2015 REVIEW

First Submission

SUBMISSION BY SOUTH AUSTRALIAN DEPARTMENT OF TREASURY AND FINANCE

JULY 2013

INTRODUCTION AND EXECUTIVE SUMMARY

This submission focuses initially on architecture and principles, with reference to Chapter 3 of the 2010 Review as requested by the Commission.

By and large South Australia is supportive of the Commission's approach to equalisation as set out in Chapter 3 of the 2010 Review, which followed a thorough process of engagement with states and territories.

That said, this submission contains a number of suggestions and proposals for modification of certain approaches and assessments adopted in the 2010 Review which are considered to be consistent with and indeed reinforcing of the approach set out in Chapter 3.

Priority issues, as requested by the Commission are identified in the summary of the submission below.

Architecture and Principles

- *Definition of HFE* – there is no need for change

- *Supporting principles*–the principles adopted in the 2010 Review are supported. Also there should be an emphasis on transparency and accessibility.

  - *Materiality thresholds* ***(TOR 2 (a))*** – an arbitrary increase in materiality thresholds such as proposed by the GST Distribution Review is not supported. This is a **priority**.

- *Architecture and framework issues*

  - Aggregation of revenue lines – a more delineated approach to the treatment of Other Revenue, including user charges should be taken.

  - *Simplified and Integrated framework* ***(TOR 2 (e))*** – this is a threshold architecture issue. Population growth needs as currently assessed can be preserved in a familiar Operating statement based model, and transparency and accessibility advanced by dispensing with the Net Lending based model. The capital assessment provides an important analytical and narrative setting for priority matters such as the assessment of transport infrastructure needs. SA requests the Commission facilitates, as a **priority**, early engagement with the states on the proposed Simplified and Integrated framework, by the issuing of a discussion paper.

Revenue assessments

- *Property taxes - emergency services* – emergency service levies are not user charges and should be differentially assessed as taxes.

- *Mining revenue assessment* ***(TOR 2(g))*** – the assessment of mining revenue needs using royalty rates as an indicator of relative expected profitability (such as the two tier model) may well be appropriate, notwithstanding the transition problem of 'iron ore fines' moving between tiers.

Expenses assessments

- *Indigenous population* ***(TOR 1(d))*** –SA is open to an examination of whether indigenous needs could be assessed separately for permanent metropolitan populations and non-metropolitan populations (the latter to include people intermittently located at regional centres including Darwin)

- *Mining related expenditure* ***(TOR 2(h))*** –SA supports an examination of the case for expanding the services to industry assessment to cover mining industry. SA also supports an examination of whether regional roads and community services assessments should be amended to reflect the impact of FIFO workforces and transport hubs, not just town populations.

- *Interstate wages* ***(TOR 2 (f))*** – This assessment is a powerful and growing driver of relativities. SA considers the methodology and rationale of this assessment needs to be revisited. This is a **priority** issue.

- *Administrative scale* – An updating of the quantification of this assessment should be considered.

Investment and Net Lending assessments

- The current Investment assessment is difficult to follow and explain. If investment needs are purportedly assessed in the year when capital expenditure occurs it is hard to follow why needs are also assessed for depreciation and amortisation in subsequent periods. The Investment and Net lending assessments can be dispensed with and an ‘upfront’ assessment of population needs can still be readily achieved in the simplified model.

Commonwealth payments

- Consistent with a population growth needs assessment relating to the dilution of accumulated Net financial worth and physical assets, Commonwealth capital payments which result in higher future interest earnings or lower interest expense should be treated by inclusion. This may not be the situation for capital payments which flow fully to the benefit of users of fully commercial PTEs.

  - *Transport assessment* ***(TOR 2(c))*** – this is clearly a **priority** issue. The assessment of depreciation expenses needs provides an appropriate context for the treatment by inclusion of Commonwealth capital payments; and also for urban transport in the Simplified and Integrated model.

  - Some Commonwealth payments address national objectives over and above services to state residents, visitors and businesses, as well as the latter.

  - Based on the example of 50% exclusion of National network roads payments, a possible approach is that of *proportional* exclusion to the extent that there are genuine direct spillover benefits to multiple states.

New Developments in Commonwealth State Relations

- *DisabilityCare Australia* ***(TOR 5)*** – during the ‘trial site’/ transition to the full scheme period, state government expenditure of both participating and non participating states is still affected by the relative size of disabled populations and should continue to be subject to differential assessment as per the existing methodology. When Disabilitycare Australia is fully functioning, and equalisation is imbedded in the disbursement of its funds, state payments to Disabilitycare Australia should be assessed on an actual per capita basis as a 'reverse' SPP.

- *NERA* ***(TOR 6)*** –SA's initial thinking is that NERA student characteristics weightings should be used by the Commission in expenditure assessments. Assessment factors in other aspects (eg administrative scale) should continue to be deployed as well. Commonwealth payments would continue to be treated by inclusion.

ARCHITECTURE AND PRINCIPLES OF HORIZONTAL FISCAL EQUALISATION (HFE) ASSESSMENT

DEFINITION AND OBJECTIVE OF HFE

The definition of horizontal fiscal equalisation (HFE), as adopted in the 2010 Review, states that:

> *“State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure to the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.”*

South Australia sees no need to change the definition of HFE.

Although considered at length by the GST Distribution Review, the adopting an alternative definition was not a recommendation of the Final Report of the Review.

Some proposals for a move away from this definition are likely to be motivated by a desire to reduce the extent of equalisation sought.

It is important that the words ‘*same standard’* be retained in the definition, rather than any alternative concept introduced (eg *comparable)*. The words *after allowing for material factors* adequately allow the Commission to resist excessive or inappropriately detailed assessments. This issue was the subject of thorough consideration in the 2010 Review. The actual outcome may be comparable in practice now because of practical limitations of assessments and materiality cut-offs, but a change of wording to the definition of HFE could facilitate a less determinate and transparent outcome.

The Commission has not received terms of reference for the 2015 Review that would require it to reduce the scope of equalisation or make its assessments more approximate than a fit for purpose approach. It has received terms of reference that request it to consider the appropriateness of the current materiality thresholds. The Commission was right to point out in the 2010 Review that materiality thresholds are a matter of judgement. This is not an issue that is adequately dealt with by setting thresholds arbitrarily. More specific comments on Terms of reference 2 (a) are provided below.

Those advocating change to the definition of HFE may refer to different definitions or partial equalisation objectives used in some other countries. The practices of other countries should not be seen as intrinsically superior. Nor should Australian practice be changed because it attempts to achieve a more complete equalisation than in other countries.

In the 2010 Review, the Commission noted that arguments in favour of partial equalisation of some type (eg not equalising some states), tended to rely on a view that equalisation reduces national welfare. It was not in any event persuaded to consider partial equalisation approaches.

In fact equalising the fiscal capacity of *all* States promotes an efficient allocation of resources which benefits both the national economy and each state or territory. It reduces migration that might be otherwise prompted by differences in the quality or cost of state services and without regard to differences in productivity or the external costs their relocation might impose on others in the States they move to.

Economic modelling of HFE undertaken by Independent Economics since the 2010 Review (copy provided with this submission), and made available to the GST Distribution Review by the South Australian Department of Treasury and Finance, found that there would be a significant efficiency loss if systematic full multi–state HFE were abandoned or diminished.

The Independent Economics modelling results show that migration on account of economic opportunities is economically advantageous but a spatial disposition of population based on arbitrary fiscal advantages (which could involve a ‘tax haven’ effect) is economically deleterious.

This ‘tax haven’ effect result holds as much as between (say) WA and NSW (relativities both above 1) as between WA and SA (relativities above 1 and below 1 respectively).

HFE does not provide a barrier to economic structural adjustment nor does it penalise economic success — it equalises the fiscal side effects of economic developments. For example, if younger families are attracted to Western Australia for job opportunities it ensures that the Western Australian GST grant share increases to meet additional requirements for schools and teachers.

Independent Economics also found that there was a major error of logical consistency in previous modelling of the welfare effects of HFE by the Centre of Policy Studies. This is not just a case of different assumptions of different modellers. The error is more fully described in the *Independent Economics Report, Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects (Appendix B*, *page 63).*[1]

SUPPORTING PRINCIPLES

In the 2010 Review, the Commission set out four principles to help the interpretation of equalisation. These constituted an evolution of three previously stated principles in the 2004 Review. The four principles are discussed *seriatum*.

What states do collectively

The Commission noted that adopting ‘internal’ standards’ removes the need for judgement on what states could or should do, and that it ensures that each state’s assessed fiscal capacity would enable it to provide the average level of services of the type actually provided by states.

The Commission also noted that equalisation is not directed to interpersonal or regional equality because States do not follow such policies. Also it was noted that the Australian government has other tax and social security measures to address interpersonal equity.

South Australia agrees with this analysis.

[1] COPs allow for the disamenity of an increase in a state’s population in dampening fiscally motivated interstate population movement in the absence of HFE, but when measuring the change in consumer welfare from that migration no amenity effect is allowed for.

The Commission may wish to expand on the issue of the relationship between horizontal and vertical equity

In a nutshell, HFE is about ensuring States have the fiscal capacity for the achievement of horizontal equity in the presence of state government fiscal settings with vertical equity effects. In other words, HFE ensures that the conditions are created to permit equal net fiscal benefit treatment of equals across Australia. Or, drawing on C Walsh, citizens of an economic and social union are only treated differently on account of democratically mandated differences in policy settings.

HFE is not a subjective regional vertical equity ‘top up’ to Commonwealth vertical equity policies.

The Commission may wish to draw upon Appendix B of the GST Distribution Review Final report.

There is a strong linkage between ‘the what states do’ concept and the principle of horizontal equity. The principle of horizontal equity is the equal treatment of equals – but the question arises ‘who are relevant equals?’ The answer is, the particular types or classes of citizens, which State governments transact with as taxpayers (eg motor vehicle owners), and as recipients of in kind social transfers (eg public hospital patients). If assessments were made on the basis of ‘sort of ‘ what states do, or ‘broadly’ what they do, or what they ‘could do’, the essential linkage with the individuals whom state governments actually transact with, and thus the principle of horizontal equity, would be lost.

An understanding of the interaction of vertical equity and horizontal equity provides a basis for equalisation assessments focussing on tax/grant funded state government activities which intrinsically involve (vertically) redistributive effects. True user charges (if properly distinguished from quasi taxes) with no redistributive nature generally do not give rise to a requirement for equalisation.

This submission will return later to the issue of appropriate systematic treatment of user charges

Boundary issues in respect of what states do

Commonwealth own purpose v included Commonwealth payments

South Australia supports the existing principles the CGC uses to determine which Commonwealth payments are non-impacting and which are non-impacting. (South Australia considers the more accessible presentation of the treatment of Commonwealth payments is as per a previous nomenclature viz exclusion, inclusion, deduction and absorption.)

The Terms of Reference contain a number of clauses that relate to the treatment of Commonwealth payments. This issue has been one which the Commission has grappled with over many decades –what is the boundary between payments which are fungible with other revenues in funding the normal activities of State government and payments which are’ post box’ payments or which represent the purchase of Commonwealth outcomes?

This issue is of particular challenge in the 2015 Review because of recent significant developments in the Commonwealth’s role in the provision of services in health, education and disability.

In general terms, South Australia proposes that the Commission interpret clauses pertaining to these developments on the basis of maximum consistency with established principles and the achievement of HFE. It is a well-established principle of legal interpretation, that where ambiguity exists, specific provisions in the law should be ‘read down’ to ensure consistency with the relevant overall legal scheme, or overarching principle rather than be applied to the extent of potential incompatibility with overarching principle.

It is telling that certain clauses in some of the newer Commonwealth State agreements (which stem from bilateral negotiations) have been conveyed to the Commission for interpretation in the context of a broader Terms of Reference commencing with 1 (a) – GST revenue to be distributed in accordance with the principle of horizontal fiscal equalisation - rather than on the basis that HFE might be discarded or overridden in some part.

Budgetary transactions* v r*egulatory scope of state governments (and off balance sheet transactions)

The regulatory scope of government, with potential implications for redistribution as between classes of citizens, is larger than that revealed by cash flows through budget statements. An instance of that is the rules for the operation of private health insurance on a community rating or age non-discriminatory basis (which also requires equalisation transfers as between health funds).

Another instance is “postage stamp” pricing/universal service obligations and feed in tariff requirements in the utilities sector whether or not ‘cross subsidies’ are recorded in Government financial statements.

A significant area of non budgetary transactions is Infrastructure concessions often involving road tolls. This is discussed more fully in the section on transport assessments below.

Equalisation transfers ought generally not to be affected by ‘financing’ alternatives or off and on balance sheet financial reporting.

Definition of what states do ‘collectively’

South Australia understands that the Commission at least in some instances makes use of ‘ a majority of states and a majority of dollars rule’ in determining what constitutes standard policy.

South Australia is open to a flexible approach on this question. It is acceptable that outlier state policies can be discarded when determining standard policy. But where there is a substantial number of states and substantial dollars in 2 camps it may be appropriate to adopt a dual policy position in respect of what states do. It is noted that the scale of an assessment based on the minority policy position is self-limiting.

Policy neutrality

South Australia strongly endorses the Commission’s rejection of the proposition that an assessment methodology that departs from what states do could be said to advance policy neutrality. This is ‘a baby thrown out with the bathwater’ proposition.

The GST Distribution Review found that policy non neutrality effects were trivial in all the Commission's assessments other than in respect of the mining revenue assessment.

This submission will return to the assessment of mining revenue below.

Practicality

The Commission introduced this principle in light of the emphasis in the 2010 Terms of reference on simplification, reliability and materiality. Either implicit in this principle or perhaps deserving of a principle in its own right is the issue of *transparency and accessibility.* South Australia considers this the key to the acceptance of CGC assessments in the face of 'black box' rhetoric.

Clearly the current capital assessment is complex and difficult to grasp. Some have described it as complex to the point of incomprehensibility. Although SA holds reservations about the scale of adverse effects assessed for population growth , we acknowledge the conceptual and intellectual breakthrough involved in the 2010 Review, in the 'upfront' approach to the secondary interest expense/income assessment. It is in the nature of conceptual breakthroughs that it becomes apparent how the same results may be obtained more simply and transparently once the hard work is done. This seems to be the situation here.

It is *transparency and accessibility* which is the primary motivator of SA's support for the Simplified and Integrated model for population growth needs outlined below.

Materiality thresholds
Terms of Reference 2 (a)

Recommendation 3.1 of the GST Distribution Review *states that 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

This represents a four-fold increase and, based on CGC analysis using 2012 Update data, would potentially see the categories like insurance tax, motor vehicle taxes, transport services and net lending no longer differentially assessed.

South Australia does not support an increase in materiality thresholds. The increase proposed by the GST Distribution Review is entirely arbitrary, has no apparent conceptual validity and would produce random outcomes.

Materiality thresholds are problematic anyway in their exposure to the degree of disaggregation involved in implementation of a multi-part but conceptually coherent whole assessment.

South Australia believes that the CGC should take a structured and considered approach in examining the need to adjust materiality thresholds - an approach which considers the impact of any adjustments on the overall aim of equalising fiscal capacity in a balanced way - across states and across the revenue and expenditure sides of the budget.

Contemporaneity

In the 2010 Review, this principle formed the basis for the adoption of 3 year averaging rather than 5 year averaging.

South Australia continues to have some concerns that the three year lagging average relativity methodology, particularly in respect of mining revenue capacity assessments, falls short of the contemporaneity objective. Once the dust has settled on a resolution of non-neutrality concerns about the mining revenue assessment it would be appropriate for there to be explicit consideration of this issue. Unless Western Australia's relativity is genuinely expected to return to its level around one (pre mining boom) the lag in assessments will have resulted in a large permanent non contemporaneity effect to Western Australia's advantage. Even if the relativity did return to around one in the future there will have been a large liquidity benefit. A large non contemporaneity effect to Queensland's advantage may be in prospect in coming years. The existence of mining revenue related non contemporaneity effects may have some bearing on consideration of mining related expenditure needs - discussed later.

It is already a well-established principle for each Update that assessments take account of significant changes in Commonwealth State roles and responsibilities in operation in the application year as compared with assessment years which advances the cause of contemporaneity.

However the operation of this general scheme faces challenges in periods where there are significant transitions occurring to new funding arrangements and roles of state and Commonwealth governments for health, education and disability, but not necessarily on an *all states* basis.

ARCHITECTURE AND FRAMEWORK ISSUES

DEGREE OF AGGREGATION OF REVENUE LINES AND TREATMENT OF USER CHARGES

Current differential revenue assessments are in SA's judgement satisfactory (setting aside the mining revenue assessment for specific comment below). However following the 2010 Review it is noted that approaching 50% of general government revenues are currently not subject to differential assessment. Most of revenues not subject to differential assessment are assigned to an aggregated Other revenue category.

On the face of it, the extent of non-differential revenue assessments is considerably greater than on the expenditure side of the standard budget.

Transparency would be improved by a more delineated categorisation of the other/miscellaneous revenues category even if differential assessments are not deployed.

We accept that there may be a category of true user charges which conceptually may not require equalisation, or are appropriately treated as offsets to certain expense categories thus reducing the scale of expense assessments.

Another category which could be separately identified is Gambling taxes which in principle may require equalisation. A separate categorisation is appropriate even if policy contamination of gambling expenditure data may make a differential assessment infeasible in the Commission's view, given current variations across states such as no poker machines in WA hotels.(SA's view is that a differential assessment is feasible)

The case for a differential assessment of emergency service property taxes which is included in the other revenue category, which is a hypothecated tax not a true user charge, is further developed later in the submission.

SIMPLIFIED AND INTEGRATED ASSESSMENT FRAMEWORK

TERMS OF REFERENCE 2(E)

The simplified and integrated model referred to in the GST Distribution Review is understood to be based on a net operating statement covering general government and in-scope public trading enterprises (PTEs).

It differs from the current framework in that an operating statement is used rather than a net lending statement, and in that PTEs subject to differential assessments are brought directly into the operating statement via a net operating deficit line rather than indirectly through general government subsidies.

Also depreciation expense is functionalised rather than treated as a separate lumpen category.

Table 1 below outlines the structure of the simplified and integrated model. In this version user charges are set against category expenses for the general government sector as well as for in scope PTEs.

Physical asset usage

Physical asset usage needs are assessed in respect of depreciation expense incorporated *by function* at Item 5.

Physical asset usage needs would also be assessed for in-scope deficit funded PTEs via depreciation expense imbedded at Item 7.

Depreciation expense/needs can be scaled up to *lease equivalents* by adjustment for imputed interest expense.

Population growth needs

Population growth needs would be assigned at Item 12. Population growth needs can be simply calculated as the change in population share x *(discounted)* total states' average Net worth balance.

This remains an 'up front 'assessment of population growth needs, which otherwise might be assessed over time for items 10 and 11 (including imputed interest income on own assets).

States' Net worth is attributable to both accumulated operating surpluses and accumulated Other Economic Flows (largely valuation gains on land and physical assets in the general government and PTE sector)).

It follows from the preceding point that population growth needs stemming from dilution of net worth could be assigned at Item 14 rather than Item 12. However, familiarity may dictate in favour of employing a transactions based Operating statement framework down only to Item 12, rather than a comprehensive income framework down to Item 14.

Table 1: Consolidated General government and in-scope deficit PTEs operating statement (transactions between General Government and In scope PTE sector eliminated on consolidation).

Revenue	**Comments**
1. Taxation revenue	
2. Other revenue (not elsewhere included)	
3. Specific purpose payments	Commonwealth payments incl. of a capital nature, contributing to future earnings on net worth would generally be treated by inclusion. (discussed further below).
4. General purpose revenue (including GST)	
Less: Expenses	
5. General government net expenses – by function	Comprises gross expenses (including depreciation) *less* revenue from relevant user charges. Needs assessment can occur on either a grossed-up or net expenses basis as considered appropriate.
6. Concessions, Community Service Obligation payments and other personal benefit payments to out-of-scope PTEs	
7. In-scope PTEs net-operating deficits before subsidies	Includes urban transport, and housing PTEs. The inclusion of net operating deficits of relevant PTEs before subsidies in the standard budget rather than general government subsidies to relevant PTEs is the essential feature of the *integrated* approach
8. Primary operating result (revenue less expenses before interest)	
9. Net interest/property income – ***comprised of:***	
10. Interest of investments and dividends received from out-of-scope sectors; ***less***: 11. Interest expenses (on borrowings and superannuation defined benefit liability)	
12. Operating result from transactions	
13. Other economic flows	These flows mainly arise from price movements in assets and liabilities.
14. Comprehensive income – change in Net worth	

It is acknowledged that dilution of legacy net worth results from population growth, whether net worth has resulted from accumulated operating surpluses or valuation gains.

A major underlying source of States net worth has been the real terms increase in the value of public sector land holdings, which form a part of Item 13. The current CGC population dilution needs calculation excludes the value of current general government land holdings. This is appropriate, including because there are significant accounting issues and variations in terms of the recognition of land under roads of relevance to the reporting of physical assets and net worth.

The CGC dilution calculation for Net Financial worth is also subject to a 25% discount. This is appropriate because public sector land holdings have previously been sold off and valuation gains liquefied, thus reducing net debt and increasing net financial worth (The main source of current government net worth historically can probably largely be traced to the liquidation of Crown land.)

These features of the current population dilution assessment can be duplicated in the simplified model.

Relative needs attributable to the effects of relative population growth on land values (and PTE net asset/ ‘franchise’ values) could in principle be assessed at Item 13.

Failing that, the recognition in principle of the crucial *positive* role of higher population growth on the *generation* of net worth per capita, is a basis for discounting a population growth needs assessment which captures only *adverse* effects of higher relative population growth in diluting legacy net worth per capita.

Commonwealth capital/infrastructure funding

Commonwealth capital/infrastructure funding contributing to net worth would generally be treated by inclusion, unless a particular relevant grant will not provide a budget benefit in future years in terms of interest saved/secondary income received.

An example of this would be if the benefit of the grant flows through fully to user charges of out of scope PTEs. In this case there would be no advantage provided to a state’s budget position from the Commonwealth payment.

This submission will return to a number of propositions which can be considered in light of the above framework.

Further development

South Australia requests the Commission to treat the simplified and integrated framework referred to in Terms of Reference 2 (e) as a threshhold architecture issue. It provides an important narrative setting for such issues as treatment of capital payments, economic development, transport infrastructure etc.

South Australia also requests the Commission to facilitate early engagement with the states by the issuing of a Discussion paper setting out the Commission’s views on how such a model might be implemented, advantages and disadvantages, and the impacts it would have.

REVENUE ASSESSMENTS

Property taxes hypothecated to emergency services

While emergency services levies are hypothecated they are not true user charges, and they should not be excluded from differential assessment on that ground.

Lack of uniformity or bifurcation of policy in this area may have also contributed to these revenues not being differentially assessed in previous assessments.

In recent years however, most states have changed, or have announced that they will be changing, the way they levy their citizens to fund certain emergency services.

Most states have moved away from a' fire services levy' on household insurance premiums to fund the operation of metropolitan/country fire services and other emergency services.

Emergency services levies now are generally based (or will be based) on the capital or improved value of properties or variants of this base.

South Australia has imposed a property-based emergencies services levy since 1999 and Western Australia introduced a similar levy in 2003. In recent Budgets, Victoria announced that it will be moving to a property based levy from 1 July 2013 and Queensland announced it will be expanding its levy to all properties receiving a rates notice from 1 January 2014.

Some jurisdictions (including South Australia) also apply the emergency services levy on mobile property (cars, trucks and motor bikes).

As it will soon be average policy (or the policy of all bar one state) to impose a property-based emergency services levy, the need for a new revenue assessment should be considered by the Commission.

Amalgamation of this category with land tax is not favoured since the land tax base is site values, whereas ESLs are levied on improved capital values,(and mobile property.)

Mining revenue assessment
Terms of Reference 2(g)

Because of the skew in location of minerals across states, the mining revenue assessment provides special and unusual challenges in terms of potential conflict between policy neutrality and what states do.

Some mining operations offer a greater state revenue raising capacity than others - essentially related to the differing operating profitability of various mines notwithstanding the formal character of state royalties (mostly) as taxes on *gross* sales. In theory if reliable profitability indicators were available a single mining revenue assessment could be conducted on the basis of mining profits by state either directly, or indirectly by application of ' profitability conversion weights' to gross sales data.

Alternatively an assessment could be conducted on a disaggregated basis by commodity and perhaps type of mine viz underground or open cut.

However, because the location of minerals is heavily skewed across states a commodity by commodity approach raises policy neutrality concerns.

Generally speaking rates of royalty across commodities are set with regard to what the market will bear/expected profitability. Royalty rates themselves contain information about expected profitability. If a commodity by commodity approach is ruled out, this fact gives conceptual support to an assessment using profitability weights based on royalty rates.

A single category assessment might be feasible using rates of royalty relative to the overall average as primary profitability conversion factors. Alternatively an assessment based on aggregations of commodities by rate of royalty category is indicated as per the current 2 tier approach, (or 3 tier approach as contemplated for the 2014 Update).

The 2 (or 3) tier alternative seems the more practical approach even if the single category approach might avoid problems when commodities shift between royalty level categories, particularly if royalty categories are likely to be stable into the future.

EXPENSES ASSESSMENTS

An appropriate methodology to capture the changing characteristics of the Indigenous population

Terms of Reference 1(d)

South Australia supports the continuation of the framework used by the Commission in its 2010 Review to assess the need to make allowances for the effects on State expenses of a particular group of people.

> *Before making allowances for the effects on State expenses of* (Indigenous people) *the Commission requires:*
>
> - *A sound conceptual argument that the group affects State expenses, which may be because they use services more (or less) intensively than others and/or each unit of service delivered to them is more (or less) costly;*
> - *Reliable data or other supporting evidence that the intensity of service use and costs per unit of service for that group differ materially from those of other people; and*
> - *Reliable data on the number of people in each group in each State, which are defined and measured in the same way as the data on service use and costs.*[2]

The 2010 Review report notes, *"The data and evidence presented by the States, and our own observations, make it clear that a major difference across States arises because of the uneven distribution of Indigenous Australians (particularly in more remote locations), and the higher expenditure States incur in providing services to these residents"*.[3]

For the 2015 Review South Australia is open to the CGC examining whether Indigenous needs could be assessed separately for permanent metropolitan populations and for non-metropolitan Indigenous populations. Reliable data would need to be available to classify remote and non-metropolitan Indigenous people in a separate grouping to metropolitan Indigenous people. Mobile populations temporarily

[2] Paragraph 117, Pg 73, Report on GST Revenue Sharing Relativities -2010 Review Volume 1 – Main Report.
[3] Paragraph 29, Pg 7, Report on GST Revenue Sharing Relativities -2010 Review Volume 1 – Main Report.

or intermittently located in or near regional centres, including Darwin, would potentially remain in a non-metropolitan category if reliable data is available.

In particular, the Commission could consider if the effect on State expenses of metropolitan Indigenous people is comparable to those of metropolitan non-Indigenous people from similar socio-economic status backgrounds. Permanent metropolitan Indigenous population needs may possibly be adequately covered by general socio-economic indicators.

Appropriate treatment of mining related expenditure

Terms of Reference 2 (h)

As an interim measure the GST Distribution Review suggested that a 3% discount be applied to the mining revenue assessment as a proxy for a needs assessment for expenditure side requirements of the mining industry, until a complete review is undertaken. This was not actioned for the 2013 Update as consensus could not be reached by all jurisdictions.

South Australia would support an examination of the case for an expansion of the services to industry assessment, currently applied to the agricultural sector, to the mining sector.

A services to industry needs assessment should not be confused with an assessment of economic development promotion or economic growth needs. All states have an equal desire and responsibility in respect of economic growth. The issue here is whether the economic structure of a state involves a relative burden in terms of services to industry expenditures.

In relation to the provision of infrastructure services to mining operations and communities, it is noted that many relevant services are provided on a cost recovery or user charges/contributions basis. The accumulated financing cost of commercial PTE investment including government equity should be recouped from later user revenue streams.

The infrastructure services which are substantially sourced from taxpayers funds are regional roads and community services.

South Australia would support the examination of whether service populations in some states are larger than resident populations, and whether rural roads and community services assessments should be amended to reflect the impact of FIFO workforces and transport hubs, not just town populations.

At the same time consideration of the relative burden on state budgets arising from an expansion of mining might also take into account the benefit obtain from a lag in the equalisation of expanding mining revenue capacity.

Interstate wages

Terms of Reference 2(f)

South Australia understands that the intention of Recommendation 6.4 in the GST Distribution Review is to examine whether to equalise interstate wage costs with reference to a hypothetical interstate **spend** gradient. Currently the assessment occurs on the basis of a **cost** gradient derived from an analysis of private sector wages. A spend gradient would modify the cost gradient, and is likely to have a lesser slope than the current cost gradient. The proposal is not necessarily to move to an actual spend basis of assessment because that data may be potentially policy contaminated.

Intrastate wage costs are assessed by and large on a spend gradient rather than cost gradient basis.

A good starting point for consideration of this issue is Table 3.1 and related discussion in the Independent Economics paper *Horizontal fiscal Equalisation: Modelling the welfare and efficiency effects.*

Of course the interstate wages assessment is contentious in establishing whether there are intrinsic interstate differences in the cost of employing teachers, nurses and police across states. But the proposition contained in recommendation 6.4 is that assuming there **are** intrinsic interstate differences in the unit wage costs of teachers, **expenditure** on teachers would not be proportionally higher with unit wage costs.

South Australia can accept the theoretical logic of the Independent Economics analysis, but notes that implementation of a discounting of this assessment on these grounds would require some empirically supported way of converting a cost gradient to a spend gradient. The relationship between intra state cost gradients and spend gradients might be suggestive, but the approach taken by a notional or hypothetical single state government to different unit costs in Melbourne v Perth may not be exactly analogous with the approach taken by state governments to Sydney v Bourke. Even so the Independent Economics discussion does invite 'pause for thought' about this assessment which is such a large driver of relativities and likely to become even more so.

In any event South Australia believes there is a strong case for discounting the assessment derived from the current methodology or modifying the methodology based on considerations other than on the spend gradient proposition.

South Australia continues to hold the view that the labour market for the majority of public sector employees has predominantly a national labour market character, with wage levels of public sector employees in one jurisdiction being more heavily influenced by developments in job specific labour markets in other jurisdictions, rather than by generic local or regional labour market influences.

The prevalence of national labour market character has been further enhanced by the greatly expanded role of FIFO workforces (from all points of the compass.) If one argument is Pilbara mining sector (construction) wages exert an influence on teachers' wages in Perth, why not in other states as well as Perth.

NT faces higher wage costs that can be understood in terms of compensating wage differentials within a national labour market context. But this is not the rationale for assessing needs in relation to higher wage costs in Perth and Sydney (not unattractive locations) for private sector occupations - which is based on state governments having to meet local State labour market expectations and circumstances such as competition for residential land.

There is an over reliance on an econometric analysis (using a small data sample) with unexplained variation across states forming the basis of quantification of the assessment. The introduction of omitted variables were suitable data available eg regional human capital capability (whether nurture or nature), into the econometric analysis, might well absorb some of the unexplained variation.

Following *Borland*[4]*,* the proposition here is that a 'true' model for earnings variation contains raw ability and that it is not implausible that there is regional variation in that variable.

If the rationale underlying the regional perspective is alleged cost of living differences does that mean employees occupying high value residential land with a harbour view or on Peppermint Grove require and are paid higher wages than other Sydney or Perth employees? As Borland noted demand (not cost) reasons for high land prices in Sydney might be distinguished from cost of house (excl land) supply reasons for high housing costs in Darwin. Where there is labour mobility apparent cost of living differences may in some cases be compensated by pecuniary and non-pecuniary benefits of voluntary location.

Material wage differentials do not exist in public sector occupations where states are the dominant employer and where local private sector employment opportunities are limited (teachers, nurses, police).

Observed public sector wage differentials can be attributed to policy effects in industrial relations, the ability of governments to contain cost of living claims, differences in employment status (eg tenure) and budget pressures in some states. These factors affect employer and employee expectations.

The national character of the Australian labour market is most obvious in the professions of teachers, nurses and police, which together make up a significant proportion of state government employees.

As noted in prior CGC Review processes, it is difficult to make direct statistical comparisons of like employees across states because of variations in classification, responsibility and non-wage benefits.

In nearly all public sector wage negotiation processes (especially for teaching, nursing and police) relevant unions refer to interstate wages as justification for pay rises and changes in working conditions. Unions, like the Australian Education Union, maintain wage comparison charts on their websites to allow their members to observe wage rates and movements in other jurisdictions.

We believe that the existence of a predominantly national labour market for public sector workers (at the very least - teachers, nurses and police) should be recognised by the CGC, probably in the form of an extra discounting of factors that cannot be reconciled to a significant national labour market character. This might leave NT cost disabilities undiscounted.

A greater role for the judgement of the Commission seems required to bring greater coherence to the interpretation and application of empirical data in the wages cost assessment..

Administrative scale

Quantification of the administrative scale disability is out of date. The Commission should further investigate an updating of this assessment. The scale of the current

[4] Professor Jeff Borland, University of Melbourne, Reponses by Professor Jeff Borland on issues relating to wage input costs, February – June 2009, page 5, Commonwealth Grants Commission.

assessment is considerably less than the intercept of a linear cost curve (expenditure and population) presented to the Data Working Party after the 2010 Review.

INVESTMENT AND NET LENDING ASSESSMENTS

The current CGC capital assessment based on a Net Lending statement (or rather a reconciliation table as between Net operating balance and Net Lending) has little in fact to do with investment.

The population growth needs comprising the largest part of the capital assessments (reported in Table 6 of the 2013 Update), relate to the legacy level of State public sector net worth. If the legacy level of net worth were near zero, population growth needs would be near zero, whatever the level of investment now occurring in one, some or all states.

Alternatively, for a given non-zero level of legacy net worth, population growth needs will not vary on account of an expansion, that may be occurring in the gross level of assets and debt comprising that net worth position. If net investment occurs matched by borrowings, net financial worth falls equally with a rise in physical assets.

The complexity and lack of transparency in the current CGC capital assessment is ultimately attributable to its misleading characterisation as related to investment needs. (The GST Distribution Review has indicated it found it a puzzle that net investment could be allegedly assessed in one period, and depreciation of assets acquired from that net investment assessed again in the next period.)

The level of and movement in residual net investment needs after population dilution needs are removed is hard to explain, evaluate and predict. But it can be observed that they do not seem to be much affected by movements in net investment standard, are somewhat volatile, (possibly on account of the role of the first difference change in expense needs in their calculation), and seem to involve interaction effects with the population dilution calculation.

As noted earlier, the ‘upfront ‘ assessment of population growth needs can readily be achieved with an operating statement based model. Together with the lease equivalent /holding cost escalation of depreciation needs, (which also achieves a neutrality of treatment with leasing of infrastructure/ PPP transactions), the simplified operating statement model delivers fully on the objective of equalising for infrastructure needs as per the definition of HFE.

This allows the unusual Investment and Net Lending assessments to be dispensed with.

COMMONWEALTH PAYMENTS

Commonwealth payments are generally fungible with other state government revenue to fund the delivery of services. Accordingly, the appropriate general treatment of Commonwealth payments, in order to achieve HFE (aside from special cases) is ‘inclusion’.

The treatment of Commonwealth payments for capital purposes raise some additional conceptual issues that directly relate to the investment and net lending assessments.

In the 2010 Review, Commonwealth capital payments became subject to inclusion treatment in the context of the introduction of the new ‘capital’ assessment.

The receipt of a Commonwealth payment for capital purposes reduces the need for state governments to borrow additional funds or draw-down of liquid assets, thus generating an interest income or interest expense benefit in later periods (ie it has a secondary impact).

On a per capita basis, the value of this secondary impact is reduced by population growth. States with higher population growth will see the per capita value of this secondary income reduced at a greater rate than states with lower population growth. This impact therefore generates needs in the capital assessment as the essential nature of population growth needs is recognition of differential needs for secondary income/expense. These population growth needs are essentially an upfront assessment of the relative dilution in earnings on accumulated net worth that will be experienced from population growth.

It follows from the (upfront) assessment of needs for secondary income/expense that if capital payments contribute to future net interest type earnings or result in lower interest expense for state budgets, they should be treated by inclusion

Notwithstanding the general principle of inclusion, an exclusion treatment is appropriate for On-passed grants (eg to local government or non-government schools) and to *commercial or fully user-charge funded PTEs (*electricity, gas, metropolitan water and ports) if the Commonwealth payments flow fully to the benefit of customers in the form of lower user charges (according to regulatory requirements). In this situation there is no flow-on benefit to state budgets in the form of future higher earnings and dividends from PTEs.

TRANSPORT INFRASTRUCTURE ASSESSMENT

TERMS OF REFERENCE (2C)

Having regard to Recommendation 6.1 of the GST Distribution Review and related discussion, the primary focus of this term of reference is taken to be the inclusion/exclusion treatment of Commonwealth payments.

Subject to new arguments and evidence (and consideration of the issues raised in respect of mining related expenditure needs), it might be taken that the current roads expenditure side assessment methodology is adequate – primarily constituting an assessment of road depreciation needs (in either the current Net Lending statement model or the Simplified model).

In respect of passenger rail, it is questionable whether the current assessment addresses physical asset needs, even within its own frame of reference. The residual investment needs component after population growth dilution needs are removed involves only general government physical assets. The integration of in scope PTEs in the Simplified model would allow a similarly adequate treatment as for roads via the inclusion of depreciation in urban public transport operating deficits. (In a sense, the integration of in scope PTEs operating deficits including depreciation expense, shores up the logic of inclusion treatment of Commonwealth payments for passenger rail infrastructure.)

The general case for inclusion treatment of transport infrastructure capital grants stands. However in some cases Commonwealth payments will fund infrastructure that addresses both national and state tasks, and this may require some form of proportional treatment.

Commonwealth own-purpose outlays received by states are generally treated by exclusion. Some instances of Commonwealth own-purpose payments to the states can be thought of as 'joint product' – part funding for state type services and part purchase of national outcomes.

The most prominent existing example of proportional treatment of Commonwealth payments is the 50% exclusion for National network roads which involve interstate freight (national purpose) as well as intrastate traffic. But other 'joint products' may also arise (eg roads to airports and to shipping ports, grants for Olympic Games etc) Even passenger rail investment may have a national (interstate) 'joint product 'benefit component if it could be established that it reduced local commuter congestion on interstate freight carrying national network roads.

State government services may be nationally important or significant, so national importance/significance is not the test for treatment by exclusion.

It is suggested that the test is **whether Commonwealth payments to a particular state involve the provision of services to residents and businesses in multiple states**. Some rules of thumb may be needed to avoid excessive complexity, and fine tuning of the national benefit proportion, but the appropriate concept for some payments seems to be one of 'proportional exclusion' to the extent there are direct spillover benefits to multiple states.

Turning to possible new developments relevant to assessment of roads (which potentially may also involve Commonwealth funding or financing,) it is noted there may be an enlarged role for toll roads in prospect. All road projects in public spaces are controlled by state governments, and collection of road tolls require the enforcement apparatus of state governments. Some road tolls are treated as income of the state or state authorities along with related expenses. Some road tolls and related expenses which form part of an Infrastructure concession grant or Service concession arrangement, such as City link, are off income statement and off balance sheet under current accounting standards. (See attached extract from Victorian Financial statement notes in Appendix A) This may change if IPSAS 32 were to be adopted in Australian accounting standards.

A treatment of toll roads which may be appropriate whatever the on or off balance sheet circumstances would be to offset road tolls against roads expenses in the standard budget (if regarded as true user charges and not motor vehicles taxes), rather than being treated as miscellaneous revenue.

There is discussion in infrastructure construction circles of state governments instigating toll road investments and then transferring the revenue and expenses streams off balance sheet to financial investors when toll revenues are known. This may have 'political economy' advantages as compared with normal debt.

The offsetting approach to road tolls is consistent with the proposed treatment of user charges as per the simplified and integrated approach already discussed. But in any event, it is proposed that the issue of toll roads is an emerging issue and that the Commission may wish to give consideration to how the assessment framework would cope with a variety of road financing arrangements, and switches between off and on balance sheet accounting.

There are also possible new arrangements in prospect over the medium term in respect of heavy vehicle road charging and investment decisionmaking.

NEW DEVELOPMENTS IN COMMONWEALTH-STATE RELATIONS

The most appropriate treatment of DisabilityCare Australia

Terms of Reference 5

When Disability Care is fully functioning and applying uniform national standards of service, horizontal equity is being achieved effectively within the operations of a national scheme. The need for equalising for the budget impact of different numbers of disabled across states falls away.

In principle, as pointed out in the first Interim Report of the GST Distribution Review, the existence of explicit fiscal equalisation facilitates vertical re assignment of functions in and out of an implicit equalisation national government setting. (Practical limitations on the accuracy of CGC assessments may mean the process is not completely seamless).

The CGC's task would remain only for contributions to DisabilityCare Australia to be assessed as a 'reverse' Payment for Specific Purposes. That is, to the extent that contributions to Disability Care by the States vary from an equal per capita amount, needs should be assessed so as to ensure a contemporaneous net population share impact on state budgets.

In the transition period State government expenditures of all states will continue to be affected by relative size of disabled populations and should continue to be subject of differential assessment. The fact that the policy settings of state governments during the transitional period have been influenced by or agreed with Commonwealth should not be determinative of a move to non-equalisation (even for any of the parts of a dual assessment.) Many state government policy settings in a variety of expenditure categories reflect agreements with the Commonwealth e.g. public hospital 'Medicare' undertakings.

In the event that assessments were changed during transition to the full scheme, South Australia does not support backcasting. As each participating State has its own individual trajectory and trial sites before reaching full scheme implementation there is no consistent policy change or contemporaneity that should be reflected through backcasting in the move to the full scheme.

The recognition of educational disadvantage in the National Education Reform Agreement (NERA) funding arrangements

Terms of Reference 6

South Australia endorses the CGC's treatment of Commonwealth payments in the 2010 Review, where Commonwealth payments were treated on a case-by-case basis to assess their impact on State fiscal capacities, unless specific instructions were specified in the terms of reference. When Commonwealth payments have an impact on State fiscal capacities these should have an impact on the GST distribution, as envisaged by the Intergovernmental Agreement.[5] When Commonwealth payments have an impact on State fiscal capacities the revenue

[5] Paragraph 34, Pg 8, Report on GST Revenue Sharing Relativities -2010 Review Volume 1 – Main Report.

should be redistributed between States on an equal per capita basis through the GST distribution.

Continuing consistent treatment of Commonwealth payments may be at risk in relation to the NERA The negotiating of national agreements on a bilateral basis with States has led to inconsistencies, with clauses agreed between individual States and the Commonwealth that are unclear and possibly contentious to other States.

Clause 6 of the 2015 Review terms of reference states: *"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."*

State expenses on schools education is a significant component of State operating expenses, calculated as 20.7% of total operating expenses by the Commission in 2008-09[6]. Schools education expenses as a proportion of total operating expenses ranged from 15.7% in the NT to 22% in NSW in 2008-09. The Schools education category includes State expenses on government pre-schools, primary and secondary schools, student transport services, and Commonwealth and State payments to non-government schools.

As schools education expenditure is a significant expense for States and each State makes an independent decision about its own State expenses, and because no explicit terms of reference has been issued for the Commission to no longer make an assessment for education category, South Australia's interpretation of Clause 6 of the terms of reference is that the Commission should continue to undertake an independent HFE assessment of State expenses in the schools education category.

South Australia looks forward to reviewing the Commission's interpretation of Clause 6 of the terms of reference and participating in any debate on this issue.

South Australia's initial thinking is that all State sourced funding and Commonwealth sourced funding including all State sourced and Commonwealth sourced NERA funding for schools education should be subject to a full HFE assessment.

The CGC's framework for the schools education expenditure assessment should continue and any NERA impact benefit to non-participating States should be annulled. However, with the exception of government school student full-time equivalent enrolments, the NERA characteristics and weightings should replace the student characteristics in the current CGC assessment. Other factors in the existing assessment category such as service delivery scale, administrative scale and school transport expenses should continue to be included in the assessment in a similar way as in the existing assessment.

On the revenue-side, South Australia would expect that all the funding provided by the Commonwealth Government for schools education including NERA funding would be subject to inclusion treatment in the normal way, subject to any benefit to non-participating States being annulled.

[6]Table 10.1,pg 145 Report on GST Revenue Sharing Relativities -2010 Review, Volume 2 – Assessment of State Fiscal Capacities.

It is noted that Clause 6 is not expressed in the way that other clauses are, which do seek to quarantine Commonwealth payments.

South Australia looks forward to engaging with the Commission in its deliberations on this issue and will respond to proposals as they arise.

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APPENDIX A

Service concession arrangements

(Extract from notes contained in Victorian Government - 2011-12 financial statements)

The State sometimes enters into certain arrangements with private sector participants to design and construct or upgrade assets used to provide public services. These arrangements are typically complex and usually include the provision of operational and maintenance services for a specified period of time. These arrangements are often referred to as either public private partnerships (PPPs) or service concession arrangements (SCAs).

These SCAs usually take one of two main forms. In the more common form, the State pays the operator over the period of the arrangement, subject to specified performance criteria being met. At the date of commitment to the principal provisions of the arrangement, these estimated periodic payments are allocated between a component related to the design and construction or upgrading of the asset and components related to the ongoing operation and maintenance of the asset. The former component is accounted for as a lease payment in accordance with the lease policy (see Note 1(M)).

The remaining components are accounted for as commitments for operating costs which are expensed in the comprehensive operating statement as they are incurred.

The other, less common form of SCA, is one in which the State grants to an operator, for a specified period of time, the right to collect fees from users of the SCA asset, in return for which the operator constructs the asset and has the obligation to supply agreed upon services, including maintenance of the asset for the period of the concession. These private sector entities typically lease land, and sometimes State works, from the State and construct infrastructure. At the end of the concession period, the land and state works, together with the constructed facilities, will be returned to the State.

Significant service concession arrangements include the CityLink network, which has a nominal term of 33.5 years expiring 15 January 2034 and EastLink, which is also a tollway, with a nominal term of 35 years expiring 30 November 2043.

There is currently no authoritative accounting guidance applicable to grantors (the State) on the recognition and measurement of the right of the State to receive assets from such concession arrangements. Due to the lack of such guidance, there has been no change to existing policy and those assets are not currently recognised.