



31 January 2017

Mr Michael Willcock  
Secretary  
Commonwealth Grants Commission  
First Floor  
Phoenix House  
86-88 Northbourne Avenue  
BRADDON ACT 2612

Dear Michael

### Work program - 2020 Methodology Review

I refer to your letter requesting input on the work program for the 2020 Methodology Review.

In your letter, you seek views on specific issues (*in italics*) and our response is structured accordingly.

***Should the review begin with a reconsideration of ‘whether the supporting principles the Commission uses to guide its work remain appropriate, including whether new principles should be adopted and whether different weights should be given to different supporting principles’?***

The 2015 Methodology Review (2015 Review) listed the supporting principles used by the Commission to guide and explain decisions on the development of a methodology to achieve horizontal fiscal equalisation. Equalisation will be implemented by methods that:

- reflect what states collectively do;
- are policy neutral;
- are practical; and
- deliver relativities that are appropriate to the application year (contemporaneous relativities).

These principles are subsidiary to the Commission’s primary objective of equalisation. In general we believe that the principles remain appropriate and do not warrant a significant review.

#### *What states collectively do*

This principle requires the Commission to consider the activities and policies of states and construct an “average state”. The policies of this average state is then applied to each individual state. Although this process does raise assessment issues around the scope of activities and how averages should be constructed, we are not sure what further work could be undertaken by the Commission that was not considered in the 2015 Review.

### *Policy neutrality*

This principle ensures that a state's own policy choices (for revenue and expenditures) do not influence its share of HFE transfers or that the distribution methodology does not influence state decision making. Addressing policy neutrality effectively requires the use of external standards which in turn raises the issue of what external standards to use (eg other standards from other countries) and the reliability/appropriateness of those standards. It is not clear what further work could be done in this area.

### *Practicality*

The practicality principle provides support for assessments to be simple and consistent with requirements for data to be reliable and fit for purpose. This supporting principle covers issues such as discounts and materiality. While South Australia supports this principle and the general approach to discounting assessments adopted by the Commission, we would support a review of the current approach.

### *Contemporaneity*

The principle of contemporaneity was thoroughly considered in the 2015 Review in the Commission's consideration of large and volatile revenues. This requires a balance between having a contemporaneous assessment and the need for data accuracy.

***What is meant by a 'comprehensive review of methods'? Does this mean that once the supporting principles have been settled, the Commission should begin with a clean slate as it did in the 2010 Review and ask what functions and related transactions of States are relevant to their fiscal capacity, how they should be grouped for assessment purposes and how they should be assessed? Or should the Commission start with the present scope and structure of assessments and make adjustments consistent with the revised supporting principles?***

South Australia believes that a comprehensive review of methods means that the Commission should at least consider the structure, data and results of each assessment at a high level, but not necessarily undertake more detailed analysis for each one. Detailed staff discussion papers are probably not required on every assessment. Certain assessments (like most revenue assessments) are well established with the major conceptual issues being fairly settled.

Accordingly, we do not see a need for the Commission to begin with a clean-slate for every assessment. Current assessment approaches should be the starting point for all assessment reviews with modifications proposed as considered necessary.

***Reviews have generally been conducted using an iterative process, with the Commission taking the lead in defining HFE principles and assessment methods, followed by the States providing feedback on the proposed approaches, leading to amended Commission views and so on. Should this review adopt the same iterative process or do States consider alternative approaches, for example with States taking a lead role in some instances, for example the development of assessments, would result in an improved HFE outcome?***

South Australia believes that the Commission is best placed to take the lead on defining HFE principles and proposing assessment methods. The CGC is uniquely placed as being an independent body with no vested interest in the outcome of assessment changes. All states and territories inherently have a vested interest in outcomes which is likely to influence positions and decisions on how assessments should be structured.



States should have the ability to propose new assessment approaches, suggest new data sources and make any other relevant suggestions to improve equalisation, but the CGC should maintain a lead role. The existing iterative approach is appropriate as it gives all states and territories the ability to respond to proposed changes, propose their own changes and allows other states to respond accordingly.

***Are there particular issues States would like to see the Commission explore?***

As previously discussed, South Australia does not feel that there is a need for a comprehensive reconsideration of every assessment area. Although every assessment area should be reviewed to see if there are changed circumstances or new data, there should not be a need to reconsider the conceptual underpinnings of every assessment.

Certain assessment areas were specifically targeted in the 2015 Review and a number of assessments are well established with little scope for further conceptual development. Most of the revenue assessments fall into this category.

The mining revenue assessment has historically been controversial and the subject of close examination. However, the Terms of Reference for the 2015 Review had a specific requirement to develop a new mining revenue assessment. This was achieved and the result was an improved methodology when compared to the previous "high/low" royalty approach. The "mineral-by-mineral" approach could be reviewed to see if the composition of mining production/revenues has changed, but South Australia believes that there may be little value in reconsidering the underlying methodology and conceptual issues.

South Australia would like the Commission to specifically consider the following assessment areas:

*Wage cost assessment*

South Australia continues to hold concerns about the conceptual validity of the wage cost assessment. We do not accept that state public sector wage costs are primarily driven by relative private sector wages.

The National Institute of Labour Studies in their 2015 report *Public-private sector wage differentials in Australia: What are the differences by state and how do they impact GST redistribution decisions* (NILS Report) provided sufficient evidence to support further review and consideration of the wage cost assessment.

The NILS Report concluded that:

- Public sector wages were found to be strongly influenced by national, sector-specific labour market pressures.
- Private sector wages alone are not a good proxy for movements in public sector wages with true comparability of public sector employees across jurisdictions being questionable.

We would like the Commission to review the conceptual case for this assessment, possibly through further engagement of an appropriately experienced consultant/academic. The discounting arrangements for this assessment should also be reassessed.

*Administrative scale*

The need to recognise the cost of providing a minimum level of administration (regardless of size/population) has been considered and debated in previous reviews. The Commission has

correctly concluded that inclusion of administrative scale is a relevant disability factor and should influence relativities.

However, the current quantum of administrative scale costs date back to the 1999 and 2004 methodology reviews with indexation over subsequent years.

Early in the 2015 Review, Commission staff reported results of a regression analysis of fixed/administrative costs in the schools education area. This analysis produced a minimum cost estimate far in excess of the prevailing cost estimate to provide school services used by the Commission in the administrative scale assessment. This provided some support that the quantum of the current administrative scale is materially under estimated. At the time, this analysis was considered by Commission staff as being too high and did not trigger a reassessment.

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

#### *Students with disabilities*

The Commission has recognised that students with a disability incur a higher level of costs compared to students without a disability. The current schools education assessment does not assess a cost weight for students with a disability for state funded school expenses.

At the time of the 2015 Review the Commission advised that there was no nationally consistent definition for students with a disability. South Australia would like the Commission to examine whether there has been any progress in deriving a consistent definition or whether states could provide data on disability type that could be used to construct a consistent base.

#### *Gambling revenue*

South Australia argued for a differential assessment of gambling revenue in the 2015 Review. Consistency in gambling regulations has continued to evolve and the Commission's position that there was insufficient evidence to construct a reliable and material differential assessment should be reconsidered.

***Most States have said they would encourage the Commission to visit their State for discussions on a range of matters. Would you want the Commission to visit your State during the review? When during the review would you want the Commission to visit and what is the rationale of this timing? How would the Commission expect to gain guidance in the development of its methods through a visit to your State?***

South Australia is open to having state visits by Commission members but does feel that the two or more day visits/tours that occurred in prior reviews do not need to be reinstated.

There may be merit in a Commission visit in the second half of 2018 – after substantive issues have been raised and discussed at officer level but prior to the development of the draft report in mid-2019.

A final decision on the practical benefits or need for state visits can be made at a later date.

***A draft report will be part of the process. In recent reviews the Commission has produced this in the June of the year before the final report. This gives the Commission sufficient time to develop well considered methods, the States time to comment on the proposed assessments and the Commission time to react to those***



***comments, including advising States of any major changes since the draft report. Do you have any particular views on this process?***

South Australia supports having a draft report and releasing it in the middle of the year preceding the final report date.

The draft report should also include an estimate (one-year) of the impact of proposed changes for each jurisdiction. Every state undertakes some form of estimation process given the potential impacts on overall budget positions. Such duplication of effort is inefficient.

After the Draft Report was released in August 2014 we had the situation of one jurisdiction including their estimates of jurisdiction-by-jurisdiction impacts in their subsequent submission. South Australia did not agree with the way the impact was calculated requiring reconciliation of differences. This could have been easily avoided with the inclusion of CGC prepared estimates of impacts in the Draft Report.

South Australia would prefer that the Commission provides one central set of impacts for all jurisdictions in future draft reports and in all Commission/staff papers. While recognising that there will always be issues with quantifying impacts, it is better to have one central estimate subject to any necessary qualifications than multiple jurisdictional estimates.

***What other types of meetings should be held between the Commission and State representatives, Commission staff and State representatives? For example, should there be a multilateral meeting between the Commission and Heads of Treasury to discuss the supporting principles and how they might interact? Could third parties, such as academics, play a role at such a gathering? Should there be meetings between State and Commission staff to help States understand the assessments set out in the draft report?***

South Australia is supportive of Commission members meeting with Heads of Treasuries. However, there are practical difficulties in being able to get all participants in one place on a specific date. We suggest that Commission members attend a scheduled Heads of Treasuries meeting on one occasion each year in 2017 (later in the year), 2018 and 2019 to discuss progress and emerging issues.

In the 2015 Review, the post draft report bilateral meetings between Commission members and Heads of Treasuries was not a useful process from our perspective. South Australia would have liked Commission members to respond to issues raised in written submissions rather than asking states to restate their views.

For the 2020 Review it would be more useful if Commission members met with staff directly involved in the preparation of submissions as this would allow for a more detailed and informed discussion.

Despite the obvious efficiency aspects, the use of Telepresence for the majority of meetings was not always conducive for free-flowing discussion on technical issues. For the 2020 Review a mix of Telepresence and face-to-face meetings may improve dialogue and allow for discussion both between the states and with CGC staff.

I am looking forward to the 2020 Review refining and improving equalisation across the Federation.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'D. Reynolds', with a stylized flourish at the end.

David Reynolds  
CHIEF EXECUTIVE  
UNDER TREASURER