trade-offs are required against other industries, such as agriculture and tourism, and other land uses, such as residential housing. Public provision of economic and social infrastructure is required and the industry needs to be regulated and managed.

In making these policy choices in relation to the mining industry, governments need to carefully consider costs and benefits and strike balances between competing interests to a degree much greater than is associated with most other industries. There is a significant opportunity cost for the government of a resource state to devote the policy attention required by this industry that other states do not face or make a contribution to.

Mining industry costs incurred by state governments

Governments incur costs in the development of the mining industry

The development and regulation of mining in Queensland has proceeded as a partnership of industry and government, with government playing an important role in the provision of economic and social infrastructure. The cost to government of providing economic and social infrastructure can manifest itself in the forms of direct expenditure, opportunity cost and risk.

The Queensland Government incurs significant direct expenditures in mining regions and areas that have linkages to mining regions. This includes the construction and improvement of roads and bridges which directly service the mining industry, as well as social infrastructure to provide for regional population growth.

These costs are not temporary and are likely to continue as long as the mining industry has a strong presence in Queensland. For example, the Queensland Government has announced a 'Royalties for the Regions' program to give back to the communities that support resource projects through the Resource Community Building Fund, Roads to Resources and the Floodplain Security Scheme.

Some costs may also be recovered by the government over time if they are directly industry related. However, there is a real opportunity cost for governments in undertaking the initial capital expenditure. Governments face budget constraints and spending on mining related infrastructure means less infrastructure spending in other areas, including social infrastructure such as hospitals and schools. For many projects directly related to assisting mining industry development, such as land acquisitions for state development areas, the expected timeframes for cost recovery are extremely long (sometimes decades). The opportunity cost of this use of limited funds is a real cost to government and the community.

There are also risks associated with expenditure on infrastructure that must be borne by government. The continuation of the mining boom is not guaranteed. World demand for

Australian resources is dependent on a number of factors, including international economic conditions and the development of alternative suppliers. The risk faced by the large mining states is that the assumptions on which infrastructure planning was based fail to eventuate, leading to an over-allocation of resources to the mining regions and under-utilisation of infrastructure.

The GST Distribution Review final report put forward a view that many of these costs were already recognised (or partially recognised) in existing assessments. Queensland does not support this view. The GST Distribution Review was intended as a high level review and as such, its analysis of this issue was based mainly on anecdotal evidence provided in state submissions and broad estimates of their effects. Despite this, it was able to conclude that the existing mining revenue assessment is flawed and needs immediate rectification, and, in particular, a discount of the mining revenue assessment should be provided in order to compensate for the fact that some mining related needs of the resource States are not fully recognised.

This conclusion is consistent with a similar Canadian Review in 2006 which concluded that a 50% discount should be applied to mining revenue.

The 2015 Methodology Review provides an opportunity to examine this issue in more detail and with greater rigour. This should include the collection of data on a consistent basis, and a thorough examination of mining states' policies with respect to the kinds of industry support they provide, and how these are provided.

Governments incur costs in the regulation of the mining industry

Governments also incur significant costs in the regulation and management of issues related to the mining industry. As mentioned earlier, the mining industry interacts with a diverse range of Queensland interests, including the environment, (for example, the Great Barrier Reef), communities (for example, on residential housing and native title), and other industries such as agriculture and tourism. These issues need to be managed and the industry needs to be regulated.

The cost to the Queensland Government of administration alone for the mining sector was $100 million in 2008-09, rising to $120 million by 2011-12. This includes departmental head office costs, planning and project costs and safety and health expenses.

Cost recovery and the impact of policy choice

One view expressed during the GST Distribution Review submission process was that infrastructure costs borne by government in support of the mining industry should not be recognised in the HFE process because the majority of these expenditures are cost recovered from industry. However, little evidence has been presented to support this assertion, and Queensland has substantial costs that are not recovered from industry, particularly in the area of roads construction. It seems likely that other mining states have similar expenditures.

For the recognition of direct expenditure on the mining industry that is not cost recovered, the Commission should apply the general average policy criteria. If, on average, mining states do not cost recover a certain proportion of direct infrastructure expenditure, this should be recognised. As described below, details of states' policies regarding cost recovery should be investigated further as part of the Commission's data collection. The opportunity cost associated with cost recovered assets may be more difficult to quantify or measure, however, the constraint placed by mining related projects on state budgets is significant and should also be fully explored as part of this review.

While it could also be argued that investment in the mining industry is a policy choice, Queensland considers that this view is inconsistent with the full equalisation of mining royalties. Investment by state governments in their mining industries can be directly linked to increased mining revenue capacity. If investment is considered to be a policy choice, it must follow that the royalty revenue resulting from this investment is also a policy decision and should not be fully assessed. Either way, this inconsistency in the mining assessment needs to be addressed.

Costs incurred by state governments are not recognised in the 2010 Review methodology

Services to Industry

The 2010 methodology for Services to Industry expenses is designed to recognise state expenditure requirements for business support and regulation. As part of the assessment:

- business development expenditure is assessed (deliberative) equal per capita because of difficulties in defining a common state policy; and
- regulation expenditure is assessed using factor income (as an indicator for the level of business activity) and the number of businesses.

In the 2010 Review, the Commission did not find sufficient evidence to conclude that differences in states' business development expenses were due to influences other than policy, so disabilities (including those that may be demonstrated for the mining industry) are not recognised. This conclusion needs to be re-examined in the 2015 Review to determine the level of additional business support expenditure required by mining states to support their industries.

As described above, part of the additional expenses faced by states with mining industries are the costs associated with mining departments, including their regulatory functions. While the level of business activity may be a reasonable broad indicator for regulatory expense needs in general, it does not recognise the additional burden associated with having a major industry with complex social, economic and environmental interactions with the community, and thereby requiring the existence of a matching comprehensive and complex regulatory regime and policy framework that are not present in other states.

As described above, in Queensland's case, the approximate average cost of running a mining department is around $100-120 million per year. In other states, it is simply not necessary to have a department that provides the same functions. This additional cost is not reflected in a broad measure of the level of business activity.

Roads (construction and maintenance)

The GST Distribution Review concluded that needs for most mining related road projects are already fully recognised, with the possible exception of roads directly linking infrastructure such as ports and regional airports. Queensland's view is that roads for the direct benefit of the mining industry are not recognised in the current assessment, and that the Panel underestimated the impact of unrecognised projects on mining states' budgets.

The disabilities of the current roads assessment (and the infrastructure assessment by extension), which are based on the length of the road network, traffic volume and heavy vehicle use, recognise needs that are conceptually different from expenditure that arises because of the requirements of the mining industry. For example, they do not recognise the requirement to create a network between mines, associated infrastructure and mining communities, as neither mines nor infrastructure are likely to be defined as a locality larger than 400 people. If roads supporting mining operations are not represented in the assessed road network, the need for such roads cannot be recognised by either the roads assessment or the infrastructure assessment.

Even if roads to support the mining industry were fully recognised in the assessed road network, the current infrastructure assessment (based on population growth) would not properly recognise mining industry support requirements. For roads in general, a population growth assessment is conceptually sound on the basis that a growing population requires a commensurate growth in the roads network. However, this is (again) a different concept from the measurement of mining related needs, which are not strongly related to population growth. While Queensland considers that population growth is the dominant factor in states' general infrastructure requirements, it is not a good representation of the requirement to build additional roads to support the mining industry.

Other Infrastructure and service provision

Queensland considers that, in general, the current infrastructure assessment is highly effective at measuring the capital requirement resulting from population growth, including the additional costs of providing infrastructure in regional or remote areas.

Nevertheless, Queensland considers there may be unrecognised needs related to mining that should be investigated by the Commission in this review, such as:

- the impact of intrastate migration on infrastructure provision (since infrastructure is immobile, migration between different parts of the state (such as migration to mining regions) creates an additional infrastructure burden, even if the total population has not increased. While the extra cost of providing a given level of infrastructure in different regions is taken into account by the application of location disabilities to the infrastructure assessment, the additional infrastructure requirement itself is not; and

- duplication of infrastructure and service provisions due to the mining industry's FIFO/DIDO workers.

Information on mining related expenditure for analysis in the 2015 Review

Queensland considers that the Commission should develop a data request so that mining related expenditure needs can be fully examined in a way that is consistent between states. This request could include:

- information on the kinds of direct expenditure associated with mining and states' policies around providing infrastructure/assistance to the mining industry – both recurrent and capital;
- data on direct expenditure for the mining industry – including information on the kinds of expenditure included and its purpose;
- data for other expenditure and capital, such as social infrastructure, including their location and purpose;
- information on state policies for cost recovery of assets for the support of mining companies; and
- data on mining towns including the number of FIFO/DIDO workers.

Queensland would also welcome advice from the Commission on the kinds of information and evidence that they believe is required to demonstrate expenditure needs for mining industry support and development.

The incentive to develop the mining industry needs to be preserved

The main benefits of the mining industry to the nation include:

- economic benefits, particularly increases in employment and wages; and
- the government revenue from both mining royalties and the economic activity generated by the industry.

The economic benefits of the mining industry are shared across the nation. For example, even states without significant mining industries may benefit from higher demand for manufactured goods or financial and engineering expertise, and mining company shareholders live throughout Australia.

However, in the case of state government revenue, the resource owning state misses out on a substantial part of the increased revenue from investment, despite being the owner of the resource.

The current methodology for assessing mineral resources equalises much of the increase in royalties from an expansion of the revenue base, so if the government works to support an expansion of the industry, it only retains its population share of the increased royalties (about 20% in Queensland's case, 10% for WA and 1% for the NT).

The economic growth benefits that would normally translate into higher revenues for the state in which the activity is taking place mostly accrue to other governments. The high level of vertical fiscal imbalance in Australia means that the Commonwealth government is the major beneficiary of this revenue windfall. Further, to the extent that the owning state's revenues, such as payroll tax, do grow, all but the state's population share is redistributed away through the HFE process.

While the costs to the government of supporting the development of the mining industry are apparent and significant, the current assessment diminishes much of the revenue benefit to the government. The risk to the national interest is that HFE reduces the incentives to a state government of supporting the development of the mining industry to such a degree that the industry will not receive the support that it should be receiving, to the detriment of the nation.

How mining revenue should be assessed

A discount for the mining assessment

There are four broad justifications for a discount to be applied to mining royalties:

- resource deposits are finite assets owned by the state;
- governments incur infrastructure costs in the development of the mining industry;
- government incur costs in the regulation of the mining industry; and
- the incentive to develop the mining industry needs to be preserved.

Queensland considers that there would be significant benefits to recognising the costs of the mining industry to states through a discount to the mining assessment rather than assessing additional disabilities in the expense and capital assessments:

- there is conceptual merit to an assessment that recognises the direct link between expenditure to support mining industry development and increased royalty capacity, and the disincentives to pursue industry development that result from the full equalisation of mining royalties;
- a discount allows for the recognition of costs that are difficult to quantify despite having significant impacts on state budget capacities, such as opportunity cost and risk;
- the recognition of additional disabilities across a range of expense assessments, as well as the infrastructure assessments, is likely to be highly complicated; and
- infrastructure investment in mining regions is not likely to be evenly spread across years, and this may lead to increased volatility in an assessment of the expenditure.

The analysis of an appropriate level of discount for mining industry costs, particularly where direct costs are measured, will need to take materiality thresholds into account. The materiality of mining costs should be considered across all relevant categories in aggregate, rather than applying thresholds to the impact of mining costs on individual categories. This may not be relevant if the 2010 methodology materiality thresholds are retained, but may become important if the Commission decides to raise the materiality thresholds for disabilities.

An appropriate level of discount to recognise the need to preserve incentives for developing the mining industry, and that resources are a finite state asset, may be difficult to quantify using the Commission's usual approaches. However, Queensland considers that these issues raise fundamental questions around the equalisation of mineral resources. As described above, it is difficult to find other areas does where the equalisation system redistributes a state asset (rather than the revenue derived from an asset). While some equalisation of mineral resources is important to HFE outcomes, equalisation in this area is done at the significant risk of impeding industry development, and must be undertaken with care to ensure that incentives are preserved.

It is important to note that the 2006 Canadian review of equalisation gave weight not only to tangible and quantifiable factors, but also to the intangible and unquantifiable factors faced by the governments of mining provinces in determining a discount. Their conclusion was that a 50% discount for mining revenues was appropriate.

Queensland considers that a review of the mining assessment cannot ignore the less quantifiable factors described in this submission, and the potential impact of the Commission's equalisation process on incentives for industry development. The conceptual case for the recognition of these less tangible expenses is at least as sound as the case for a CALD disability, where the effects are difficult to measure and Commission has applied its judgement. While Queensland is not suggesting any particular level of discount be applied at this stage (as investigating an appropriate level should be a focus of this review), a starting point of 100% equalisation for mineral resources is not appropriate in light of the uncertainty of the impact of less quantifiable factors. Queensland considers that a more appropriate starting point for this review would be a 50% assessment of mineral resources, consistent with the Canadian findings.

A Single Rate Mining Assessment

Unlike other categories, the outcome of the mining assessment is heavily influenced by the policies of individual states. These policy neutrality issues result in part from the mining revenue base being concentrated in a small number of states, but much of the potential for grant design is caused by the two-rate structure of the current assessment. Examples of the way the current mining assessment adversely impacts on policy neutrality are the assessment of Western Australia's iron ore fines and the impact of mining states' policy changes on their GST shares.

Following the royalty rate of iron ore fines being increased into the high royalty rate range, the Commission was issued with a terms of reference directive to continue assessing iron ore fines in the low royalty rate category. If iron ore fines had been assessed in the high royalty rate category, Western Australia would have lost more in GST than it had gained in own-source revenue, removing all incentive for Western Australia to increase its royalty charges as appropriate. On the other hand, with further increase to the iron ore fines rate expected, iron ore fines cannot remain in the low royalty rate group after the 2015 Methodology Review. While the Commission has released a discussion paper on options for the treatment of iron ore fines in the 2014 Update, the options suggested are short term fixes.

A long term solution is to remove the high/low value split and assess mining as a single category. This would greatly enhance policy neutrality in the mining assessment, and remove the potential for grant design effects similar to the iron ore fines issue. The impact of individual states' policy decisions on their GST shares would be dampened.

If a single rate system is in place when Western Australia makes further increases to its iron ore fines rate, the increase will have far less impact on Western Australia's GST share than if iron ore fines are moved from the low royalty rate category to the high royalty rate category as must eventually happen. A single rate system would also alleviate the grant design effects facing Queensland should it increase its coal royalty rate.

An aggregated mining assessment would also be consistent with a broader approach (such as the application of a broad revenue indicator of revenue capacity) for the other revenue categories and complement the application of a discount to mining.

NATIONAL REFORM ISSUES

DisabilityCare Australia and the National Education Reform Agreement

Terms of Reference

5. The Commission will consider the most appropriate treatment of disability services during the transition to DisabilityCare Australia (the National Disability Insurance Scheme) and once the full scheme is operating nationally.

6. The Commission will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain through the GST distribution from non-participation in NERA funding arrangements.

Queensland considers that a fundamental concern of the Commission in deciding how to treat national reforms should be implementing the methodology that best reflects horizontal fiscal equalisation (under Terms of Reference clause 1a). While the methodology must be consistent with more specific Terms of Reference instructions relevant to these reforms, there is a risk that some interpretations of the Terms of Reference instructions around national reforms could severely compromise the HFE principle. It is important that, unless all states and territories agree otherwise, Terms of Reference directives around national reforms be implemented in a way that as far as possible remains true to the HFE objective.

Following from this, it is also important that the Commission resists accepting interpretations of its Terms of Reference that may result in unduly penalising or rewarding states for their decisions around participation in particular Commonwealth agreements. This can be contrary to the important principle of policy neutrality, that seeks to ensure that the actual policies of states do not affect the GST they receive. As the Commission suggests in its 2010 Methodology Review Report, the policy neutrality principle is "intended to ensure the GST distribution process itself does not provide the States with incentives to vary their policies" (Volume 1, page 36). Some interpretations of the Terms of Reference directive relating to the NERA could appear to have precisely the opposite intention.

Queensland feels there is a risk that the HFE system will lose the confidence of the states and the public if a perception develops that it is becoming a tool to enforce specific Commonwealth policy objectives.

At the time of making this submission, it is unclear whether a majority of states will become signatories to the NERA, so the average state policy for schools education cannot be clearly determined. Further, as the arrangements for states under the NERA are still being negotiated, it is too early for either states or the Commission to reach definitive positions on how the NERA should be treated in the Review methodology. Queensland would welcome the opportunity to provide further comments on this issue as more detail on the funding arrangements becomes available.

The Commission has provided states with advice as to how it would approach the assessment of state disability expenses in a scenario where DisabilityCare Australia becomes the average state policy. Queensland considers the Commission's suggested approach to be reasonable in general, understanding that it is conditional on further details of the DisabilityCare Australia implementation becoming known. Queensland will provide further comments when the Commission has further developed their proposal.

One aspect of the future assessment of disability services is the treatment of the National Disability SPP (where it continues to be provided to non-signatory states when DisabilityCare Australia is average policy). As the SPP serves much the same purpose as Commonwealth contributions to DisabilityCare Australia, it should be considered equivalent to DisabilityCare Australia funding for the Commission's purposes, just provided by the Commonwealth in a different form. Whatever the methodology eventually chosen for the assessment of disability services, consistency in the treatment of fundamentally similar Commonwealth contributions is important.

Similarly, while some proportion of the Commonwealth's contribution to the NERA is associated with the recognition of disadvantage, some is simply base funding support for all students. This funding supports a normal state function where needs will be assessed in some form (regardless of whether NERA becomes average policy) and is equivalent to current National Schools SPP funding. Under a scenario where some states sign up to NERA and some do not, it should be recognised that base NERA funding and National Schools SPP funding serve the same purpose and should be treated consistently in the Commission's assessment.

National Health Reform

The Terms of Reference for the 2015 Methodology have instructed the Commission to assess National Health Reform (NHR) funding as affecting state relativities. The National Health Reform Agreement and funding are Commonwealth payments for public hospital services and primarily related to the Admitted Patients assessment.

The NHRA is now average policy, and the NHR funding replaces the hospital component of the National Healthcare Specific Purpose Payment (Health SPP). NHR funding is equal to the Health SPP with indexed growth in 2012-13 and 2013-14. From 2014-15 on the funding depends on the calculation of efficient growth in public hospital services.

An indication of how the NHRA and funding might be treated in the Commission methodology has not yet been provided.

Queensland considers that in general the NHR funding could be treated in the same way as the Health SPP is now. However, as with DisabilityCare Australia and National School funding, the Commission should consider the changed funding arrangements as part of the 2015 Methodology Review and provide states with an opportunity to comment on the proposed treatment.

There may be opportunity for the Commission to explore the use of the national efficient price and efficient growth data and methodology that will be used in the NHRA in a future review of the health assessments, but it is unlikely that there will be enough time for its use within the timeframe of the 2015 Review.

OTHER PRIORITY ASSESSMENTS

Revenue

Broad Revenue Assessment

The March 2010 KPMG paper The Excess Burden of Australian Taxes identifies the final economic incidence of major taxes. According to this analysis, the burden of the majority of taxes, including those raised by states, is borne by labour. States employ varying tax mixes to access the same general base of households and individuals. Because states are able to raise taxes across the entire tax base from a variety of mechanisms, a global revenue indicator such as household disposable income (HDI) reflects what states do.

Abelson[6] argues that 'a jurisdiction's revenue-raising capacity is primarily a function of the real household disposable income after allowances for major cost-of-living differences, such as housing and journey-to-work costs, and tax exportation.' This is supported by research on the Canadian system of HFE[7] which argues that revenue measures should 'reflect the

[6] Abelson, P 2011, *Estimating the Revenue-Raising Capacities of the States and Territories and the Implications for the Equitable Distribution of GST Revenue*, Economic Papers, Vol. 30, No. 4, December 2011, 443-454.
[7] Barro, SM 2002, *Macroeconomic Versus RTS Measures of Fiscal capacity: Theoretical Foundations and Implications for Canada*, Institute of Intergovernmental Relations, Working Paper No. 7, Queen's University, Ontario.

economic or financial resources or revenue bases on which the province can draw but should not reflect decisions of the provincial government or local governments about how much revenue to raise or in what forms to raise it', and suggests that a macroeconomic measure should be used.

In Australia, the most suitable global revenue indicator may be HDI. By basing the measurement of state revenue raising capacity on HDI, which reflects labour's capacity to pay tax, the GST distribution would better reflect the capacity of states to raise revenue based on economic incidence.

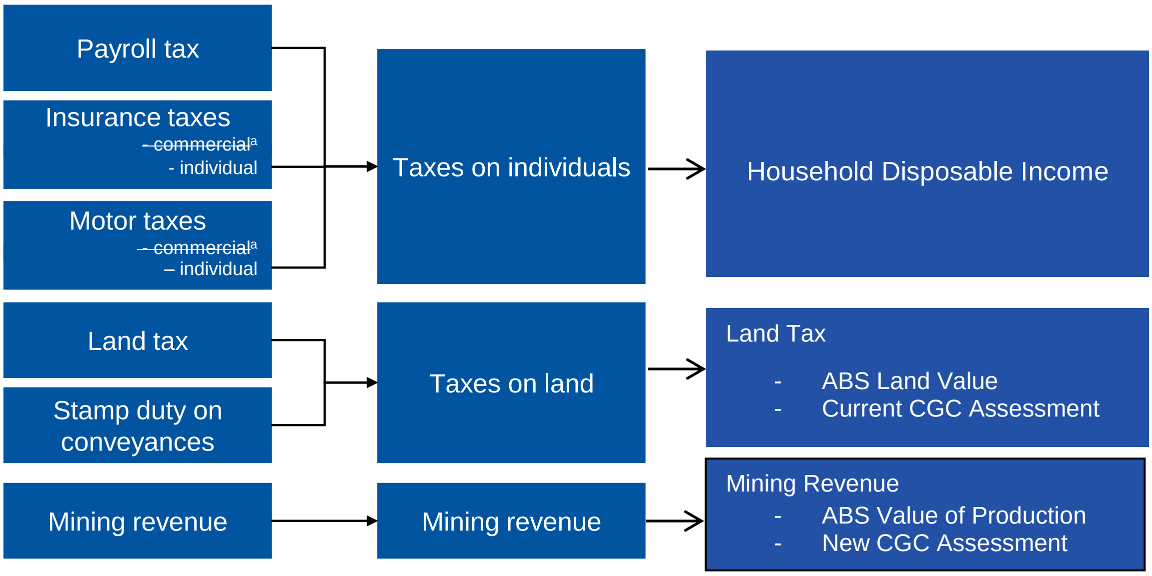
A broad indicator such as HDI reflects a wider base than the current methodology as it includes revenue not currently assessed, such as gambling taxes, making it a more robust measure. It is more flexible in dealing with varied tax mixes and changes in tax mix, such as changes through tax reform, than the current methodology.

One aspect of the revenue base that HDI may not capture is "exported taxes", that is, taxes on non-resident households and businesses. In Australia, this is principally a capacity to tax corporate surpluses that accrue to non-residents (Abelson 2011). Of the exported taxes, the ability of states to raise revenue on natural resources is the most significant, and therefore there may be a need for an assessment of mining revenue to be included with the broad indicator of revenue. However, the mining revenue assessment in its current form would not be satisfactory for this role and would need to be reformed as outlined elsewhere in the submission before it could be considered suitable to be part of a broad based revenue assessment.

Although some portion of other state revenues may be attributed to non-residents of a state, these are unlikely to be significant for revenue other than mining royalties. For example, for land tax revenue in Queensland, the proportion of resident individual taxpayers with an address outside of Queensland is less than 8%.

Queensland's preference is for consideration of a measure of revenue raising capacity through HDI and a reformed mining revenue assessment, to reflect both the capacity of labour to pay tax, and the capacity of states to raise revenue from "exported taxes". This produces a relativity distribution that is not dissimilar to that derived from the current methodology, while being far simpler and more robust.

The Australian Government Treasury's submission to the Review of the GST Distribution grouped the current revenue assessments in to three broad categories based on their tax incidence:



(a) Components of some existing assessments are expected to no longer meet the CGC's materiality thresholds
Source: Australian Government Treasury Submission to the GST Distribution Review, October 2011, and Queensland Treasury and Trade

Queensland argues that HDI captures the incidence of taxes on land, as governments' ability to raise revenue is still constrained by individuals' ability to pay tax despite the value of land they hold.

However, the inclusion of a land tax assessment as part of a broad revenue measure could be investigated alongside HDI and an assessment of mining revenue, if its inclusion is found to be more comprehensive or robust. Consistent with the assessment of other revenues using a broad HDI measure, a broader approach could be applied in the land category. Queensland has some concerns about the current land tax assessment, particularly that revenue offices may not be able to provide data to the level of detail required in a consistent way. A broader approach, either by including land tax in an HDI assessment or making a separate assessment using a broader indicator, such as the value of land in the ABS National Accounts, could eliminate these concerns.

Even with the inclusion of land tax to form a three component revenue assessment, revenue can be measured with a far simpler methodology that captures states' capacities to raise revenue more fully than the current system.

Transport

A detailed review of the assessment of transport services expenses should be undertaken as part of the 2015 Methodology Review, including the methodology and data used in the assessment.

The conceptual case for the current methodology, that the per capita cost of providing public transport increases with population density, relies on a model of expenses that is derived from a small number of large capital cities driving the trend.

Queensland remains concerned that the derivation of a relationship between urban population and per capita subsidy is too policy influenced to be considered a robust and comparable assessment of urban transport expenses, particularly for the large urban centres.

Based on chart 18-5 in Volume 2 of the 2010 Methodology Review final report, the relationship appears to hold reasonably well for smaller centres but less well for larger populations. As part of the 2015 Methodology Review, further testing of whether the relationship holds as well for large centres as for small centres should be undertaken. It may be necessary to consider alternative models to measure transport services expenses.

Data used during the 2010 Review of passenger-km per capita, population, population density and urban structure showed either weak relationships, or relationships that were highly affected by individual data points (such as Sydney). Much of this analysis was based on data from the 2001 Census.

Queensland faced considerable issues collecting updated data on the basis required for the assessment in the CGC's recent data request. In many cases it is very difficult to segregate data by Urban Centre/Locality or location. It would seem likely that there are similar issues with other states' data.

As with all GST distribution assessments, the methodology is only as robust as the data it is based on. If the data used to derive the relationship between urban population and per capita subsidy cannot be improved, the suitability of the current assessment as a whole must be considered.

Queensland believes there is a strong case for reviewing the Transport Services assessment methodology and especially the suitability and comparability of the available data. At the very least, a discount to the assessment should be considered.

Location

Interstate Wage Costs

Queensland considers that the approach to the Interstate Wages assessment needs to be revisited in this review to ensure that it reflects the average state practice.

The measured relationship between actual public sector wage levels and private sector wages levels (adjusted as per the model) is highly relevant to whether the current wages model is suitable for use in the Commission's Interstate Wages assessment. This relationship tests whether the model satisfies the criteria that assessments reflect average policy. While the private sector wages model may be a reasonable theoretical construct of the underlying pressures on public sector wages, it is not suitable to be used in the assessment unless it reflects average policy and what states do. A weak or non-existent relationship between the model outcomes and states' actual wage levels demonstrates that states, in practice, base wage level decisions on different considerations than those built into the model. For example, during the negotiation of wages agreements, interstate comparisons of wage levels are continually made. All states are under pressure to set wages at levels commensurate with those of other states, regardless of the relative wage levels that may be appropriate under a theoretical model. States that are assessed as requiring relatively lower wage levels do not necessarily have the capacity to implement these in practice.

The 2009 ABS Survey of Education and Training data results indicated that the wages model is no longer well correlated to actual public sector wages. If this result is verified by the alternative data source (the ABS Employee Earnings Benefits and Trade Union Membership survey), the assessment should be redeveloped in the 2015 Methodology Review.

Interstate non-wage costs

Queensland considers that the assessment of Interstate non-wage costs is among the least reliable of the current methodology, and should be revised in the 2015 Methodology Review. The Interstate travel assessment relies on detailed assumptions around the amount of travel required by states and the requirements for overnight stays to attend interstate meetings, based on flight schedules. This should be revisited in this Review to determine if a simpler, more reliable assessment can be developed.

For the interstate freight assessment, the conceptual case is not strong, being based on an assumption that freight costs are lower in New South Wales, Victoria and Queensland because these states are main centres of production and importation. Also, the shares of freight costs on which the assessment relies are based purely on judgement, as no evidence or data were available to construct an assessment. Queensland considers that this assessment should be revisited if data or evidence has become available to support the conceptual case and the calculation of freight cost shares. Otherwise, the assessment of interstate freight should be removed from the Commission's methodology.

Indigeneity

Census Estimates of the Indigenous Population

Queensland notes that for the 2011 Census, the ABS implemented an improved Indigenous Enumeration Strategy (IES), designed to address potential barriers to the enumeration of the Indigenous population. This involved earlier engagement, greater support and the increased recruitment of field staff. A higher degree of Indigenous identification was observed in the 2011 Census, compared to previous Censuses.

As described in the next section, Queensland considers that the relevant characteristics of the Indigenous population (including changes observed in the 2011 Census) and the way these affect expenditure are reflected in the current approach. The 2011 Census results do not necessitate a major overhaul of the way Indigenous influences are measured by the Commission.

Data working party approach

Queensland does not consider that the data working party investigation so far has demonstrated differences in the level of disadvantage of states' Indigenous populations beyond what can be explained by other factors that are currently recognised (eg level of remoteness and socio-economic status). While census indicators such as the unemployment rate or car free households are useful in illustrating differences in disadvantage levels between states, they do not demonstrate that differences in disadvantage levels are higher than indicated by data used in current disability calculations. The data working party analysis shows that controlling for SARIA and SEIFA greatly reduces the differences between states in the level of Indigenous disadvantage under census indicators (comparing Figure 1 to Table B3 in Staff Discussion Paper CGC 2012-04). It has not been demonstrated that any remaining unexplained differences in the use or cost of services between states are the result of higher levels of disadvantage rather than policy choice.

Further, the nature of a disadvantage beyond what is explained by socio-economic status or remoteness has not been defined conceptually. If such a disadvantage were to be recognised in the 2015 methodology, the Commission would need to be clear on what exactly it is intended to measure. One issue that was raised during the 2010 Review was whether the needs of Indigenous populations in some states are greater than those in comparable regions of other states due to higher rates of community dislocation, the impact of the stolen generation and the greater marginalisation of some urban Indigenous populations. Queensland attempted to find historical and contemporary evidence of these effects, but was unable to do so. If such evidence were presented, it would also need to demonstrate that these historical factors impact on current levels of disadvantage. We note that current levels of disadvantage do not necessarily reflect greater historical disenfranchisement, and may instead be as a result of current policy settings. Queensland would welcome a more rigorous explanation and analysis of this issue.

While Queensland supports the Commission's use of broad indicators wherever possible, we do not consider it is desirable to base an assessment on narrow proxies for expenditure need. A broad indicator (such as the proportion of people in different age groups in the health assessments) should be clearly identifiable as a dominant driver of expenditure, although it may not capture the full complexities of expenditure needs. This is distinct from an indicator that measures something specific and narrow and can only be related to expenditure requirements through correlation with other factors or states' actual expenditures. Many of the potential indicators suggested in the data working party paper are narrow proxies rather than broad indicators, and Queensland does not support the use of these kinds of indicators. Any extrapolation of these proxies to expenditures more broadly would be based on assumptions rather than evidence. They also have a far greater risk of policy contamination – for example, one of the factors suggested in the data working party analysis is the proportion of low birthweight babies, but a narrow indicator such as this can be influenced by policies governing the type and quality of prenatal care, or the focus of health service delivery on modifiable risk factors. A relatively minor change in policy for service delivery could have a significant impact on a narrow indicator, which would then be extrapolated to a broader assessment.

If further investigation finds there is a higher underlying level of disadvantage in some states relative to others than is indicated by other factors such as socio-economic status and remoteness, one possible explanation is that the method of measuring these disabilities is not accurate. In particular, the SEIFA index (while being generally reliable) may not be accurate in some instances, such as for the Indigenous population, which usually makes up a minority of the population in an area. Rather than resort to using a proxy indicator, Queensland considers that the Commission should focus on investigating whether an alternative socio-economic index should be used for the Indigenous population. Some alternatives suggested in the data working party paper (for example the Index of Relative Indigenous Socioeconomic Outcomes) warrant further investigation. It may be that using an alternative index is not material - the Centre for Aboriginal Economic and Population Research note that the correlation between SEIFA and the Indigenous SES rank for Indigenous areas is positive and high[8].

Queensland supports the Commission upholding the current general approach of disaggregating populations by Indigeneity and other factors where these are applicable to assessments. This approach is well defined conceptually, is directly linked to the drivers of expenditures, and can be reliably measured. It is not clear conceptually what an additional or replacement proxy indicator for differences in states' Indigenous disadvantage would be able to measure that the current indicators do not. Queensland does not support changing the approach to measuring Indigenous disabilities where the method is likely to be less reliable and has no clear benefits. The work program in this area for the 2015 Methodology Review should focus on the measurement of Indigenous socio-economic status.

Capital

Queensland does not consider that it is necessary for the Commission to re-examine the capital assessments in this Review. Capital was one of the key areas of focus for the 2010 Review, which overhauled the methodology for assessing new investment, net lending and depreciation requirements. Since the 2010 Review, the capital assessments have been functioning well. As described in the assessment framework section of this submission, the GST Distribution Review suggested some potential issues with the capital assessments, but Queensland does not consider these concerns to be warranted. Alternative capital methodologies (such as net worth/holding cost approaches) were examined at length during the 2010 Review, but the current method was preferred because it provided a higher level of reliability, robustness and contemporaneity.

The current capital assessments recognise that population growth is the key driver of states' needs for new infrastructure. States require comparable per capita stocks of physical assets to have the same capacity to provide services. For a state with high population growth to maintain the average level of service provision and infrastructure per capita, it will require additional capital funding. The Commission's methodology must recognise the demands of rapid population growth on new infrastructure delivery. Queensland's growth has been above the national average for some time, which has placed increasing demands on Government to invest in infrastructure.

Queensland considers the current direct method of assessing capital requirements adequately identifies the demands that rapid population growth places on states and the need for infrastructure investment to keep pace with population growth. Queensland supports the current direct assessment as it appropriately delivers funding in a timely and

[8] Biddle N, Centre for Aboriginal Economic Policy Research, *Ranking Regions: Revisiting an Index of Relative Indigenous Socioeconomic Outcome,* Working Paper No. 50/2009

contemporaneous manner that provides states with funding when it is most needed, namely when non-replacement or new capital has to be physically built or purchased. Equalisation is best achieved by providing states with above average capital needs with funding at the time that capital costs are incurred. This direct assessment methodology best reflects what states do.

The application of the population growth parameter to investment and net lending is arguably one of the simplest of the Commission's assessments. Complexity (in so far as it exists in the capital assessments) arises from the application of cost and stock disabilities in the Investment assessment, which are designed to approximate the impact of other factors, such as socio-demographic composition and location, on infrastructure. As described in the assessment framework section of this submission, if greater simplification is to be achieved in the capital assessments, efforts need to focus on the parts of the assessments that are actually complicated.

Queensland's view is that the current application of expense disabilities in the Investment assessment strikes a good balance between accuracy, complexity and volatility considerations. We consider that it is important the Investment assessment continues to recognise the disabilities captured by the current cost and stock factors, but that these could potentially be applied to the assessment in a different way that would alleviate the concerns some states have over the assessment's volatility. Also, Queensland would not object to the further investigation of potential additional disability factors if there is evidence they may have a material impact on capital needs. As described in the assessment framework section, if the Commission decides to revisit any part of the capital assessments, this should focus on investigating potential ways of simplifying the application of expense disabilities to the Investment assessment, and whether there is a case for applying any additional disabilities.

Other Data Working Party projects

There are other issues that the Commission has raised since the 2010 Methodology Review. It is Queensland's view that the issues raised by the GST Distribution Review should be the priority, along with a small number of other issues that have a significant impact on the GST distribution and are in need of review. Given the short timeframe of the Review, lower priority should be given to the following lesser issues:

- Administrative scale – the data working party has been investigating approaches to collecting data from central and service agencies to update the quantum of administrative scale expenses. This requires the collection of data where tasks and services performed are as homogeneous as possible, but differences in states' organisational structures and the tasks performed by areas within them makes consistent data collection highly problematic. While there may be a need for the administrative scale quantum to be reviewed at some point, the short timeframe for the 2015 Methodology Review means that it may be preferable to defer the administrative scale project in favour of higher priorities. In the interim, the Commission could continue to index the administrative scale quantum using the current methodology.

- Water and wastewater – The Commission has sought more detailed financial and service delivery data at the community level to conduct an investigation into the cost of state domestic water and wastewater service provision. This is similar to an attempt during the 2010 Review to improve the assessment. State responses to this request indicated that there is little in the way of new data available. With this in mind, it is appropriate that this project be delayed.

- Roads – Queensland notes the Physical Environment consultancy report found environmental factors to have a material impact on the Investment and Depreciation assessments, and supports further work in the 2015 Review. As noted in the consultancy report, Queensland is willing to provide additional data if required to support this work.