Victorian Response to 2020 Methodology Review Draft Report

September 2019

Treasury and Finance

OFFICIAL

The Secretary
Department of Treasury and Finance
1 Treasury Place
Melbourne Victoria 3002
Australia
Telephone: +61 3 9651 5111
Facsimile: +61 3 9651 2062
dtf.vic.gov.au

Authorised by the Victorian Government
1 Treasury Place, Melbourne, 3002
Printed on recycled paper.

If you would like to receive this publication in an accessible format, please email information@dtf.vic.gov.au

This document is also available in Word and PDF format at dtf.vic.gov.au

Contents

1. Introduction

Victoria welcomes the Commonwealth Grants Commission's (the Commission) draft report for the *2020 Methodology Review of GST Revenue Sharing Relativities* (the Draft Report).

Victoria acknowledges the efforts made by the Commission and its staff in conducting the *2020 Methodology Review* (the 2020 Review). Victoria recognises that many of the Commission's proposals represent methodological improvements or the best that can be developed with the information available.

Victoria's response should be read in conjunction with the Draft Report, noting that comments have been made by exception rather than reiterating each of the Commission's proposals. While supportive of many of the Commission's proposals, Victoria has concerns with some of the proposed approaches and treatments – outlined in this response. There are a number of proposals which Victoria regards as being particularly important and should be further considered by the Commission. These include:

- the treatment of stamp duty on major asset sales – Victoria considers that these sales are not policy related;
- the treatment of non-real property transfers that were to be abolished under the Intergovernmental Agreement on Federal Financial Relations (IGA FFR) in 2009 – Victoria considers that the revenue from these taxes should be assessed on an APC basis;
- the 50 per cent discount applying to the national network road and rail projects – Victoria considers that this approach should be discontinued as it is arbitrary and has the potential to influence state decision making, detracting from the Commission's policy neutrality principle;
- the assessment of interstate wage costs – Victoria continues to consider this issue as a matter of principle and considers that the Commission should revise the model specification;
- the assessment of cost weights for schools – Victoria considers that the regression model could be improved;
- the assessment of actual rural road length – Victoria requests that an adjustment be retained to account for the difference between actual state unsealed road length and the Commission's measures;
- the use of a 'general cost gradient' to measure the disabilities for different categories of expenses – Victoria raises a number of concerns regarding the current application of the general cost gradient;
- the recognition of the additional costs of providing non-transport infrastructure in brownfield sites – Victoria requests the Commission elaborate on how it reached its conclusion that it is unlikely to be material despite the strong conceptual case; and
- more generally, the Commission's approach to altering its own methodology in some assessments despite not having evidence or a clear rationale to do so, whilst

also rejecting state and territory proposals for methodology changes on the grounds that there is insufficient data to support the conceptual case.

Further discussion on these issues, Victoria's views on the main report and each of the attachments to the Draft Report are discussed in the sections that follow.

2. Measuring relative fiscal capacity

2.1 Principles of HFE

Victoria notes that the Commission intends to use the same definition of horizontal fiscal equalisation (HFE) that was used in the *2015 Methodology Review of GST Revenue Sharing Relativities* (the 2015 Review), with a minor adjustment to acknowledge the changes to the arrangement for determining GST payments to the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States).

While supportive of the intent of this change, Victoria considers that the proposed amendments do not capture the change in the Commission's equalisation task. The proposed definition simply reiterates that the Commission recommends relativities for the Commonwealth Treasurer's consideration. If the Commission does wish to outline the changes to the GST distribution system as a result of Commonwealth legislation, Victoria considers that this could be achieved by including a description of the equalisation standard instead.

Victoria would also like to highlight that the Commission has not accepted a number of suggestions put forward by States in assessing the value of including new disabilities. The Commission has argued that these suggestions fail on at least one criterion of the assessment guidelines. The Commission requires that there be a:

- conceptual case;
- supporting evidence;
- reliable data upon which the disability can be measured; and
- for the disability to be sufficiently large as to be worth including (material).

Victoria is supportive of the criteria employed by the Commission and acknowledges that the Commission uses its judgement to devise the best overall result consistent with the principle of HFE. However, the Commission seems to apply these criteria more strictly to the inclusion of new disabilities compared to assessing existing disabilities.

Victoria is concerned that there are instances where the Commission considers that the conceptual case for a disability is so strong that HFE would be better achieved by including this disability even where there is no reliable data to support it. This includes for example, the application of:

- a general cost gradient – where there is no evidence that the gradient being applied is appropriate for the expense being assessed; and
- the removal of discounts in some categories despite no indication that the Commission has found new or more reliable assessment data.

In light of this, the Commission should apply its stated criteria more consistently across existing disabilities, as it does in the consideration of including new disabilities.

2.1.1 Supporting Principles

Victoria maintains the view that the four current supporting principles are sufficient and supports the Commission applying these principles flexibly so that the best HFE outcome can be achieved. Victoria acknowledges that the interaction and constraints between the supporting principles require a balance of competing considerations when determining the choice of methods that the Commission employs.

'What states do'

Overall Victoria supports the current approach to disability measurement taken by the Commission. However, in its endeavour for assessments to reflect what States do on average, the Commission should also ensure that it balances the risk of under compensating a State for a disability with the equally detrimental risk of over compensating for a disability. The Commission does not appear to weight the two risks equally, demonstrating a preference to avoid under compensation – to the detriment of achieving HFE. The Commission should also ensure that in making its assessments there is minimal double counting of disabilities and that the measurement and application of disabilities is supported by reliable evidence.

Policy neutrality

As expressed in its submission to the Productivity Commission's (PC) inquiry into Horizontal Fiscal Equalisation (HFE), Victoria considers that there is little evidence to suggest that HFE poses significant impediments to economic growth, reform and productivity. The view that the system creates a financial disincentive for States to undertake policy reform over-simplifies the process of policy development and implies that States only take a simplistic revenue-based approach to reform.

Practicality

Victoria supports the Commission's practicality principle. However, as noted above, Victoria is concerned that the reliability of data is not always adhered to in the Commission's assessments.

Contemporaneity

Victoria supports the Commission's view not to use estimates or forecasts of revenues and expenditure in the application year for its assessments. This would increase complexity, volatility and uncertainty in relation to GST distribution. Victoria considers the current approach achieves equalisation over time and supports the current approach of using the most recent three years for which reliable data are available.

2.2 Implementation issues

2.2.1 Discounting assessments

Victoria notes the Commission's intention to include fewer discounts in the 2020 Review. However, there are instances where the Commission has decided to discontinue discounts despite using the same or similar data as used in the 2015 Review. For example, within the Health Category, the removal of the discount applied to the socio-demographic composition assessment and non-State sector adjustment for community health. In these instances, it is unclear that the removal of the discount will improve HFE or that the Commission has found new data to support its actions.

2.3 Legislated changes to HFE

From 2021-22, the Commission's methods will need to give effect to the Commonwealth Government's legislated changes to the GST distribution, including the calculation of relativities under 'previous' and 'new' arrangements in relation to the no-worse-off guarantee.

Victoria considers that the Commission's proposed approach to implementing these changes is appropriate and in alignment with the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*.

3. Commonwealth Payments

Victoria does not support the Commission’s decision to continue the 50 per cent national network discount for road and rail infrastructure payments despite the issues raised by the States regarding this discount.

While Victoria recognises that Commonwealth payments may be influenced by factors other than those recognised by the Commission as disabilities, it is not convinced that the national network is the best means to identify such payments. An example relevant for Victoria relates to Commonwealth funding for an airport rail link. However, as some, or all of this link will be new track, it is not currently part of the national network and it is not clear whether it will be placed on the national network, either at all or while the payments are assessed.

Victoria notes that the Commission has not dealt with the issue that the existence of this discount has the potential to influence state decision making. This detracts from the policy neutrality principle.

If the Commission is concerned that certain Commonwealth infrastructure payments are not aligning with its measure of state needs, then it would be more appropriate to consider these payments on a case by case basis rather than apply an arbitrary rule. This is particularly the case for new roads or rail projects.

In regard to equalising capital grants over a longer period, Victoria is surprised that the Commission considers that providing the information on the expenditure of each infrastructure payment would be a significant burden for States. Approved capital projects almost always have an associated funding profile with States undertaking an annual acquittal process for the Commonwealth.

4. Payroll Tax

Summary of proposed changes to the 2015 Review methodology

- The assessment method is unchanged from that used in the 2015 Review.

Victoria has no further comments to make in this area.

5. Land Tax

Summary of proposed changes to the 2015 Review methodology

- The category excludes other land-based taxes. Other land-based taxes are assessed equal per capita (EPC) in the Other revenue category. In the 2015 Review, other land-based taxes were assessed EPC in this category.
- The assessment discount has been reduced from 25.0 per cent to 12.5 per cent.

Victoria supports the Commission's proposals to:

- continue to apply an adjustment to capture the progressive rates of land tax;
- reduce the data reliability discount to 12.5 per cent;
- continue to treat foreign ownership surcharges on residential property as land tax revenue;
- treat other land-based taxes as EPC in the Other revenue category; and
- continue to use Victoria's State Revenue Office (SRO) land holdings data as the best source of data.

6. Stamp Duty on Conveyances

Summary of proposed changes to the 2015 Review methodology

- The category excludes Stamp duty on motor vehicle transfers, which is assessed equal per capita in the Other revenue category.
- The adjustment to treat concessional rates of duty for first home owners as an expense is discontinued.
- Where the Commission determines some property transfers should not affect State revenue capacities, they are excluded from the category. They are assessed equal per capita in the Other revenue category. In the 2015 Review, they were assessed equal per capita in this category.
- Duty on non-real property transactions are assessed equal per capita in the Other revenue category. In the 2015 Review, they were differentially assessed in this category.
- Duty on land rich transactions by listed companies are differentially assessed. In the 2015 Review, they were assessed equal per capita in this category.

Victoria supports the Commission's proposals to:

- not make a separate assessment for the foreign investor surcharge;
- continue to make an adjustment for differences in the progressivity of state taxes;
- to treat concessional rates of duty, such as for first home owners, as a reduction in States' effective rates of tax; and
- moving property transactions assessed EPC into the Other Revenue category.

Victoria notes the proposal to assess stamp duty on motor vehicle transfers EPC in the Other revenue category. Previously this revenue was differentially assessed within Motor taxes prior to the 2015 Review and subsequently within Stamp duty. No explanation has been offered for the proposed change, although it is noted that in recent years a separate assessment would not be material.

With regard to the adjustment made to take account of revenue foregone with respect to Victoria's off-the-plan (OTP) concession, staff in the Victorian Department of Treasury and Finance have recently provided transactions data by purchase price to Commission staff. Data for 2018-19 can be provided for the forthcoming data collection round. Consequently, Victoria believes that an adjustment for OTP will no longer be necessary.

Victoria does not support the proposal to continue to assess the duty from the sale of major assets as EPC. As outlined in Victoria's submission in response to the Commission's *Staff Draft Assessment Papers*, Victoria's preference is for such duty to be treated actual per capita as the ability to generate revenue from asset sales is mainly determined by individual state circumstances.

Victoria also disagrees with the proposal to continue to assess the duty from non-real property transfers as EPC. As outlined in Victoria's submission in response to the Commission's *Staff Draft Assessment Papers*, Victoria's preference is for such duty to be treated actual per capita. Victoria believes that States still charging this duty have not met their obligations under the IGA agreement.

7. Insurance Tax

Summary of proposed changes to the 2015 Review methodology

- Revenue from fire and emergency services levies (FESLs) on insurance has been moved from this category and offset against Other expenses.
- Revenue from workers' compensation duty is included in the category and assessed using the general insurance premiums. In the 2015 Review, it was assessed equal per capita (EPC) in the Other revenue category.
- The capacity measure no longer includes:
    - premiums paid to public insurers
    - premiums paid to private insurers for compulsory third party (CTP) motor vehicle insurance.

Victoria has no further comments to make in this area and supports the proposals to:

- treat insurance based FESLs as user charges and offset them against emergency services expenses;
- leave workers compensation duty revenue in the insurance tax category; and
- exclude premiums paid for compulsory third-party motor vehicle insurance on insurance from the insurance category.

8. Motor Taxes

Summary of proposed changes to the 2015 Review methodology

- The split of light and heavy vehicle registration fees has been updated.

Victoria has no further comments to make in this area and supports the proposal to update the split of light and heavy vehicle registration fees with the latest available data.

9. Mining Revenue

Summary of proposed changes to the 2015 Review methodology

- The Mining revenue assessment methodology is unchanged from the 2015 Review.
- Minor proposed changes in its application reflect market developments for individual minerals.
- The category excludes Commonwealth payments to Western Australia and the Northern Territory under revenue sharing agreements. They are assessed actual per capita with other Commonwealth payments. In the 2015 Review, they were assessed actual per capita in this category.
- Nickel royalties are assessed in the other minerals component. In the 2015 Review, they were separately assessed.
- Lithium royalties will be separately assessed if it becomes material to do so. Until then, they will be assessed in the other minerals component, as they were in the 2015 Review.

Victoria notes the restriction placed on the Commission in relation to the mining assessment by the supplementary terms of reference approved by the Commonwealth Treasurer.

Regarding non-royalty mining revenue, Victoria considers that this revenue should be differentially assessed as not all States have the capacity to raise these revenues. One possible method of assessing these revenues is to add them to the revenue from the respective minerals. The materiality of this can then be assessed. If the assessment is not material, then the existing approach can be retained.

Victoria supports the Commission's proposals to:

- continue to assess Commonwealth payments under revenue sharing agreements to two States as actual per capita with other Commonwealth payments; and
- assess nickel royalties in the other minerals component.

10. Other Revenue

Summary of proposed changes to the 2015 Review methodology

- There are no changes to the assessment approach. Revenues in this category are assessed equal per capita.
- There are minor changes to the composition of the category.

Victoria has no further comments to make in addition to earlier comments made in this submission and supports the proposal to treat various categories of revenue on an EPC basis, including user charges, gambling taxes, interest income and dividend income.

11. Schools

Summary of proposed changes to the 2015 Review methodology

- The regression models used to estimate cost weights for Indigenous status, socio-economic status, service delivery scale and remoteness have been respecified.
- The Commonwealth funding of non-government schools component has been removed from the Schools category and is now treated as out of scope. This means that neither these expenses, nor their associated Commonwealth payments, are included in the Commission's assessments.
- The student transport component has been removed from the Schools category, with these expenses now assessed in the Transport category.
- Total actual enrolments are now used. In 2015 Review methods, pre-year 1 student data were imputed from year 1 student data.

11.1 Assessment Categories

11.1.1 State funding of government schools

Victoria supports the proposed use of government school student population as the basis of the school education assessment. With respect to the socio-demographic composition (SDC) of the student population, Victoria requests that the Commission explore the interaction effects between low SES and remoteness. Victoria considers that this may result in a larger or smaller cost weight compared to the Commission's current proposal to simply consider the additive cost weights of these two factors.

11.1.2 State funding of non-government schools

Victoria supports the proposal by the Commission to use a similar model used to assess state-funding of government schools to assess state funding of non-government schools.

11.1.3 Commonwealth funding of government schools

Victoria supports the Commission's proposal to isolate the Commonwealth-funded component of government schools expenditure as a separate component of this assessment. This is the most transparent means of giving effect to the terms of reference.

11.2 Assessment Issues

11.2.1 Redeveloped regression model

The Commission has redeveloped the regression model for the 2020 Review. Victoria has a number of comments on the model specification and calculation of the actual cost for funding schools.

- Service delivery scale (SDS) has been treated differently to how it was in the 2015 Review, with the effect of scale now associated with remoteness areas rather than

SDS areas. Victoria notes that the definition of SDS has now changed for school education. In the 2015 Review it was purported to capture the increased costs of schools in smaller communities due to the indivisibility of labour and other related effects. However, SDS is now related to the additional costs associated with smaller scale of operations, regardless of school location. Victoria supports the updated treatment of SDS.

- While Victoria acknowledges that expenses per students vary across schools with different proportions of Indigenous students, in some areas with low Indigenous population, there is less variation in the proportion of Indigenous students among schools. Victoria recommends the Commission include a separate Indigenous status variable for schools with a proportion of Indigenous students below a threshold. This will capture the difference of average spending between schools with a low concentration of Indigenous students and high concentration of Indigenous students.

- The model assumes a linear relationship (negative) between school size and per student cost. Victoria rejects this assumption. With a fixed cost, average cost decreases with an increase in quantity (school size). However, at a certain point the economies of scale will disappear. Victoria recommends that the Commission capture this non-linear relationship by adding a quadratic term of the inverse school size to the regression model.

11.2.2 Adjusted student numbers

Victoria supports the proposed use of all FTE student numbers published by the ABS as the basis of the school education assessment. This approach most simply and accurately captures the costs faced by States.

11.2.3 User charges

Victoria supports the proposed change to net user charges off the state funded government school assessment. However, Victoria is concerned about the nature of user charges used for calculating net expenditure, since there is a $100 million discrepancy between ABS Government Finance Statistics (GFS) user charges and ACARA data (see p.21 of Attachment 10). Victoria is concerned that the ACARA finance data records use net rather than gross funding provided to government schools. It is quite likely that schools record the funding they receive from the responsible department which would be on a gross basis.

11.2.4 Student transport

Victoria supports the Commission's proposal to remove the student transport component from the Schools category, and to now assess these expenses in the Transport category.

11.3 Other issues considered

11.3.1 Secondary school students

Victoria noted in its response to the Commission's *Staff Draft Assessment Papers* that including school type in the regression model greatly improves the robustness of estimation for school expenses. However, the Commission considers that it is inappropriate for use in measuring school costs because it considers that school type significantly reflects State policy choice. Victoria disagrees with the Commission's contention and considers that school type is largely driven by the demographics of an area except, as noted by the Commission, South Australia's policy decision to include Year 7 in primary school. Therefore, Victoria recommends that the Commission investigate the possibility of including school type in the regression model by adding a state dummy variable to control for the policy difference of South Australia.

11.3.2 Early childhood education

Victoria does not agree with the Commission's view that separately assessing early childhood education would not be materially different to including its costs with other school costs. While this component only makes up a relatively small proportion of expenses, the service delivery and funding model is different to that for school education. Victoria considers that Commission staff should investigate the feasibility and materiality of separately assessing early childhood education.

12. Post-secondary Education

Summary of proposed changes to the 2015 Review methodology

- The Commission has introduced a category specific remoteness gradient, replacing the general gradient.
- The Indigenous cost weight has been updated with new data from States.
- The way in which socio-economic status (SES) quintiles are aggregated into three groups each with similar use patterns has been revised.

12.1 Assessment Approach

12.1.1 Socio-demographic composition

Victoria supports the concept that SES and remoteness affect the use of post-secondary education services. However, Victoria requests the Commission compare the impact of changing social index groupings for remote and non-remote areas on assessed post-secondary education expenses.

Victoria is concerned that the upward revision of the cost weight for Indigenous students and the addition of a fixed cost for Indigenous funding programs may overstate the true cost of offering Indigenous-specific programs.

12.2 Assessment Issues

12.2.1 Remoteness cost gradient

Victoria agrees that it is more costly to deliver services to remote areas. Victoria supports the Commission's proposal to develop a category specific regional cost gradient for post-secondary education based on the location at which the course is provided. Victoria considers that the Commission should make an allowance for the difference between where the service is provided and where students mainly reside, even though the Commission claims the effect is small.

12.2.2 Treatment of user charges

The current treatment of user charges is to net all post-secondary education revenue including student fees and other income off expenses. For the 2020 Review, the Commission proposes to net off only fee-for-service income from full fee-paying students. Victoria is not convinced that only fee-for-service revenue should be deducted as the Commission does not provide any information about the proportion of other income for post-secondary education. Therefore, Victoria does not support the new approach proposed by the Commission in its Draft Report and recommends the retention of the 2015 Review approach of netting off all user charges.

12.2.3 Qualification level

Differences in costs between qualifications are affected by a state's industrial profile and individual demand, which should be independent of state policy influence. Victoria considers that the Commission should investigate the feasibility of a qualification level loading using data provided from States.

13. Health

Summary of proposed changes to the 2015 Review methodology

- A block funded hospital loading is applied to the national weighted activity unit (NWAU) data for block funded hospitals in the admitted patients (AP), emergency departments (ED) and community health components to ensure appropriate recognition of regional and service delivery scale (SDS) costs.
- The regional costs factor for the non-admitted patients (NAP) assessment uses the Independent Hospital Pricing Authority's (IHPA) data. An SDS factor base on ED data has been included.
- The 25 per cent discounts applied to the socio-demographic composition (SDC) assessment and non-State sector adjustment for community health have been removed.
- The SDC assessments for all components (except non-hospital patient transport) disaggregate remote and very remote populations.
- The assessment of Indigenous grants uses Australian Institute of Health and Welfare (AIHW) data instead of proxy data. A regional costs factor based on IHPA data is applied.
- A cross-border capital stock factor has been included in the health infrastructure assessment.
- The ACT’s cross-border allowance for community health has been reduced.
- Annual expenditure data for ED and NAP services from the National Hospital Cost Data Collection have been used to split outpatient expenses. This replaces the previous 50:50 split.
- The non-State sector substitutability levels for NAP and community health are 35 per cent and 60 per cent respectively.
- The non-State sector indicator for NAP is based on bulk billed medical operations and specialist services.
- Expenses for pharmaceuticals, medical aids and appliances and health administration not elsewhere classified are included in the admitted patients component.

13.1 Assessment Categories

Victoria has no further comments to make in this area.

13.2 Assessment Issues

13.2.1 The direct versus subtraction approach

Victoria agrees with the Commission’s intention to retain the direct method for assessing all State health expenses.

13.2.2 Impact of the non-State sector

The Commission proposes to retain the 2015 Review approach to assessing the substitutability level of the admitted patients (AP) and emergency department (ED) categories. Victoria supports this approach.

The Commission intends to reduce the rate of substitutability from 40 per cent to 35 per cent for non-admitted patients (NAP). Victoria notes that the Commission's current proposal now differs to the Commission's previous proposal put to States in *Discussion paper CGC 2018-05-S*.

In its Draft Report, the Commission uses activity levels and average expenditure data on each type of NAP clinic to estimate the proportion of State expenditure for each group of NAP services. Based on this information, the estimated substitutability level is approximately 70 per cent. However, this is deemed to be an upper bound for the proportion of NAP services in public hospitals that the non-State sector could have provided. The Commission proposes to multiply the expenditure weighted substitutability level by 50 per cent, which results in a proposed substitutability level of 35 per cent. The Commission states that this is in recognition that most NAP services are linked to previous hospital attendance. It is not clear to Victoria how 50 per cent was calculated.

In the Commission's *Discussion paper CGC 2018-05-S,* the bulk billing rate for each NAP service was used as an indicator of the substitutability level for a given service. The bulk-billing rates were multiplied by the State's estimated share of expenditure. According to this approach, the substitutability level was considered to be approximately 20 per cent. As the presence of bulk-billed services is a requirement for potential substitutability, Victoria considers the Commission's approach in its *Discussion paper CGC 2018-05-S* more accurately estimates the actual substitutability NAP services.

Victoria considers that the Commission has not put forward a strong enough rationale in its Draft Report to justify why it has changed its approach since *Discussion paper CGC 2018-05-S*.

Victoria believes that the non-state sector substitutability levels for NAP services will be overstated if the Commission proceeds with the substitutability level of 35 per cent it has proposed in its Draft Report. Victoria strongly recommends that the Commission use the method it put to States in its *Discussion paper CGC 2018-05-S* and reduce the substitutability level to 20 per cent.

Victoria supports the Commission's decision to reduce the non-State sector substitutability level for Community and public health services from 70 per cent to 60 per cent. However, Victoria does not think the Commission has put forward a strong enough case to remove the 25 per cent discount.

Table 1: The Commission's proposed substitutability levels and indicators for the 2020 Review

	Substitutability R2015	Substitutability R2020	Indicator R2015	Indicator R2020
Admitted patients	15%	15%	Private patient separations	Private patient separations
ED	15%	15%	Bulk billed GP services	Bulk billed GP services
NAP	40%	35%	Bulk billed specialist and diagnostic services	Bulk billed operations and specialist services
Community health	70%	60%	Bulk billed GP services	Bulk billed GP services

13.2.3 Regional costs and SDS costs for block funded hospitals

Victoria supports the Commission's intention to apply a block funded hospital loading to the NWAU data for block funded hospitals in the AP, ED and community health components to ensure appropriate recognition of regional and SDS costs.

13.2.4 SDC assessment for non-admitted patient services

Victoria agrees with the Commission's intention to continue using admitted patient separations as a proxy indicator for NAP services in the 2020 Review. Going forward, Victoria supports the Commission's intention to review IHPA's 2018-19 NAP NWAU data and consult with States on whether to use it in the 2021 Update.

Victoria agrees with the Commission's approach to apply a combined regional costs and SDS loading, based on data for ED services.

13.2.5 SDC assessment for community and public health services

In the absence of comprehensive and comparable State data, the Commission considers that IHPA NWAU data on ED triage category 4 and 5 remain the best proxy for measuring the SDC disability for community health services. It is proposed that the 2015 Review approach will be retained. This approach is supported by Victoria.

However, Victoria disagrees with the Commission's intention to remove the 25 per cent discount to the SDC assessment for community health.

While Victoria considers that it is unclear that a discount improves the assessment, conversely, it is also unclear that removing the discount will improve the assessment.

The approach taken in the 2015 Review to apply a 25 per cent discount reflected concerns about how closely the socio-demographic profile of people using EDs reflects the profile of people using community health services. Victoria considers that these concerns remain.

By removing the 25 per cent discount, the influence of disabilities including Indigeneity, remoteness and service delivery scale, which affect State spending are increased and potentially overstated. The Commission has not put forward a case to justify its intention to remove the discount.

13.2.6 Culturally and linguistically diverse (CALD) patients

Victoria has no further comments to make in this area.

14. Housing

Summary of proposed changes to the 2015 Review methodology

- The Housing assessment is mostly unchanged from the 2015 Review approach.
- The Commission is requesting data from States to update the Indigenous cost weight and regional costs gradient for the social housing assessment. In addition, data on the split between maintenance and other social housing expenses will be requested to update the expense weights for constructing the regional costs factor.
- Tax expenditures on concessional rates of conveyance duty for first home owners are assessed in the Stamp duty on conveyances category. First home owner grants are assessed in this category.

14.1 Assessment Categories

14.1.7 First home owner grants

Victoria accepts the Commission's intention to no longer include tax expenditures on concessional duties for First Home Owners (FHO) in this component. Tax expenditures on concessional rates of conveyance duty for FHO will be assessed in the Stamp duty on conveyances category.

14.2 Assessment Issues

14.2.1 Treatment of housing related land acquisition expenses

Victoria notes that the Commission does not intend to make a differential assessment of expenditure on housing related land.

14.2.2 Recognition of clients with CALD backgrounds

Victoria has no further comments to make in this area.

15. Welfare

Summary of proposed changes to the 2015 Review methodology

- Non-NDIS disability expenses are assessed with aged care on an equal per capita (EPC) basis.
- The ABS Experimental Index of Household Advantage and Disadvantage (IHAD) is used as the low SES indicator in the other welfare component.
- Service delivery scale has been removed from the family and child services component.
- Expenses for the National Redress Scheme for Institutional Child Sexual Abuse are assessed EPC with expenses on non-NDIS disability and aged care services.

15.1 Assessment Categories

15.1.3 Non-NDIS disability services and aged care

Victoria notes that the Commission has accepted its concern regarding assessing aged-care and disability services using a low SES measure when there is limited evidence available to conclude services users are predominantly from low SES groups.

Therefore, Victoria welcomes the Commission's decision to assess both aged care and non-NDIS disability expenditure on an EPC basis.

15.2 Assessment Issues

15.2.1 National Redress Scheme for Institutional Child Sexual Abuse

Victoria supports the Commission's intention for expenses for the National Redress Scheme for Institutional Child Sexual Abuse to be assessed EPC with expenses on non-NDIS disability and aged care services.

15.2.2 Regional cost gradient

Victoria disagrees with the Commission's intention to remove the discount to the regional cost factor.

In the 2015 Review, the Commission used a general regional costs gradient calculated from cost gradients for police and schools. This was discounted because the extrapolation of the police SDS disability to family and child welfare results in increased uncertainty.

In the 2020 Review, the Commission intends for the general regional costs gradient to be measured using admitted patient and schools data. The Commission argues that this is the best proxy available to measure general regional costs. This is the only argument the Commission employs to justify removing the discount to the regional cost factor.

Victoria does not consider the Commission's rationale to be a valid reason for removing the discount. The uncertainty surrounding the application of the gradient remains and the discount should be continued to be applied to the assessment. Whilst the proxy may be improved, it remains a proxy. The extrapolation of the patient and schools SDS disability to family and child welfare will still result in increased uncertainty.

The Commission cannot be fully confident about the size of the effect of the regional cost factor and should therefore continue to apply a discount to the factor.

16. Services to Communities

Summary of proposed changes to the 2015 Review methodology

- Electricity subsidies and water subsidies are separately assessed.
- The following changes apply to the electricity subsidies assessment.
  - The definition of remote communities has changed. The new definition is communities in a remote or very remote area with a population of over 50 people and a population density of at least 60 persons per km2.
  - The regional costs assessment has changed. The new assessment applies regional cost weights to the population in very remote communities. The cost weights are derived from regression analysis of State subsidy data.
  - The proportion of remote community electricity subsidies and other electricity subsidies will be updated annually using State data.
- The following changes apply to the water subsidies assessment.
  - The definition of small communities has changed. The new definition is communities outside of major cities with a population of over 50 but less than 1 000 people and a population density of at least 60 persons per km2.
  - The regional cost assessment has changed. The new assessment applies regional cost weights to the population in small communities. The cost weights are derived from State subsidy data.
  - The proportion of small community water subsidies and other water subsidies will be updated annually using State data.
- Indigenous community development expenses are derived using State data.
- Indigenous community development expenses includes general revenue grants to Indigenous councils.
- Changes to the Government Finance Statistics (GFS) classification mean that national parks and wildlife expenses are now included in this category.

Victoria has no further comments to make in this area.

17. Justice

Summary of proposed changes to the 2015 Review methodology

- In police,
  - the split between ‘specialised’ and ‘community’ expenses has been removed, including the discount previously applied to specialised policing expenses
  - police costs are assessed using cost weights derived from a regression analysis of police districts predicting police costs per capita, and incorporating an assessed offenders measure using age, SES and Indigenous status
  - no separate regional costs factor has been applied, as regional costs are implicitly captured within the model
  - there are minor changes to the way the number of offenders is assessed. The non-Indigenous population is assessed against five SES groups, rather than three, and offender rates have now been assessed for the 0-14 and 65+ year age groups, rather than assessing a zero offender rate for these age groups.
- In courts and other legal services,
  - in place of having a Courts component split into criminal and civil courts sub-components, two separate components have been identified, Criminal courts and Other legal services
  - Indigenous status non-response has been allocated in proportion to the population shares, rather than responding criminal court defendant shares
  - regional costs have been measured directly from court cost data, rather than extrapolated on the basis of police regional costs
  - defendant rates have now been assessed for the 0-14 and 65+ year age groups, rather than assessing a zero defendant rate for these age groups.
- In prisons,
  - regional costs have been measured directly from prison cost data, rather than using police regional costs
  - imprisonment rates have now been assessed for the 0-14 and 65+ year age groups, rather than assessing a zero offence rate for these age groups.

17.1 Assessment Categories

17.1.1 Police

Victoria has no further comments to make in this area.

17.1.2 Courts and other legal services

Victoria notes that the Commission has applied its judgement in determining the additional costs of defendants from remote and very remote areas. A more appropriate approach would have been for the Commission to obtain from all States data on the defendants' place of residence compared to the receipt of court services, as provided by Victoria (presented in Table 14 on p. 25 of Attachment 16).

17.1.3 Prisons

Victoria is concerned that regional costs and SDS for prisons is based on a regression model which has a very low explanatory power (refer to Table 17 on p. 25 of Supplementary Information). Regional costs are based on a regression coefficient that is statistically insignificant. GST should not be redistributed on the basis of a relationship that has no statistical basis. If the Commission considers that there is a conceptual case for regional costs then it should be explicitly stated that it is using its judgement regarding the impact of regional costs as the results from the regression model are unreliable.

In regard to SDS, these costs should relate to the location of prisons to be consistent with the conceptual case for SDS (as outlined on p. 16 of Attachment 25). The residence of prisoners in prisons subject to SDS is irrelevant. The costs due to the residence of prisoners should be captured in regional costs. Victoria considers that when the base cost of a prisoner is calculated for purposes of SDS, the differences in the number of maximum-security prisoners (who incur additional costs) should be taken into account. As prisons in remote areas have a lower proportion of maximum-security prisoners than prisons in non-remote areas, the base cost per prisoner will be lower.

An alternative approach would be one that follows the methodology of the schools assessment, where a cost weight for maximum security prisoners is applied to the relevant prison population by region. If the Commission seeks to apply the regression results to the prisons assessment, then it must take into account the higher cost of maximum-security prisoners shown in the regression results.

18. Roads

Summary of proposed changes to the 2015 Review methodology

- The Commission has revisited how it estimates rural road length. New road connections have been added, to link significant areas, including mines, ports and national parks. The number of lanes on roads is also taken into account. The adjustment for unsealed roads has been removed.
- Local roads expenses have been reallocated proportionately to the urban and rural road components.
- Bridges and tunnels are now assessed using actual lengths of bridges and tunnels that are State managed, measured across comparable structures.
- The number of heavy vehicle classes has been reduced from five to three. Light commercial vehicles are now classified with passenger vehicles.
- Other services expenses have been reallocated proportionately across the rural roads, urban roads and bridges and tunnels components.

18.1 Assessment Issues

18.1.1 Rural road length

Rural road length is measured by lane-kilometres. The Commission has developed a rural state road network to assess the length of roads connecting urban centres or localities (UCLs), connecting mines, ports and national parks. However, Victoria considers that this network cannot identify roads to tourism and agricultural areas. Furthermore, it is difficult to split the rural road network between state-owned roads and roads run by local governments. Victoria supports Commission staff undertaking further work to investigate the possibility of assessing the actual rural road length, with a consistent definition of state roads.

The Commission assumes that some mining roads are maintained by States even though they are owned and maintained by the private sector. This assumption is made on the grounds that it does not have reliable information on the length of privately funded roads to mines in each state needed to make an adjustment. Victoria reiterates its position that the Commission needs to investigate the extent to which the private sector meets the need for roads to mining towns before including mining roads in the assessment.

18.1.2 Unsealed roads

Victoria notes that the Commission has discontinued its adjustment for unsealed roads because of the large variation in the cost ratio between unsealed and sealed roads. Part of the reason for the variation was the differing data sources used[1]. It is likely that each state road authority would be able to provide the Commission with a cost ratio based on a common concept and reflects that the maintenance of unsealed roads is cheaper than

[1] The 2015 Review uses unsealed/sealed information in the PitneyBowes StreetPro dataset. This information is also available from the state roads datasets.

sealed roads. At a minimum the Commission could have taken the average of the various cost ratios provided by all States. In other assessments, it is common for the Commission to use an average measure for a disability.

Victoria recognises the difficulties in measuring unsealed road length but considers that the conceptual case for the recognition of the lower maintenance costs associated with unsealed roads justifies an adjustment for unsealed roads. Therefore, Victoria considers that the Commission should use the best data that is fit for purpose and make an adjustment for unsealed roads. Uncertainty about data has not prevented the Commission in other assessments where the conceptual case is strong.

The Commission states that the assessment is material for only the Northern Territory. According to the discussion on materiality thresholds (refer to Chapter 2 p.60 of the Draft Main Report), if the assessment is material for any state then the disability should be included. Based on these arguments, Victoria recommends that the adjustment for unsealed roads be maintained for the 2020 Review.

18.1.3 Urban road length

Victoria supports the Commission's proposal to retain the current definition of urban areas as UCLs with a population of greater than 40 000 people and to use urban population as the measure of urban road length needs.

18.1.4 Local roads

The Commission proposes to reallocate local roads expenses proportionately to the urban and rural road components. While this differs from the 2015 Review, in which expenses on minor roads in sparsely settled areas were assessed separately in the Roads category, Victoria supports the Commission's intended approach. Additionally, Victoria recommends that the Commission use state actual kilometres for local roads, with an appropriate and consistent definition of local roads, as the basis of determining local road length.

18.1.5 Road use measures

The Commission proposes to reduce the number of classes of heavy vehicles from five to three. Victoria supports combining buses with rigid and other trucks because their average weights are very similar.

However, Victoria does not support the Commission's intention to combine light commercial vehicles with passenger vehicles. One of reasons for this proposal is that the Commission assumes that the average weight of light commercial vehicles is similar to passenger vehicles. Victoria does not agree and considers that there is not enough evidence to support this assumption. Victoria requests the Commission assess light commercial vehicles separately.

Road maintenance work does not only depend on the weight of vehicles but also on the frequency of road use by vehicles. Victoria recommends that the Commission consider using other measurements such as passenger car equivalent units (PCEU) to determine road use.

18.1.6 Bridges and tunnels

Victoria supports the Commission's decision to use spatial data on state managed bridge and tunnel length to measure bridge and tunnel needs. Victoria also supports the Commission's intention to explore possible expense drivers for bridges and tunnels.

18.1.7 Other services expenses

Other roads services cover expenses on corporate services, vehicle registration and driver licensing. Victoria notes that the Commission proposes to allocate other services expenses proportionally across rural roads, urban roads and bridges and tunnels components. The Commission states that these expenses are influenced by the same disabilities as the other components.

Victoria considers that while traffic volume may be a reasonable influence on other services expenses, road length is less likely to have an influence. As the Commission has not provided enough information on how other services expenses relate to the drivers of road maintenance expenses, Victoria recommends that allocating these expenses to the other components of roads expenses is not appropriate and the Commission should continue to assess them on an EPC basis.

Victoria notes that a differential assessment is only material for the Northern Territory. If the Commission decides against an adjustment for unsealed roads because it was only material for the Northern Territory then for consistency it should not differentially assess other services expenses.

19. Transport

Summary of proposed changes to the 2015 Review methodology

- A new urban transport expenses assessment is introduced. It is a blended assessment of State shares of urban centre population and a model that measures urban transport needs through an assessment recognising the influence of population density, passenger numbers by mode of transport, the presence of ferry services, distance to work and topography to measure State urban transport needs.
- A new urban transport investment assessment is introduced. It is a blended assessment of State shares of the square of urban population and the model developed for the assessment of urban transport expenses.
- The Commission has included all ABS Significant Urban Areas (SUAs) as in the urban transport assessment, instead of only those with a population above 10 000.
- Non-urban transport expenses are assessed on an EPC basis.
- All student transport expenses are now included in the urban transport component.

19.1 Assessment Categories

19.1.1 Urban transport

The Commission assesses the urban transport component using a weighted disability of 75 per cent for urban centre characteristics and 25 per cent for urban population, on the grounds that data limitations resulted in the use of proxies in the model. It is evident that this approach benefits New South Wales more than other States. Victoria requests the Commission provide more justification for its proposed approach and present other blends of results for comparison.

Victoria supports the proposed econometric model as it has greatly improved the assessment of urban transport needs.

Compared to population, the variable population density is more policy-related. This can be seen from the deviations of the relationship between population density and population. Victoria recommends that the Commission try different model specifications to compare the overall significance of the model rather than focusing on R-square.

Victoria is also concerned about the bias of estimation from the consultant's econometric model because of many omitted SUAs. The result being that it is not representative of the whole Australian urban population. The Commission should use better data to improve the assessment.

Victoria notes that the Commission incorrectly states the Victorian position (refer to paragraph 110 of Attachment 18 on p.29). Victoria's comment, based on its experience, was that heavy rail was not a form of transport used within non-capital city SUAs and requested details of the non-capital city SUAs used in the consultant's model.

19.1.2 Non-urban transport

Victoria supports the Commission's proposal to assess non-urban transport expenses on an EPC basis. Victoria also supports the Commission's decision to not consider the share of population outside capital cities as the main driver of non-urban transport expenses. However, Victoria considers that a general regional cost factor may not properly reflect the costs faced by regional operators and, as the impact of this factor is extremely minor, it is not worth pursuing.

19.2 Assessment Issues

19.2.1 Proposed method of modelling passenger numbers

Victoria welcomes the Commission's proposed method to estimate the number of public transport passengers. This method better captures a state's real need of public transport.

Victoria has found that, using the proposed method in the Draft Report with 2017-18 data, urban public transport factors fall for most States except New South Wales, Tasmania and the Northern Territory. The new assessed transport usage number may increase Victoria's urban transport factor, and hence public transport expenses. However, the Commission staff have advised that the changes have no material impact on the current assessment. Victoria considers that a pre-assessment is needed before moving to the new method to better understand the impacts on individual jurisdictions.

19.2.2 Other issues

Victoria supports the Commission's proposal to include student transport in the urban transport component.

Victoria also supports the Commission's proposal to assess net expenses after depreciation in the infrastructure assessment. However, Victoria requests that the Commission provide a justification for the disability weights applied to urban centre characteristics and urban population.

20. Services to Industry

Summary of proposed changes to the 2015 Review methodology

- Mining regulation expenses are now assessed in a separate component (as this assessment is now material).
- The assessment of major project expenses is discontinued (due to immateriality).
- User charges has been deducted from regulation expenses for each industry.
- A single broad indicator has been adopted to assess agriculture and mining regulation respectively.
- Other industry regulation has been assessed using sector size (75%) and population (25%).

20.1 Assessment Issues

20.1.1 Using single broad indicators for the agriculture and mining regulation assessments

The Commission has excluded business count data from the disability weights for the regulation of agriculture, mining and other industries. The rationale provided is that business counts tend to be proportionate to the size of the economy, which suggests production measures alone could be used as a broad indicator for the regulation assessments.

Victoria considers that the number of businesses will affect the size of the regulation task (in addition to the level of economic activity and population). At least in the case of agriculture and mining, the Commission has access to reliable business count data sourced from the ABS. Victoria considers that excluding these data from the assessment risks oversimplifying the regulation task and makes the assumption that all businesses in a particular sector are equally productive.

Victoria suggests that the Commission reconsiders the exclusion of business count data from the assessment of agriculture and mining regulation.

21. Other Expenses

Summary of proposed changes to the 2015 Review methodology

- The natural disaster relief expense assessment excludes local government net expenses.
- The ACT cross-border disability for recreation and culture expenses within the service expenses component has been discontinued due to lack of evidence supporting the disability.
- Capital grants to local government are no longer being assessed because the driver of spending is unclear.
- National parks and wildlife expenses and pipeline expenses were previously part of the services expenses component, but are now included in the Services to communities category and Transport category, respectively. These changes are due to aligning categories with new Government Finance Statistics (GFS) classifications. National parks and wildlife expenses and pipeline expenses continue to be assessed equal per capita (EPC).
- National capital allowances for roads have been discontinued and the national capital planning allowance has been updated to reflect current needs.
- User charges are netted off expenses. They mainly comprise fire and emergency services levies (FESLs).
- No adjustment has been made for interstate non-wage costs.
- The regional costs disability now uses hospitals and schools data.

Victoria has no further comments to make in this area.

22. Investment

Summary of proposed changes to the 2015 Review methodology

- Investment and depreciation expenses are assessed together in the Investment assessment.
- Investment associated with each expense category is measured directly, rather than based on share of stock value.
- Three year averaging of disabilities has been removed to ensure consistency of population change and change in disabilities.
- Administrative scale is no longer assessed in the Investment assessment because depreciation associated with fixed administrative functions is now captured in the Administrative scale assessment.

Victoria has no further comments to make in this area.

23. Net borrowing

Summary of proposed changes to the 2015 Review methodology

- The 12.5 per cent discount to total assessed net borrowing is no longer applied.

Victoria has no further comments to make in this area.

24. Administrative scale

Summary of proposed changes to the 2015 Review methodology

- The estimate of total administrative scale expenses for 2017-18 has increased by 27%, from $2.2 billion to $2.8 billion.
- The Northern Territory dual service delivery adjustment has been removed. However, an adjustment of $1.8 million for the Northern Territory has been included to recognise a difference in its organisational structure requiring additional engagement with Indigenous stakeholders for policy development and coordination.
- The wage costs proportion of administrative scale expenses has been reduced from 80% to 60%.

Victoria has no further comments to make in this area.

25. Wage Costs

Summary of proposed changes to the 2015 Review methodology

- Due to the timing of the release of a new ABS data set, the Characteristics of Employees survey (CoES), the 2015 Review of the Wage costs assessment was deferred until the 2016 Update. The proposed assessment does not differ from the methodology adopted in the 2016 Update and finalised in the 2017 Update.

25.1 Assessment Issues

25.1.1 The specification of the econometric model and interpretation of its results

Victoria is disappointed that the Draft Report does not address in detail the issues raised by Victoria in its response to the Commission’s Staff Draft Assessment Papers. In particular, the inclusion of a large number of variables in the econometric model will lead to inflated standard errors for the regression coefficients. For example, the proposed model has produced coefficients for state dummy variables that are statistically insignificant. Victoria’s position is that greater econometric rigour is required for the specification of the model and the interpretation of the results.

26. Geography

Summary of proposed changes to the 2015 Review methodology

- Regional costs have been assessed directly in a broader range of categories than in the 2015 Review.
- For categories where a direct assessment has not been possible, a general regional costs gradient has been applied. The general gradient is based on the average of the regional cost gradients measured in Schools and admitted patients.
- Service delivery scale is measured using remoteness areas, rather than service delivery scale specific geography.
- The interstate non-wage cost assessment has been discontinued.

26.1 Assessment Issues

26.1.1 General Cost Gradient

Victoria maintains the view that the application of a general cost gradient for a number of category components is inappropriate. It is unclear how an average of schools and admitted patients data (general cost gradient) is related to, for example, environmental protection data.

The application of the general cost gradient without relevant data, and in particular the removal of discounts, risks overstating the additional costs associated with remote service delivery. The Commission seeks to minimise this risk in such a way that it overlooks the risk of understating these costs – over compensating States with these disabilities. Victoria considers that the risk of understating costs (over compensating States) should be equally relevant and that the Commission should not favour the minimisation of one over the other.

In some instances, the Commission has removed the discount applied to the general cost gradient without a corresponding increase in the confidence of data, or the acquisition of new data. Victoria considers that where the general cost gradient is applied, a medium discount factor should also be applied to recognise the use of a proxy which is extrapolated from another service.

Victoria considers that the Commission appears to favour the retention of existing practice as long as there is a conceptual case despite a lack of reliable or relevant data, over the acceptance of new proposals that exhibit the same characteristics. Victoria accepts the Commission's decision not to include new disabilities due to a lack of data, but requests that this rationale is applied consistently across proposed and existing assessments.

26.1.2 Service Delivery Scale and Regional Costs

The issue of place of residence and place of service receipt is important when the regional cost gradient is based on the cost of service provision but applied to the place of residence of the client population. Victoria appreciates the work that the Commission has undertaken to address this issue but considers that further work is required. While there may not be sufficient time left for the 2020 Review, the Commission should investigate the availability of data from the States similar to the data provided by Victoria (presented in Table 3 of Attachment 25) to better address this issue.

Victoria accepts the conceptual difference between regional costs and service delivery scale (SDS). The proposed application of SDS to remoteness areas rather than SDS and non-SDS areas (which overlapped remoteness areas) has alleviated some of Victoria's concerns. Victoria observes that the general application of SDS is based on scale (for example, average students per school) and that the factors attributed to SDS are implicit, that is, smaller scale is more common in more remote areas. Victoria considers that the Commission's calculation of SDS costs does not fully align with the conceptual case of what these costs represent.

26.2 Other Issues

26.2.1 Brownfields development

Victoria notes that the Commission considers that a conceptual case to recognise the additional costs of providing infrastructure in brownfield sites is strong, but unlikely to be material. It would be helpful if the Commission could elaborate on how it reached this conclusion. Victoria is in the process of compiling data relevant to this issue and will liaise with the Commission on possible implementation methodologies.

27. Other disabilities

Summary of proposed changes to the 2015 Review methodology

- National capital planning allowances have been revised.
- National capital allowances for wider roads, above average urban space, above average urban/bush interface and bus subsidies are no longer being assessed.
- The general method of estimating cross-border costs has been discontinued and a cross-border factor will not be applied to welfare expenses and recreation and culture expenses.
- The remaining cross-border assessments are considered in their relevant attachments.
- Land rights expenses are assessed for all States (not just the Northern Territory). They are assessed on an actual per capita basis.
- The native title and land rights expenses are assessed together as some States indicated they could not be reliably separated.

Victoria has no further comments to make in this area.

28. Population

Victoria has no further comments to make in this area.

OFFICIAL

Treasury and Finance