Department of **Treasury and Finance**

Commonwealth Grants Commission 2015 Methodology Review

Victorian Government Submission

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State Government Victoria

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1. Introduction and Overview

Victoria welcomes the *2015 Methodology Review* and the opportunity to provide its initial views in response to the terms of reference.

Despite the significant truncation of the time available, the *2015 Methodology Review* is the primary opportunity to contemporise and improve the current system until governments can agree a more fundamental reform of federal financial relations.

This submission to the review responds to the Commission's request for state and territory views on:

1. the principles and architecture of the methodology;
2. priority issues highlighted in the terms of reference; and
3. assessments that need to be re-examined in more detail.

An overview of Victoria's position on these is provided below. This submission also addresses the other elements of the terms of reference, particularly those recommendations referred from the *GST Distribution Review*.

1.1 Principles and architecture of horizontal fiscal equalisation

Victoria continues to support the principle of horizontal fiscal equalisation (HFE). However, the current scope and application of HFE to the GST is not reflective of the Australian federation in 2013 or the changing nature of federal financial relations. It is apparent that:

- **the scope of equalisation has been expanded**: the inclusion of the capital assessment in the *2010 Methodology Review* introduced the notion of assessing relative future need;
- **the methodology is being asked to do more than was intended or than it is capable of doing:** for example, the unique and extreme service delivery challenges faced by the Northern Territory have a disproportionate and distortionary effect on the assessment. The application of HFE to the GST pool is not the appropriate mechanism to address these challenges; and
- **data revisions and the application of judgement produce problematic volatility in GST distribution**: such as the large impact of the revised interstate wages assessment in 2011 Update.

The case for full equalisation of GST revenue is no longer valid.

The current system is also increasingly at odds with the evolving shape of federal financial relations. The *2008 Intergovernmental Agreement on Federal Financial Relations* (IGA) attempted to ensure that HFE was achieved primarily though the role of the Commission in distributing GST amongst the states and territories (the states). It did this by moving major tied payments to a per capita share basis and removing many Commonwealth prescriptions on service delivery. In 2013 these principles are largely redundant, with a shift back toward prescriptive tied funding arrangements and funding provided to the states weighted for their relative need and costs.

Arrangements for health and hospitals, the largest single area of state government responsibility and Commonwealth state transfers, have undergone the most significant reforms to date. Disability services and schools education may follow suit. In these policy areas the Commonwealth Government has sought to impose more detail on the use of funds and direct funds to states on its policy priorities and measures of need and cost, overriding state government discretion. These changes make it necessary to examine the appropriateness of duplicative, secondary equalisation through the grants commission process, and to identify alternative options—including partial equalisation options. Chapter 7 of this submission outlines options for further investigation.

1.2 Terms of reference priority issues

The Commission has been asked to have regard to a number of specific recommendations of the final report of the *GST Distribution Review*. This was an extensive, independent review. Jurisdictions agreed to refer these recommendations to the Commission for consideration for further advice on implementation and impacts, in order to progress negotiations between governments.

Of the recommendations referred to the Commission, recommendation 6.1 relating to the consistent treatment of national network roads and rail projects, is Victoria's highest priority. This is reflected in *2015 Methodology Review* term of reference 2(c). This recommendation should be immediately implemented.

In addition to suggesting how to correct the current policy bias in the infrastructure assessment, Chapter 4 of this submission also identifies alternative approaches to the capital assessment that would promote greater simplicity and less volatility.

Chapter 3 of this submission discusses mining expenditure and revenue. Own source revenue raising capacity remains a key source of interstate fiscal disparity, and one which is not captured elsewhere in the system of federal financial relations. The recent increase in the capacity of the resource-rich states due to their unique revenue base is significant. The large movements in the mining assessment are not due to fundamental flaws in the methodology, but reflect the undisputedly larger revenue raising capacity of these states. All revenue from these sources should continue to be assessed, in boom times or otherwise.

The conceptual case for special treatment of mining related expenditure, as previously found by the Commission, is also weak. The *2010 Methodology Review* could not identify any material expenditure need over and above that already captured in the assessment, or identify why mining should be treated differently to any other industry. The Commission's methodology needs to continue to retain its credibility by avoiding a political bargain on the treatment of resource-rich states.

The Commission's consideration of methods to appropriately capture the changing characteristics of disadvantaged populations is discussed in Chapter 5. Equalisation through the distribution of GST cannot address significant policy challenges that are unique to one or two states. Beyond this issue, the assessment of disadvantaged populations must be consistent across such populations. Data must be high quality and fit for purpose in all circumstances in order to maintain a robust and trustworthy system of HFE.

1.3 Assessments that need to change

The Commission has asked for nominations of other areas of the assessment that states believe need to be re-examined as part of the *2015 Methodology Review*. Consistent with the Commission's assessment guidelines for the *2010 Methodology Review*, the assessment of interstate differences needs to be legitimate, material, supported by evidence and data that is fit for purpose, with GST outcomes which are commensurate to actual differences.

Chapter 2 outlines Victoria's concerns with the interstate wages assessment in this context. There are significant conceptual, methodological and data issues with the current operation of the assessment. The data on which this assessment is based is no longer collected by the Australian Bureau of Statistics (ABS), and a viable replacement will not be available for a number of years. The various alternative measures available fall far short of any reasonable standard of fitness-for-purpose. In the absence of reasonable supporting data, it is untenable for the Commission to continue to apply an interstate wages disability.

Across all categories the Commission should continue to seek opportunities to make further improvements to the simplicity and transparency of assessments, and to ensure data is—without exception—of high quality and fit for purpose. Specific issues are discussed in Chapters 6, 8 and 9.

2. Interstate Wages

Victoria accepts there are underlying differences in nominal wages between states, and that it is reasonable for the Commission to attempt to account for these in a policy-neutral way. However, the current assessment of these differences is unduly complex, based on unsound data, and not reflective of actual costs faced by state governments.

The determination of an interstate wages disability is currently informed by the results of a regression analysis of private sector wage data from the *Survey of Education and Training* (SET). There are significant issues with this approach, providing grounds for a methodological overhaul or the application of a much larger discount. However, the ABS has ceased collection of the SET, and will not introduce a dataset potentially appropriate for the Commission's purposes for some years[1].

In the interim, the interstate wages disability cannot continue to be credibly applied. The various measures presently available to the Commission fall far short of being fit-for-purpose. Continuing with the wages assessment as currently constituted in the absence of reasonable supporting data would redistribute large amounts of GST revenue (interstate wage scale factors resulted in a redistribution of $1.4 billion in the *2013 Update*) based on little more than speculation. This is unacceptable. In several other areas, the Commission accepts that even where a good conceptual case for an adjustment exists, a disability cannot be applied in the absence of appropriate data. The Commission must be consistent in its approach and discontinue the use of the wages assessment, at least until better data becomes available.

2.1 The current methodology overstates wage differentials

Wage costs are a large component of state budgets, and it is appropriate that their impact is considered by the Commission. However, private sector wages as currently used by the Commission are not a reasonable proxy for a state's public sector wages, and so the measure is not reflective of the cost pressures actually experienced by state governments in delivering services and infrastructure.

The Commission's model, described above, currently controls for variables including educational attainment, industry and gender. The Commission employs private sector wage data in an attempt to develop wage scale factors which are policy neutral, and outside the direct influence of state governments.

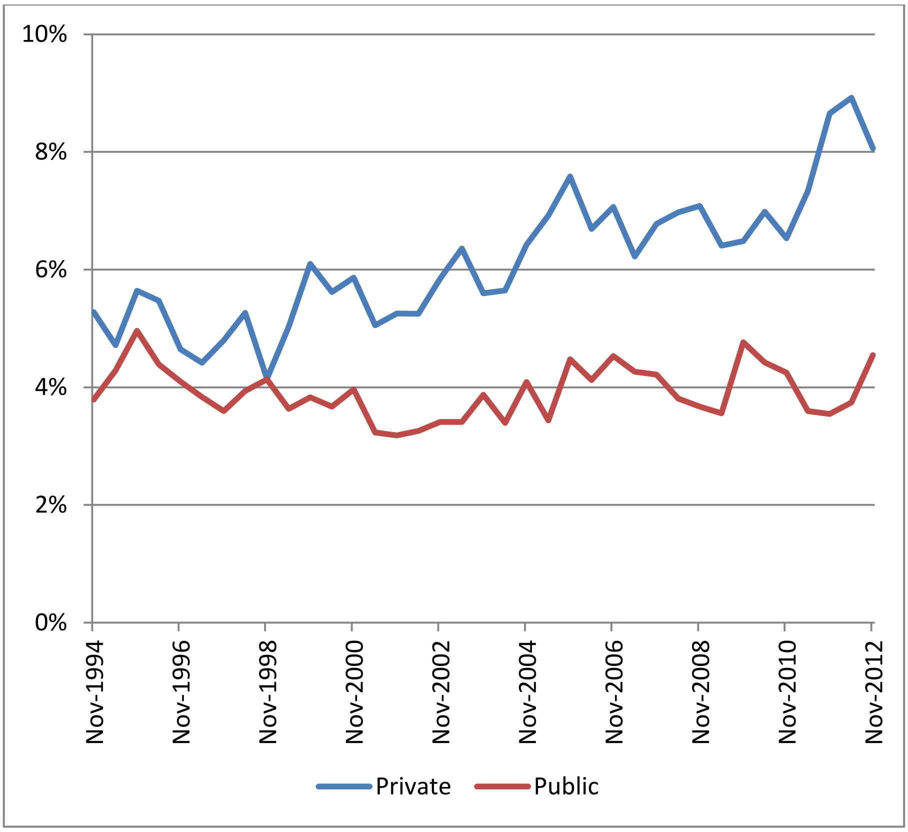
The current approach makes the implausible assumption that the interstate differences in private sector wages apply to the same extent for public sector wages. This unrealistically inflates relative state wage expenses in every expense category.

While the scale of variation may vary from year to year, a clear picture of this phenomenon emerges over time. Shown below is the average interstate variance in private sector wages from the national private sector average, and the average interstate variance in public sector wages from the national public sector average. It demonstrates that interstate public sector

1 The ABS will introduce *Compensation of Employees* in 2016.

wage variance has been relatively stable since 1994. By contrast, interstate private sector variance tends to be higher, and the disparity has increased over time. In fact, in the last 18 months, interstate variation in private sector wages has been more than double that of the public sector. Despite relative stability in public sector wage differentials, the level of redistribution caused by the interstate wages disability is now almost ten times greater than when the disability was introduced in 1992–93. Inflating public costs by these larger private differentials overstates the scale of any required adjustment.

Chart 2.1: Average variance in interstate wage levels from national sector average



Source: Australian Bureau of Statistics, *Average Weekly Earnings, Full Time Adult Total Earnings*, Cat. No. 6302.0.

Equally concerning is the lack of any significant relationship between public and private sector wages within data used in the Commission's calculations. The 2009 SET data on which the assessment of wage factors is based showed a much less significant correlation between underlying public and private wage differentials than in previous years. The statistical measure of that relationship, the R^2 value, was just 0.15. This may be construed as evidence of very little correlation at all, and certainly provides no reasonable grounds upon which to conduct such a large redistribution of GST revenue.

The Commission itself has acknowledged the significant shortcomings of the current approach. In 2009 the Commission's analysis suggested underlying wage levels of Western Australia were almost six per cent higher than the national average, and proceeded to greatly increase the assessed cost of providing every service in that state. Subsequent working papers prepared by the Commission found that public sector wages in that state were actually almost four per cent *below* the average—that is, it was much more likely that cost pressures faced by Western Australia in 2009 were actually lower than the national average. It is extremely concerning that a disability predicated on analysis which misjudges the magnitude and even the direction of impacts should form part of the Commission's methodology.

This issue is not confined to one year's worth of anomalous data. The Commission's wage scale factor for Western Australia has increased markedly in recent years. However, over this time levels of variation in public and private sector wages in Western Australia from national sector averages have diverged sharply, with public sector pay actually closer to the national public sector average than immediately before the beginning of the mining boom. Examining ABS *Average Weekly Earnings, Full Time Adult Total Earnings* data over the decade to November 2012 paints a clear picture. At the beginning of this period, private and public wages in Western Australia were respectively around 1 per cent above and below national sector average wages. In November 2012, public sector wages in that state had risen to just 3.4 per cent higher than the national sector average, while over the same period, private sector wages in Western Australia had risen to 19.9 per cent higher than the national sector average.

2.2 Data issues

The Commission acknowledges elsewhere that a strong conceptual case alone cannot form the basis of an assessment or disability where data quality is not sufficiently robust. The same standard must be applied here.

There is a strong case that continued use of SET data following the *2015 Methodology Review* is untenable. By this time, the data will be badly out of date. The most recent 2009 SET already saw an unacceptable deterioration in the correlation between underlying public sector wages and their private sector proxy. The current approach of indexing SET regression results by Wage Price Index (WPI) data each year has also been unsuccessful—it has been typified by large corrections following the release of new SET data, suggesting that it provides a poor measure of actual underlying wage pressure. Continuing to use this approach based on 2009 SET data is not a viable option.

Examination of the standard errors associated with the regression of SET data by the Commission also indicates an indefensibly high level of uncertainty. This is particularly the case for small states, which are the principal outliers under the current approach. The very large deviation in the ACT's assessed wage levels from the national average is almost wholly within range of being statistically insignificant. This cannot be justified. The results of the Commission's regression model are necessarily imprecise, but are then applied as if they are exact measures, resulting in the potentially groundless redistribution of very large amounts of GST.

Even were the ABS to have continued to conduct the SET, there would have been a solid case to apply a much steeper discount to the wages disability based on the issue of standard errors alone, let alone all of the other drawbacks highlighted above. Victoria appreciates that the weak wage relationship in the 2009 SET data became evident following the *2010 Methodology Review*, and that accordingly it would have inappropriate for the Commission to respond with wholesale changes to the calculation of the disability as a result. The Commission should take the opportunity afforded by this review to rectify this situation.

One option which has been flagged is for the Commission is to use the ABS' *Employee Earnings, Benefits and Trade Union Membership* (EEBTUM) for the purposes of conducting the required regression analysis. The Commission have previously noted that EEBTUM has a number of known shortcomings[2]. Unlike SET, EEBTUM includes no data on the education status of respondents. As education level is a characteristic typically associated with productivity, a move to EEBTUM would misrepresent productivity differences as location effects, thereby significantly overstating the importance of the latter. A series of other variables relevant to the Commission's regression model (such as employee experience) are not as precisely defined as for the SET data, potentially further compromising the integrity of the model's output. EEBTUM data are also less reliable than SET data generally, as they are not gathered using face-to-face interviews. The problems with EEBTUM appear so great that it cannot reliably be used to inform the calculation of a wages disability, regardless of the level of discount applied.

The ABS will introduce a new measure, an expanded *Compensation of Employees* (COE), in 2016. COE promises to include educational attainment as a variable, and like EEBTUM would provide a contemporaneity advantage over the SET. However, even were COE available now, there would still be a compelling case for a rethink of the wages assessment or the application of a larger discount. As it stands however, there will be no suitable data available to allow the wages disability to continue to be applied until after 2016. Even after COE data is made available, the Commission will need to establish its fitness-for-purpose, and any subsequent inclusion in the methodology would best occur in the context of the *2020 Methodology Review*.

If there is no satisfactory data available, there is no way for the Commission to continue to apply a wages disability. There are many factors affecting the ability of states to deliver an average level of services which are currently excluded from the methodology because it is not possible to accurately measure their magnitude by policy-neutral means. Interstate wage differentials fall within this category.

2.3 Other methodology issues

The treatment of wage scale factors following their initial derivation by the Commission also raises concerns. For example, the Commission currently adjusts the interstate wage disability of the ACT and NT based on judgement about the impact of superannuation arrangements peculiar to these jurisdictions. While the system remains broadly unreflective of actual public sector wage costs faced by states, it is incongruous and unnecessary to make these micro-level adjustments. There is also no obvious justification for applying these factors—modified as they are for very particular state government costs—to capital expense categories where the majority of work is completed by private contractors whose wage costs are unaffected by state government superannuation arrangements.

The Commission also uses an average of the proportion of all government costs related to wage expenses to inform the wage scale factor for the roads and transport services assessments. While it is difficult to determine the wage-related component of state government expenditure when work is performed by external contractors, it seems likely that the wage component of total expenses in these capital intensive categories is less than the average of all expense categories.

2 Commonwealth Grants Commission, *Input Costs Working Paper 2008,* p. 4.

These are just some of the adjustments made to already imprecise statistical outputs, which are then applied by the Commission as if they were a precise measure. Issues with the interstate wages disability should not be dealt with through an increasing series of ad-hoc interventions, but through a fundamental rethink of the assessment. The complexity of the calculation and application of wage scale factors also does little to more closely align the disability with actual cost pressures, and could be significantly streamlined.

2.4 A move to a broad indicator

There is no appropriate data to support ongoing application of a wages assessment, if the Commission wishes to continue using underlying private sector wage levels as the basis for its calculations. The Commission could undertake work to examine the underlying drivers of differences in interstate wage levels if it was considered crucial to retain some form of interstate wages adjustment.

In the long run, nominal wage differences are largely driven by differences in the cost of living between states. While real wages between states tend to equalise over time, the higher cost of living in a city like Sydney will ensure that the New South Wales Government continues to incur higher nominal wage costs. The Commission could investigate the use of a broad spatial cost of living indicator to provide a simple, transparent proxy measure for the underlying wage differentials between states.

There may be a case for pairing a cost-of-living indicator with a simple labour market measure, if the Commission wished to consider transient factors affecting wage levels (such as labour shortages currently pushing up wage levels in Western Australia).

2.5 Conclusion

There is no data which is fit for the purpose of continuing to calculate a wages disability, and its use should be discontinued until appropriate data can be identified. The movement of such large sums of revenue without reasonable supporting data cannot be justified. While the current methodology is already highly questionable, Victoria considers that the discontinuation of the SET means the case for removing the interstate wages disability altogether is overwhelming.

If the Commission is determined to continue to make an adjustment for differential wage costs, there is merit in examining broad indicators. This approach has the added benefit of addressing the problems of undue complexity and false precision inherent in the current methodology.

Although highly doubtful, if data of sufficient quality could be sourced by the Commission, the extensive issues identified with the derivation of wage scale factors from private sector wage data indicate that the maximum 50 per cent discount should be applied. Victoria considers that this would be the only reasonable course of action, in light of the high level of uncertainty about the assessment's inherent conceptual, data and methodological issues.

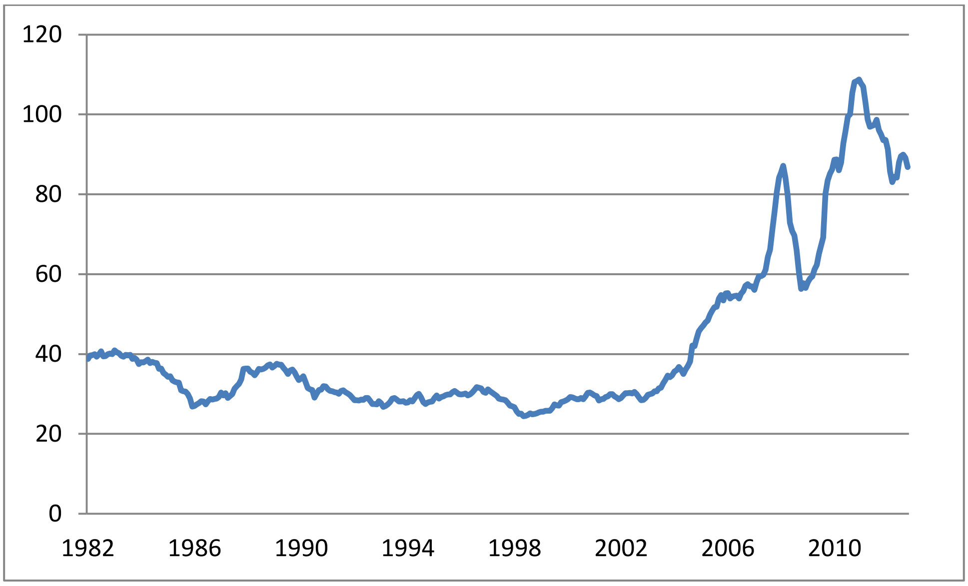
The scale of any discount should be determined with reference to the characteristics of the assessment. Small changes in assessed variance in interstate wage costs tend to result in the redistribution of large amounts of revenue. Accordingly, if there is any doubt at all over the integrity or fitness for purpose of the data underlying the assessment, the Commission should err on the side of caution and apply the largest possible discount.

3. Mining Revenue and Expenses

Mining revenue must continue to be fully assessed if the methodology is to retain credibility as a conceptually consistent approach to equalisation. The *2010 Methodology Review* thoroughly considered the appropriate assessment of these issues, and significantly improved the assessment of mining revenue. There remain some minor issues when minerals move between royalty rate groups which can be handled within the current assessment framework. There is no basis for broader, arbitrary changes, including discounts on or exclusions of mining revenue.

Increased redistribution associated with the mining revenue assessment does not indicate there is a problem with the current assessment. The increasing significance of the mining revenue assessment reflects the significant and increasing disparity in the capacity of states to raise revenue from mineral resources, reflecting the unprecedented increases in commodity prices in recent times (see Chart 3.1).

Chart 3.1: Reserve Bank of Australia Index of Commodity Prices, August 1982 to May 2013



Source: Reserve Bank of Australia, *Index of Commodity Prices*.

Similarly, the current assessment already captures expense needs associated with state support for industry, including those from an expanding mining industry. Any policy neutral requirement for states to provide services is already addressed and there is no conceptual basis for special treatment of selected industries.

The remainder of this chapter will focus on the recommendations of the *GST Distribution Review* final report referred to the *2015 Methodology Review* for further consideration.

3.1 Treatment of iron ore fines (GST Distribution Review Recommendation 7.1)

The *GST Distribution Review* final report recommends the Commission consider the appropriate treatment of iron ore fines for the 2012–13 assessment year and future years (recommendation 7.1).

As observed in previous methodology reviews and in the course of the *GST Distribution Review*, the large differentials in states' inherent capacity to raise revenue from mining makes this assessment particularly subject to policy contamination. Western Australia's experience with iron ore fines highlights this challenge. In 2010–11 Western Australia removed a concession on the iron ore fines royalty rate, to bring it into line with iron ore lump royalty rates over time. The current mining revenue assessment splits minerals between a high royalty and low royalty rate minerals. The threshold for a mineral to be included as high royalty is approximately five per cent. All other treatment held constant, the change in royalty applying to iron ore fines would have resulted in the iron ore fines moving from the low royalty rate group to the high royalty rate group. As the royalty rate applying to iron ore fines during the transition period was significantly below the average royalty rate for high royalty minerals, it was likely Western Australia would have lost more revenue via a reduction in GST than it gained from increasing the iron ore fines royalty rate.

As found by the *GST Distribution Review*, this presents an issue of how this revenue should be assessed, rather than whether it should be assessed in full.

It appears this issue could have been avoided if iron ore fines had been grouped in the high royalty rate group with all other iron ore after the *2010 Methodology Review*, reflecting the concession on iron ore fines being a policy choice of Western Australia.

In any case, if the *2015 Methodology Review* maintains the two value group structure then iron ore fines should be assessed in the high royalty rate group, as the average royalty rate is above the relevant threshold. The circumstances which made the outcome perverse during transition no longer apply and there is no longer a case for special treatment of iron ore fines. Effectively iron ore fines and lumps will have the same royalty rate from 2013–14. As such, Victoria agrees with the *GST Distribution Review* that "Further intervention is no longer required"[3].

3.2 Mining revenue assessment (*GST Distribution Review* Recommendation 7.2)

Recommendation 7.2 of the *GST Distribution Review* final report suggests the Commission and other stakeholders develop a new mining assessment. Given the comprehensive consideration this was given as part of the *2010 Methodology Review* it is not clear a new assessment is required. However, should a new assessment method for mining revenue be explored there are two possible approaches which could address the current issues with the mining revenue assessment: a single category assessment or an actual per capita (APC) assessment.

It is clear that mining is a significant source of state revenue and a material driver of differing fiscal capacity. It should therefore continue to be fully assessed when determining state fiscal capacity.

3 The Commonwealth Government, *GST Distribution Review*, p.112.

The Commission has observed that “differences in states’ royalty revenue are primarily driven by states circumstances. i.e. their natural endowments”[4]. Mining revenue raising capacity is overwhelmingly dictated by resources located within state boundaries.

As illustrated in the previous section, it is difficult to create a perfectly policy neutral assessment of mining revenue raising capacity. The uneven distribution of resources means that the current assessment of revenue raising capacity can be influenced by policy changes of a single jurisdiction, including as they apply to unrelated minerals within a given value group. For example, if Queensland changed the royalty rate applying to its coal resources, perhaps to reflect an increase in the market value, this will influence the average royalty rate applying to the high royalty rate group. As a result Western Australia will be assessed as having an increased revenue raising capacity from iron ore, despite the fact that the prevailing value of iron ore could have remained unchanged.

More detailed sub-category assessments, for example separate assessments for iron ore and coal, would remove the influence between unrelated resources. However, this would reverse the simplification achieved in the *2010 Methodology Review*. An APC assessment could approximate the outcome of a more detailed assessment more simply and transparently.

If the Commission decides to focus solely on overcoming the issues with the current two rate structure it could explore a single rate mining assessment. A single rate mining structure could retain the conceptual basis of average state policy while increasing the simplicity and predictability of the assessment. This approach would determine the average royalty rate by dividing total mining revenue by the total value of production, as used in the current assessment. Multiplying the average royalty rate by each jurisdiction’s total mining value of production gives the assessed mining revenue for each jurisdiction. This removes the artificial royalty rate split between high and low royalty rate groups in the current two-rate mining assessment.

Finally, suggestions to discount the mining revenue assessment have not been justified. As Western Australia has previously observed:

> *“Discounting assessments should be avoided, and only used if an improvement in equalisation can be demonstrated.”*

And: *“Discounting reduces transparency, as the basis for the discount can rarely be explained using objective data.”* [5]

A discount or ‘carve out’ to the mining revenue assessment would reduce transparency, equity and efficiency, and undermine the conceptual consistency and credibility of the system.

3.3 Mining expenditure (*GST Distribution Review* Recommendation 7.3)

The *GST Distribution Review* 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*

4 http://www.cgc.gov.au/attachments/article/36/Mining%20revenue.pdf

5 Western Australia, *February 2009 submission*, CGC2008/04, p.1 and p.3.

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."

An ad hoc adjustment to mining expenditure was never considered a permanent or genuine reform measure.

3.3.1 Assessment of costs associated with mining in the current assessment

The Commission's assessment already covers the drivers of expenditure need which are beyond a state's policy control. To date, no substantiated evidence has established that there are 'extraordinary costs' associated with the mining boom not already captured in the methodology. A *prima facie* case alone is clearly inadequate for resource states to receive compensation during an unprecedented economic boom. The *GST Distribution Review* final report considered that there were some unassessed expenses related to the mining industry. However the current assessment of expenses is likely to cover them, as outlined in Table 3.1. If this is not the case than evidence must be produced by the advocating states to demonstrate the extent to which expenses are not covered, how any associated differentials can be robustly measured without double counting or policy influence, and that the resulting impacts are material.

Table 3.1 Current assessment already covers state expenses incurred

Claimed unmet need	Current assessment treatment
Mining industry support costs	Services to industry
State provided services, social infrastructure and other community amenities in mining regions	Services to communities for water and electricity subsidies Service delivery scale—Schools education, police, Community and other health, Welfare and housing
Financial support for local government for the provision of community amenities	Services to communities
Services and infrastructure for FIFO and DIDO workers	Investment for infrastructure provision Services—no evidence provided for increased demand for state services from FIFO and DIDO workers
Very high costs in Western Australia's remote mining communities	Locational disabilities
Capital costs approximated using current costs	Investment assessment
Roads in mining regions	Investment for construction Roads category for maintenance

Table 3.1 (continued)

Claimed unmet need	Current assessment treatment
Opportunity cost and risk (or cost of in-advance provision of infrastructure)	Opportunity cost outside the scope of HFE

3.3.2 Equity in the treatment of industry support expenses

The resources-rich states are the beneficiaries of large infrastructure investment from the private sector: mining companies are spending billions of dollars on infrastructure.[6] This suggests that, far from being an additional cost, 'resource states' benefit from significant private sector investment in infrastructure relative to other states.

It is difficult to develop a policy neutral indicator of the requirement for industry support. Ultimately it is a state government policy choice to support particular industries. To recognise only the specific, policy-driven costs associated with supporting the mining industry would be inconsistent and inequitable.

Governments incur 'unique' costs and challenges associated with supporting each industry. If the costs of mining were to be recognised, a conceptually consistent approach would entail recognising the costs of every other individual industry. This would significantly increase the complexity of the assessment in order to account for a need which has, to date, not been supported by objective evidence. It would also reverse the simplification introduced with the *2010 Methodology Review*. As such Victoria opposes expanding the industry support assessment, or the assessment in general, to account for a states' mining industry support.

6 Bureau of Resources and Energy Economics, *Mining Industry Major Projects*, p. 16.

4. Infrastructure

4.1 Consistent treatment of Commonwealth NNR and rail funding (*GST Distribution Review* Recommendation 6.1)

Recommendation 6.1 of the *GST Distribution Review* proposes a methodology change to rectify the current inconsistency in the treatment of Commonwealth funding for National Network Roads (NNR) and rail projects. This inconsistent treatment creates a significant distortion in the assessment of infrastructure funding and resultant GST relativities.

Recommendation 6.1 is clear that the methodology should change. This is a fundamental difference from other *GST Distribution Review* recommendations referred to this review, which require the Commission to re-examine or consider the need for a change to an assessment. This recommendation is clear the methodology should change to ensure Commonwealth rail funding is given equivalent treatment to Commonwealth funding of NNR. Recommendation 6.1 also specifies *how* the methodology should change:

> *"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."*

Victoria supports the full implementation of this recommendation in the *2015 Methodology Review*.

4.2 The current assessment

4.2.1 Treatment of Commonwealth funding in the Investment assessment

More broadly, the Commission should consider how large one-off infrastructure projects that are outside average state service delivery can be treated appropriately and consistently.

For example the Commonwealth Government has committed to provide $3.225 billion to Victoria for the Regional Rail Link (RRL), 75 per cent of the total project funding at the time of announcement. The nature of this funding is to facilitate the provision of infrastructure that is well beyond the scope of average state policy. Equalising such extraordinary funding across states, as if it were equivalent to the standard Commonwealth support for infrastructure historically provided every year under programs such as AusLink, compromises the delivery of these nationally significant, transformational projects. This is to the detriment of the entire nation and future generations.

As discussed above, the current discrepancy between the treatment of Commonwealth funding for rail projects and NNR projects needs to be addressed as a matter of priority.

Discounting the impact of Commonwealth grants for NNR projects alone creates a significant and specific bias in the assessment. This treatment appears to be based on the mistaken assumption that the NNR represents the only transport network where:

> *"investment is influenced by Commonwealth considerations which are not captured in our State based disability measures. These include the need to develop an efficient*

national transport network to facilitate national economic growth and productivity gains in the long term."[7]

The National Land Transport Network (NLTN), which includes the NNR and rail transport corridors, is defined at the discretion of the responsible Commonwealth Minister. The NLTN will not accurately cover all Commonwealth funding which are intended to increase economic and productivity growth and currently the assessment does not even reduce the impact of all NLTN funding. The Commonwealth Department of Infrastructure and Transport outlines that rail infrastructure is also important for productivity and economic growth:

> *"A competitive, safe and reliable rail network—both within and between our major urban communities—is critical to lifting national productivity, curbing the escalating cost of traffic congestion and tackling climate change by contributing to reducing carbon pollution."*[8]

The objective identification of projects which have national objectives and scope is clearly complex. If a transparent, robust methodology cannot be identified then the Commission should simply remove the identified distortion between NNR and rail projects.

4.2.2 Use of disabilities in the investment assessment

The broader assessment of infrastructure needs also bears review, including through further consideration of the case for and application of the Investment category assessment. Further improvements to the Investment assessment could be made by reviewing the application of expense disabilities, including socio-demographic composition, location, service use disabilities and service delivery scale. There does not appear to be an adequate conceptual case for the application of disabilities—identified for their relevance to the unit use and cost of government services by particular population groups—to the provision of buildings, roads and other capital stock. For example it is not clear that there is a strong link between socio-economic status and the need for capital investment.

If this conceptual case cannot be demonstrated, disabilities should be removed from the Investment assessment. While the current assessment accepts the relationship between expense disabilities and capital need is not linear (by applying a 12.5 per cent discount), it is not clear this adequately reflects the relationship likely being much less than one to one. The current discount is arbitrary, and for simplicity and transparency it is better to remove the disabilities.

The impact of urbanisation is a disability directly relevant to the provision of infrastructure requiring further consideration in this review. The level of urbanisation increases the cost of delivering road and other large infrastructure projects due to factors such as population density, increased land values and access difficulties. This is currently not adequately taken into account in the assessment of infrastructure. Currently only a road use disability is specifically included in the infrastructure assessment. Urbanisation is also indirectly included in the stock of infrastructure where it is captured in expense assessment.

Urbanisation will increase the cost of construction over and above the current factors included in the investment assessment. Increasing population density will result in more complicated engineering works being required to deliver new infrastructure. This means that

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7 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2010 Review—Volume 2*, p. 444.

8 Commonwealth Department of Transport and Infrastructure website, http://www.nationbuildingprogram.gov.au/funding/projects/rail.aspx

building new infrastructure involves a significantly higher of construction relative to "green field" projects. For example the East-West Link project will require tunnelling. High rates of urbanisation result in less readily available land to build infrastructure and the need to acquire properties when building infrastructure, often at significantly higher property values than in greenfields areas. For example, the Regional Rail Link project involved the acquisition of 78 residential and commercial properties. Finally, urbanisation makes access to undertake work on infrastructure projects more difficult to coordinate, which increases the cost. For example, projects in busy urban environments require "work-arounds" to allow road and rail transport to continue while the new project work is undertaken.

4.3 Simplified and integrated assessment (*GST Distribution Review* Recommendation 6.3)

The *GST Distribution Review* final report recommendation 6.3 proposes making adjustments to the current assessment of capital needs to simplify the assessment. However, removing the assessment of capital needs would deliver a far more significant improvement.

The Investment and Net lending assessments (capital assessment) expanded the scope of the GST distribution to capital needs resulting from population growth. It also significantly increased the complexity of the assessment.

Population growth is not necessarily a good indicator of capital needs in a given year. The need to invest in infrastructure can be lumpy and it may take a number of years of population growth before an infrastructure project is viable. Alternatively projects may be undertaken in anticipation of, or to increase the likelihood of, population growth. This makes it difficult to assess states' need for capital on a year by year basis.

Maintaining an assessment of depreciation expenses will account for and smooth the consumption and distribution of capital spending over time, reflecting all states' need to invest to maintain, or save for, capital over time. This would refocus the basis of equalisation to the net operating balance rather than net lending. A simplified approach for the depreciation expense is outlined in Chapter 6 – Simplification.

States have a policy choice as to how they apply the cash from their net operating balance—to retire debt, invest in "pure" financial assets, invest in financial assets for policy purposes (through the Public Non-Financial Corporation (PNFC) sector), or invest in depreciable assets (including infrastructure). This policy choice should not be subject to equalisation.

The current capital assessment creates inconsistencies depending on the method and source of capital investments. For example if one state provides infrastructure through the General Government sector and one through the PNFC sector, there will be significant differences in the respective GST distribution outcomes. In the case of general government investments, the methodology assumes that this infrastructure is required to support service delivery. This is contrasted with the treatment of investment in the PNFC sector, which is treated as an investment capable of deriving a financial return.

In effect, the form of a transaction is driving the GST outcome rather than the substance of the transaction. This is not a policy neutral outcome and something the Commission strives to avoid. Removing the capital assessment will ensure that the method and source of funding capital projects will not influence the distribution of GST revenue.

5. Disadvantaged populations

Victoria supports the use of robust data to ensure a consistent assessment of the needs of disadvantaged populations, including those of Indigenous Australians. In submissions to the *2010 Methodology Review*, subsequent *GST Distribution Review* and discussion of incorporation of *2011 Census of Population and Housing* data, some states made the case for further disaggregating Indigenous populations using additional measures, arguing that the current assessment did not fully recognise variation in need between states. Following revised Census population estimates for Indigenous Australians, some states have argued that measures such as birth weight or cultural indicators may more fully reflect unmeasured cost differences in providing an average level of services to their Indigenous populations.

Victoria believes that the methodology currently used by the Commission strikes a reasonable balance between capturing differences in the cost of service provision between states and maintaining the integrity of an assessment previously beset with data quality issues. Further disaggregation would necessarily depend on the use of poor quality data, and would unwind the substantial simplification gains made to the assessment of disadvantaged populations in the *2010 Methodology Review*.

As a basic principle, populations who are materially the same should be treated in the same way by the Commission's methodology. Not all individuals from a given disadvantaged population will be characterised by a similar level of need, but the current methodology already recognises this by disaggregating these populations to provide for the existence of heterogeneity. Depending on the assessment (for example, the admitted patients assessment), higher-cost cohorts are already disaggregated by age, sex, remoteness and socioeconomic status. The cost of providing services to the Indigenous population is not the same in all states and territories, however the last of these two factors already explain most of the variation between states. In particular, it is accepted that remoteness (as measured by SARIA) is strongly correlated with the additional cost of service provision. In various relevant assessments, the application of these disaggregating factors is already finely calibrated.

While there may remain some residual unmeasured difference between disadvantaged populations, this is true of all populations. More pressingly, while most of the variation between members of the Indigenous population is already captured by the current, finely detailed assessment, it becomes increasingly difficult to isolate any residual difference without recourse to ever poorer quality data. This is a particularly relevant consideration in relation to the current assessment of indigenous disadvantage, in which there are already data quality issues. The preferred approach for improving the assessment of these populations is improving the quality of existing data, rather than further compromising the reliability of the assessment. All individual-based measures available to the Commission (including proposed cultural indicators) pose unacceptable data quality issues.

An alternative approach is the use of additional area based measures such as the *Index of Relative Indigenous Socioeconomic Outcomes* (in addition to SARIA and SEIFA) to further disaggregate the Indigenous population. While there are fewer data quality issues associated with area rather than individual data measures, unequal concentrations of these populations mean it is exceedingly difficult to rely on further geographic classification without severely compromising policy neutrality. Similarly, the use of proxy measures also poses problems. Such an approach would constitute a significant departure from the national average method usually employed by the Commission. The use of proxy measures also risks further compromising data integrity in this area.

The Commission must apply guidelines relating to the reliability of disability assessment and data quality consistently. It is very difficult to employ any proxy measures to assess disadvantage in tandem with SARIA and SIEFA without double counting of need. The only viable solution to this problem would be to rely solely on proxy measures, which would unacceptably damage the accuracy of this assessment. Additionally, the proxy measures most suited to use in assessing need are measures related to individual health, such as birth weight. However, even more so than in other areas, the current health assessments already disaggregate disadvantaged populations in detail, capturing most heterogeneity. The basis for widely applying health related proxies to other areas (such as justice services) is also unclear.

More broadly, as noted in Finding 10.1 of the *GST Distribution Review* Final Report, overcoming the entrenched hardship of disadvantaged populations is a task that is simply too great for HFE. The sheer scale of the challenge means that it can only be appropriately addressed outside of the equalisation process. Moves to further weight the expense side of the assessment towards meeting this challenge risk refashioning equalisation solely into a mechanism by which to address a single critical and complex problem, the scope of which is far beyond the capability or proper responsibility of the system to solve.

6. Simplification

The *2010 Methodology Review* significantly simplified the method for calculating GST relativities. This was a much needed and welcome improvement. It is important that further simplification is maintained as an objective of the *2015 Methodology Review* to build on those gains. Further simplification will have the additional benefit of making the GST relativities methodology more transparent.

6.1 Materiality thresholds (*GST Distribution Review* Recommendation 3.1)

The *GST Distribution Review* final report recommendation 3.1 proposed increasing the materiality threshold for the *2015 Methodology Review*. The *GST Distribution Review* argued that a four-fold increase in materiality thresholds would result in greater simplicity. In the *2010 Methodology Review* it was stated that the materiality thresholds may be reviewed in light of the knowledge gained from their application.

Increasing materiality thresholds is an indirect and arbitrary method of achieving simplification. The best way to simplify the assessment is to directly focus on reviewing the methodology.

Simplification that builds on the *2010 Methodology Review* is possible in the short time frames of this review if there is a focus on the parts of methodology which remain highly complex. This will more directly and transparently achieve the outcome that increasing materiality thresholds intends to achieve. It will also ensure the largest gains from simplification, as the most complex areas will be reviewed. In contrast, increasing materiality thresholds is a blunt instrument which could result in straightforward parts of the assessment being removed and therefore little gain in terms of simplification.

6.2 Achieving further simplification

Further simplification of individual expenditure and revenue assessments should be explored. Significant simplification could potentially be achieved in expense assessments by taking into account the changing roles and responsibilities resulting from the NHRA, the NDIS and the potential changes as a result of the NERA. The expense assessment should not duplicate the work undertaken to assess needs as part of these agreements. Possible methodology changes to account for these changes are discussed in Chapter 7.

For areas of the expense assessment which are not affected by national reform agreements further simplification can be achieved by only relying on up to date and reliable data, not compromising these in pursuit of further disaggregation, as discussed in Chapter 5. Simplification of the current capital needs assessment is discussed in Chapter 4, while simplification of location factors is discussed in Chapter 8.

The depreciation assessment could also potentially be simplified by applying the national average rate of depreciation to each state's assessed total stock of non-financial assets, without applying expenditure disabilities. This is consistent with the proposed simplification of the capital assessment.

Revenue assessments might be simplified by exploring the implications of assessing revenue bases according to the potential legal tax base. For example, states are able to levy tax on total payrolls, and make choices to apply thresholds and exemptions. An assessment based on the total potential tax base would be simpler and arguably more policy neutral than the current approach to defining average policy.

In addition to these specific areas to review within the framework of the current methodology, further aggregation of revenue categories, as discussed in the Commonwealth Treasury submission to the first Issues paper of the *GST Distribution Review* may also warrant further investigation. A similar approach could be taken to the expense side of the assessment, although this will depend on the outcome of national reform agreements. The expense assessments could be similarly grouped into fewer and broader categories which make greater use of broad based measures of expenditure need. The greatest gains for simplicity and transparency are available on the expense side of the assessment.

7. Commonwealth funding reforms and implications for equalisation

7.1 Federal reforms, policy harmonisation and horizontal fiscal equalisation

Since the *2010 Methodology Review* there have been significant changes to federal financial relations as a result of the NHRA. Further changes are in the process of occurring through the NDIS and the NERA.

These changes have been acknowledged in the terms of reference for the *2015 Methodology Review* (terms of reference 3(a), 5 and 6). Notwithstanding the apparently prescriptive nature of term 6 (relating to the NERA), the Commission faces the considerable challenge of interpreting and applying specified conditions and still achieving conceptually appropriate treatments.

All of these reforms will or are likely to harmonise approaches to service delivery and more directly address state differences in service delivery need. The *2015 Methodology Review* provides the opportunity for the Commission to provide leadership by clarifying how these and future reforms to service delivery and funding will be treated within the system of equalisation.

In simple terms, where policies of all states are the same, and the Commonwealth reforms are directly assessing differential need and costs, these categories need to be adjusted to avoid duplicating effort. The Commission has guidelines for the application of different assessment approaches to expenditure and revenue:

- **Actual per capita assessments** are used when the policies of all states are the same and any differences in expenses or revenue per capita are due to differences in state circumstances.
- **Equal per capita assessments** should be applied when there are no material disabilities affecting the states and any differences between the states in the cost of providing services or raising revenue reflect differences in state policies.

The 2008 *Intergovernmental Agreement on Federal Financial Relations* (IGA) sought to have core Commonwealth payments distributed on an equal per capita basis, recognising that the Commission's methodology appropriately adjusted for need. However, this approach has been largely undone through the reforms to the National Healthcare Specific Purpose Payment (SPP) (the single largest tied transfer), the changes to the National Disability SPP through the implementation of the NDIS and the likely changes to the National Schools SPP.

Expenditure on hospitals (included in the admitted patients expense category), schools education and disability services (included in the housing and community welfare expense category) represents a significant proportion of states expenditure. While only the national health reforms are significantly advanced in their implementation, the Commission's framework needs to appropriately recognise the changing nature of Commonwealth payments and provide recommendations for future category assessments. This would provide certainty and reduce the incidence of partial, confused debate about GST impacts and treatments within specific negotiations. The latter has the potential to undermine conceptually appropriate treatment.

7.2 Health funding—National Health Reform Agreement

The terms of reference for the most recent two annual updates provided direction on the changing responsibilities for aged care and this direction is maintained in the terms of reference for the *2015 Methodology Review*. However, the more significant changes to roles and responsibilities and mechanisms for funding and delivering acute care need to be reflected in a revised methodology.

The key features of the NHRA are:

a. Commonwealth Government funding to states will be provided as activity based funding (ABF) based on a national efficient price.
b. All Commonwealth funding will be provided through the independent National Health Funding Pool.
c. The Commonwealth will assume a greater share of funding responsibility over time, funding 45 per cent of efficient growth (in activity) between 2014–15 and 2016–17 and 50 per cent of efficient growth from 2017–18 onwards; and
d. block funding will be provided for small and remote hospitals.

The changes are intended to lead to:

- The harmonisation of how acute care is funded across the country;
- Commonwealth funding for services (activity) being provided at their efficient price, as specified by an independently determined efficient price;
  - The efficient price will be determined so as to "have regard to legitimate and unavoidable variations in wage costs and other inputs which affect the costs of service delivery including: a) hospital type and size; b) hospital location, including regional and remote status; and c) patient complexity, including Indigenous status" (Clause B13); and
- Commonwealth funding will flow to states through the National Health Funding Pool rather than to state treasuries or health departments.

These changes in responsibilities, funding flows and the national setting of efficient price (that already adjusts for disabilities), raise a number of issues that require consideration as part of this review. These include:

- The need for an admitted patients category. Significant components of the assessment, such as price, are standardised across the country and already adjusted for needs;
- The magnitude of 'what states do', and the extent to which costs and use differentials are borne by states. States' need to spend more on disadvantaged populations is being reduced due to the Commonwealth meeting 45 per cent (increasing to 50 per cent) of that need through the cost weighted efficient price; and
- The appropriate treatment of Commonwealth funding given that the states will no longer have discretion on how it is to be spent.

7.3 National Disability Insurance Scheme (NDIS)

All states will be contributing the same amount per capita under the fully rolled out NDIS scheme, so there will be no need for any redistribution of GST from expenditure on disability services. Consistent with the Commission's assessment of average state policy, the actual per capita assessment should apply when more than 51 per cent of the Australian population is covered by the scheme.

In relation to transition, Victoria supports the position as outlined in the Commonwealth paper to the NDIS taskforce—Funding and Governance Working Group meeting of 10 April 2013 that:

> *"In transition, states' contributions to the NDIS would take account of the number of service users but not local cost drivers, since contributions would be based on the national average cost. For the purposes of HFE assessment of NDIS contributions, there would no longer need to be an adjustment for economies of scale or local cost drivers …"*

7.4 Schools funding reform

While there is significant uncertainty about the future of school funding reforms, the terms of reference for the *2015 Methodology Review* are quite explicit in directing the Commission in its assessment of the NERA funding arrangements

The first part of term of reference six states that the Commission should not 'unwind' the recognition of educational disadvantage embedded in the NERA funding. The NERA schooling resource standard (SRS) could be considered analogous to the efficient price under the NHRA, incorporating the differential assessment of socio-demographic, service delivery scale and location factors which would otherwise be undertaken in the schools education assessment.

If the total level of funding to government schools is determined by the application of the loadings for disadvantage provided by the SRS then the Commission should consider using the SRS loadings to determine need rather than its own disability factors.

The Commission needs to give careful consideration to how it deals with the second part of term of reference 6 relating to 'windfall gains'. This provision is unfortunately the result of a bilateral negotiation, with relatively little available information about intended implementation or conceptual validity. However, it appears intended to avoid the assessment of increased Commonwealth government schools funding to participating states resulting in those states being assessed as needing a lower share of GST.

Superficially, it would appear that this requirement could be met by assessing that component of school education expenditure funded by the additional Commonwealth funding on an APC basis.

However, the participation of states in NERA, regardless of the Commonwealth funding component, will change the assessment of GST needs as there will be changes to those states' own funding of schools education expenditure. Changes to own-source revenues will presumably be necessary in order to finance that additional expenditure.

The Commission needs to ensure that while 'windfall gains' in GST do not result for states not participating in NERA, these states also do not lose GST. This would inappropriately penalise states for a policy choice, undermining the credibility of the equalisation system.

7.5 Intergovernmental Agreement taxes

The 2008 IGA included a commitment by all states to abolish a number of taxes before 1 July 2013. The *2015 Methodology Review* will be the first to encounter the situation where certain taxes (hereafter called IGA taxes) should not be part of the states' tax regimes if all states have honoured the IGA.

Despite this agreement, a number of states have announced that they will not be abolishing particular IGA taxes (mainly non-real business conveyancing duty), in order to improve their revenue raising capacities. Victoria is disappointed that the Commonwealth Government has not provided guidance to the Commission in the *2015 Methodology Review* terms of reference on how to appropriately assess revenue from these taxes.

In the absence of this direction the Commission would be expected to assess revenue raised from IGA taxes according to its average state policy criteria, based on the stated policy intentions of states. Regardless of whether it is, or is not, average state policy to collect a particular IGA tax in 2013–14 and subsequent years, the Commission will assess states which *have* abolished agreed taxes as receiving revenue from that tax (either assessed according to national average tax rates or on an EPC basis).

It is obviously unfair to assess those states which have abolished a tax under the IGA as obtaining revenue from that tax, regardless of how that tax is assessed. States that do not impose that tax have not done so as an independent policy choice, but as part of agreement that all the states signed. Conversely, the additional fiscal capacity of states which have elected to contravene previous agreements should be directly recognised in the revenue assessment.

Accordingly, it would be appropriate for the Commission to assess revenue from IGA taxes APC, or according to average tax rates only for the states that impose the tax.

8. Location Factors

8.1 Assessment of regional costs (*GST Distribution Review* Recommendation 6.4)

The *GST Distribution Review* Final Report recommended:

> *"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."*

In the *2010 Methodology Review*, the Commission accepted there was a conceptual case that the costs of providing state services increase with remoteness. The Commission obtained or estimated the regional costs associated with teachers and police. These data were used to calculate the cost per full-time equivalent (FTE) employee by SARIA region. These costs per FTE employee were converted to a 'cost gradient' by dividing by the total costs per FTE employee in highly accessible areas.

The *GST Distribution Review* recommendation suggests it may be inappropriate for the full cost gradient to be applied in determining the regional cost factors. One reason for this is that people living in more remote areas tend to experience lower service standards, although states may spend more per person in those areas. Accordingly the Commission should not make assessments based on the premise that people in more remote areas receive the same standard of services as those in more accessible regions.

In addition, state government policy has numerous and strong influences upon where people decide to live. As a consequence the Commission should discount the impact of location to account for the policy influence involved.

One way in which the *GST Distribution Review* recommendation and policy neutrality concerns could be addressed is to discount the cost gradients, with the discount increasing with remoteness. An example of the discount regime that could be applied is presented in Table 8.1.

Table 8.1: Suggested discounts for cost gradients

SARIA Region	Discount
Highly accessible	0.0%
Accessible	2.5%
Moderately accessible	5.0%
Remote	7.5%
Very remote	10.0%

This discount regime results in the cost gradient being discounted by 2.5 per cent as the SARIA region moves away from being highly accessible, culminating in a ten per cent for the very remote region. This approach would be no less arbitrary than many of the other features of the assessment methodologies. Table 8.2 presents the original cost gradients from the 2013 Update and their values with the suggested discounts from Table 8.1 applied.

Table 8.2: Original and discounted cost gradients for schools and police

	Schools cost gradient		Police cost gradient	
	original	discounted	original	discounted
Highly accessible	1.0000	1.0000	1.0000	1.0000
Accessible	0.9993	0.9993	1.0479	1.0467
Moderately accessible	0.9969	0.9971	1.1427	1.1356
Remote	1.0662	1.0613	1.2978	1.2755
Very remote	1.2020	1.1818	1.5331	1.4798

Source: Commonwealth Grants Commission*, On-Line Assessment System* and DTF calculations.

If the cost gradient had been discounted in this way in the 2013 Update then it is estimated that there would have been a redistribution of GST to the value of $47.1 million. This redistribution varies from $1.17 per capita for South Australia to $101.22 per capita for the Northern Territory. This indicates that discounting of the cost gradient would have a material impact.

The Commission should consider the need for the schools cost gradient in the light of the requirement in the terms of reference not to unwind the recognition of education disadvantage embedded in the NERA funding arrangements (term of reference 6). Under the NERA there is a location loading to the SRS which varies according to remoteness and this potentially removes the need for the Commission to separately determine a schools cost gradient.

The Commission should also consider the implication of the classification of remoteness on the cost gradient in its consideration of the appropriate measurement of geographic classification (either by use of SARIA or ARIA).

Apart from the determination of the cost gradients, Victoria has some concerns about their application. These concerns are outlined in the following sections.

8.2 The police cost gradient

Victoria has concerns about the application of the police cost gradient to determine the location cost factor for the entire justice expenses category. The service expenses component of justice services is assessed by applying (multiplicatively) the socio-demographic composition factor, the service delivery scale factor and the location factor to the per capita value of total service expenses. The expenses included in the justice expenses category include court expenses and corrective services expenses, as well as police expenses.

Victoria is aware of no clear evidence that the impact of SARIA region on costs for courts or corrective services is related to that for police services. Indeed it is not clear that the

Commission is applying the police cost gradient to the entire justice services expenses. In the absence of any evidence regarding the impact of region on costs for courts and corrective services the Commission should either:

- apply the location cost factor to only the police component of service expenses if this component can be determined;
- apply the largest discount to the location cost factor to acknowledge that it is not fully fit for purpose; or
- not apply a location cost factor to the justice services assessment, to acknowledge that is not possible to obtain a factor that can be applied to all the services covered.

8.3 The general cost gradient

In the *2010 Methodology Review* the Commission considered that there was a strong conceptual case that costs associated with other categories also increase in more remote regions. The Commission considered the conceptual case was so strong that it derived a general factor, despite no or only partial data being available to support the case. The general cost gradient was specified to be the average of the schools and police cost gradients.

This approach to a general cost gradient appears inconsistent with the assessment guidelines that the Commission specified for the *2010 Methodology Review*, particularly in regard to the quality of the data.[9] It differs to the approach the Commission took in regards to the needs of people from culturally and linguistically diverse (CALD) backgrounds. While the Commission has acknowledged the conceptual case for CALD (and provided an allowance in the Other Expenses category), it chose not to incorporate CALD as a disability factor for specific expenditure categories as the data were not sufficiently comprehensive to fully establish the case or to reliably measure the effects.[10]

The Commission should take a consistent approach to factors that have a conceptual case but inadequate supporting evidence. This would require the Commission not to use a general cost gradient, or if it were to use one, to apply the maximum discount to the resultant location factors.

8.4 Interstate freight assessment

The concept behind this assessment is that some states tend to be more self-sufficient, and are therefore likely to have below average shares of interstate freight. Conversely others, forced to source goods from other states, will tend to have above average shares of freight costs.

The interstate freight assessment is so fraught with data quality issues, which the Commission acknowledges through applying its maximum discount, that it should be removed. The input-output tables data on which the estimate of freight costs are based are now quite dated. Although more recent input-output tables are now available, these are for 2008–09 and so cannot be regarded as contemporaneous.

9 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2010 Review Volume 1—Main Report*, p. 39.

10 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2010 Review Volume 1—Main Report*, pp. 75–76.

The freight factor also produces results which appear contrary to expectations. For instance the ACT, which is contained within NSW, has a freight factor which is over 2 and half times that of NSW. The ACT is no more isolated than NSW and so would be expected to have a similar freight factor as NSW. The fact that it does not suggests that the data used are inappropriate.

If the Commission were to adopt ARIA instead of SARIA as its geographic classification then Commission staff discussion papers have observed that the regional costs assessment would incorporate the high cost of isolation and so the interstate freight assessment may no longer be required.

8.5 Interstate travel assessment

The Commission needs to consider the impact of state policy and technology on the need for interstate travel. It is not clear that each state should be regarded as needing to send the same number of staff to interstate meetings. For instance, there may be a minimum number of people required to attend a meeting in Canberra. NSW may decide to send more than the minimum required as travel from Sydney to Canberra is relatively cheap. The number of meetings hosted by the states is also subject to policy choice. Technological developments such as teleconferencing will also reduce the need for interstate travel. For instance, Commission staff recently conducted a teleconference to outlines its assessment methodology to state officials and the recent Heads of Treasuries meeting was conducted by teleconference.

As was the case for the interstate freight assessment, the outcome for the ACT seems unexpected. The ACT would incur no interstate travel for national meetings held in Canberra and its travel costs to meetings elsewhere should be similar to those for NSW. It would be expected that the interstate travel factor for the ACT would be similar that for NSW, not above it.

Victoria considers that at the minimum the largest, not the smallest, discount be applied to this factor. The preferable treatment would be not to include this factor at all.

The non-wage cost factor combines the impacts of the interstate freight and travel assessments. If the non-wage cost factor had not been applied in the 2013 Update then it is estimated that there would have been a redistribution of GST to the value of $118.4 million. This redistribution varies from $4.09 per capita for Victoria to -$158.39 per capita for the Northern Territory. This indicates that the impact of removing the non-wage factor would be material, but it would still provide an useful simplification.

8.6 Administrative scale

The Commission assesses administrative scale as it considers that states with small populations have intrinsically higher per capita costs (because the minimum functions of government have to be spread over a smaller number of residents). The assessment captures the minimum administrative cost that would be incurred for a state with a population size of the smallest state. It includes costs associated with core head office functions of departments and services that are provided for the whole of the state.

The data used for the assessment is of doubtful quality. They are based on that obtained for the *2004 Methodology Review* and have been adjusted for price movements for subsequent annual updates. The basis for this assessment needs to be revisited for the *2015*

Methodology Review as it is likely that there have been changes over the last decade in the way in which governments do business. The Commission needs to reassess the data it currently uses to ensure that it still meets the fit for purpose guideline.

If the data underlying the administrative scale assessment cannot be made contemporaneous then the Commission should then apply the maximum discount to the administrative scale factor to reflect the uncertainty regarding the data used.

9. Other Issues

9.1 Data revisions (*GST Distribution Review* Recommendation 6.2)

The *GST Distribution Review* Final Report recommended that:

> *'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.'*

There are two main types of data that are subject to revisions between annual updates:

- financial data—reflecting corrections to data and the impact of variations made to tax assessments; and
- data used for disability factors—primarily population data where data for the latest assessment year are unavailable and data for the previous year are used.

Table 9.1 presents an example of the changes between annual updates for financial data, as illustrated by the values for net lending for 2009–10 from the last three annual updates.

Table 9.1: Actual net lending for 2009–10 ($ million)

Update	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
2011	-2,606	-2,059	-6,549	-1,055	-1,092	-291	-201	-39	-13,893
2012	-2,607	-2,423	-6,571	-1,063	-1,094	-292	-202	-41	-14,293
2013	-2,607	-2,493	-6,571	-1,063	-1,093	-292	-202	-41	-14,362

Using data with a lag would reduce the revisions that occur between updates. It can be seen that between the 2011 and 2012 Updates there were significant revisions to net lending for 2009–10 for some states, reflecting changes to the values of revenues and expenses. There were only revisions to the values of two states between the 2012 and 2013 *Updates*.

Table 9.2 presents an example of the changes between annual updates for a disability factor, in this case the admitted patient services hospital based service factor. The factor is based on a number of data sources:

- AIHW expense data by Indigeneity, SARIA, SEIFA and age: these data are not available for the latest assessment year of an update so the previous year's data are used. This results in the data for that year being updated in the following update.
- Population data by Indigeneity, SARIA, SEIFA and age—these data are not available for the latest assessment year of an update so the previous year's data are used. This results in the data for that year being updated in the following update.
- State population data—this is estimated for the latest assessment year and is revised for actual data in the following update.

Table 9.2: Admitted patient services hospital based service factor for 2009–10

Update	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2011	1.00247	0.96238	0.99900	0.97044	1.10045	1.12022	0.76891	1.51674
2012	1.00232	0.96232	1.00198	0.96644	1.09359	1.12933	0.77532	1.52341
2013[(a)]	1.00232	0.96232	1.00198	0.96644	1.09360	1.12933	0.77533	1.52338

Notes: (a) Based on *2012 Update* population.

It can be seen that there were revisions to this factor between the 2011 and 2012 Updates. There were significant revisions to the population data used in the 2013 Update (resulting from the 2011 Census) so for the purpose of comparison the 2012 Update population data were used to calculate the 2013 Update values. This shows that there were minor revisions to this factor for only a small number of states between the 2012 and 2013 Updates.

The current assessment methodology uses the data for the 2013 Update to determine the annual per capita relativities for 2009–10, 2010–11 and 2011–12, which are then averaged to produce the GST relativity for 2013–14. The *GST Distribution Review* recommendation would use the annual per capita relativity for 2009–10 from the 2011 Update and the annual per capita relativity for 2010–11 from the 2012 Update in the determination of the GST relativity for 2013–14.

Table 9.3 presents the GST relativities for 2013–14 that result from the *GST Distribution Review* recommendation and from the 2013 Update.

Table 9.3: GST relativity for 2013–14

Method	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
GST Review Panel	0.97910	0.89888	1.05259	0.42541	1.24734	1.60448	1.20691	5.45406
2013 Update	0.96576	0.90398	1.05624	0.44581	1.26267	1.61454	1.22083	5.31414

It can be seen that there are noticeable variations between the two sets of GST relativities. It is estimated that these differences would result in a redistribution in GST of $291.2 million.

The extent of the revisions that occur for a particular financial year between updates are concerning. It implies that the assessments in an update may not be an accurate representation of the relative financial capacities of the states. However, Victoria recognises that consideration of this issue will require the Commission to balance contemporaneity, data accuracy and stability.

While the *GST Distribution Review* recommendation could result in greater stability in GST relativities from year to year, and would make the forecasting of GST relativities easier (as existing annual per capita relativities would not change), these benefits would be at the expense of the more accurate representation of the states' financial situations expense needs and revenue raising capacities.

If most of the revisions to data for a particular financial year occur in the following financial year, then improvements to the accuracy of assessments could be potentially achieved by delaying the use of data. As an illustration, the 2013–14 GST relativity is obtained as the average of the per capital relativities for 2009–10, 2010–11 and 2011–12. If the 2011–12 data were to be subject to revision during 2013–14, but not the earlier data, then an alternative approach to obtaining the 2013–14 GST relativity would be to average the per capital relativities for 2008–09, 2009–10 and 2010–11.

While this approach would not be as contemporaneous as the current approach, it is likely to provide a more accurate representation of the financial situation of states, their expense needs and revenue raising capacities. It also needs to be kept in mind that some of the data needed to determine expense needs are not available for the most recent financial year, as noted above.

Victoria encourages the Commission to consider how it can best achieve the compromise between accurately reflecting the states' GST needs, using timely data and having stability in the annual per capita relativities. All are important considerations and Victoria is concerned that the *GST Distribution Review* recommendation is weighted too much towards stability.

9.2 Adjusting to application year circumstances

The *2010 Methodology Review* report outlined a number of principles to be applied to the assessment methodology. Two principles that are relevant to this section are:

- What States do: as far as practical assessments should reflect what States collectively do.
- Relativities are contemporary: as far as possible equalisation should reflect state circumstances in the year the funds are used—the fundamental structure in the historical years used to determine the GST distribution is assumed to continue in the application year, with the exception of federal financial arrangements where the assessments are adjusted to reflect any major changes that occur.[11]

The second of these principles contains some tension between reflecting the circumstances in the year the GST funds are used (the 'application' year) and maintaining the structure in the historical years (the 'assessment' years). In the past the Commission has applied this principle only to changes to Commonwealth payments that are to apply in the application year. An example is assessments taking into account certain Commonwealth payments moving to a per capita basis.[12]

The Commission appears to have placed an undue emphasis on the principle of relativities being contemporary, to the detriment of achieving HFE. It is also concerning that this undue emphasis seems to have been applied in an inconsistent manner.

In the 2012 Update, the Commission changed the adjustment for non-real property transfers '…to reflect the average policy not to tax such transfers in the application year (2012–13)'.[13] This change appears to be contrary to the Commission's principle that the 'fundamental structure in the historical years used to determine the GST distribution is assumed to continue in the application year'. It would have been useful if the Commission had explained why it was considered necessary to depart from this principle.

11 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2010 Review Volume 1—Main Report*, pp. 35–36 and pp. 37–38.

12 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities—2013 Update*, p. 57.

13 Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities—2012 Update, p. 87.

While it could be argued that the Commission was reflecting ‘what States collectively do’ in the application year, it is not clear what this was intended to achieve. It could be inferred that the Commission was attempting to capture the lower amount of revenue that would be raised from stamp duty on conveyances in the application year and so achieve an outcome that was a better reflection of states’ revenue raising capacities in the application year.

To determine what this change in assessment actually achieved it is necessary to examine how the assessment of stamp duty revenue is undertaken. In the 2011 Update, when it was considered average state policy to impose non-real property transfer duty, the revenue bases of the states that did not impose this duty were increased by six per cent as an attempt to bring all revenue bases to a common basis. However, no adjustment was made to the revenues collected, so that the national average tax rates were lower than would be the case if all states did impose non-real property transfer duty.

In the 2012 Update, when the Commission made the assumption that average state policy in the application year would be *not to impose* non-real property transfer duty, the revenue bases of the states that imposed this duty in the assessment years were reduced by six per cent. Again no adjustment was made to revenues collected. This implies that the national average tax rates were higher than would be the case if all states did not impose non-real property transfer duty, or if the Commission had based the assessment on what ‘states collectively did’ in the assessment years.

The reality of the situation for 2012–13 was that the actions of a number of states meant that it *was* average state policy to impose non-real property transfer duty. Had the Commission made its assessment on this basis Victoria estimates that it would have received an additional $14.9 million in GST revenue and that there would have been a $15.9 million difference in the amount of GST redistributed. While these amounts were below the per capita materiality thresholds, it should have alerted the Commission to the dangers of basing its assessments on announced intentions of state governments.

If the objective of this approach was to better reflect the revenue raising capacities of the states, then it is not clear why other revenue measures announced by states that would apply in the application year (such as the proposed increase in coal royalties by NSW) were not taken into consideration.

In the 2013 Update, the Commission continued to assess stamp duty on conveyances on the basis that it would be average state policy in the application year (2013–14) not to impose non-real property transfer duty. This decision was based on intentions announced by a number of states which, as was the case for the 2012 Update, were subsequently revised.

This meant that average state policy for 2013–14 would be the imposition of non-real property transfer duty. Had the Commission made its assessment on this basis Victoria estimates that it would have received an additional $55.6 million in GST revenue and that there would have been a $113.7 million difference in the amount of GST redistributed.

The treatment discussed here appears to runs counter to the principle that the fundamental structure in the historical years be used to determine the GST distribution in the application year, and to be inconsistent in its treatment of other state revenue measures. The Commission should only make adjustments for the application year situation in relation to Commonwealth payments, and should ensure that clear and thorough justification is provided for any treatment that would apparently vary from the normal treatment.

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