Commonwealth Grants Commission 2015 Methodology Review

Tasmanian Government Submission in Response to the Commission Position Paper (CGC 2014-04) – Significant Changes since the Draft Report

December 2014

Tasmania
Explore the possibilities

Contents

Chapter 1 **Mining Revenue**

The Commission has raised the possibility of developing a method and principles for making adjustments to its revenue assessments to deal with the impact of large scale revenue shocks and has sought States' views on the general principles, guidelines and processes which should be developed.

The Commission has recognised that if any adjustment is to be made, it must improve the HFE outcome.

Tasmania has addressed the following issues in response to the Commission's request:

- contemporaneity and flexibility;
- a standardised adjustment mechanism;
- appropriateness of adjusting to ameliorate impacts;
- use of projections or forecasts;
- adjusting for "expected" circumstances; and
- practicality of agreeing and applying principles.

Contemporaneity and flexibility

Tasmania considers that the Commission's current methodology is suitably flexible and contemporaneous to respond appropriately to changes to revenue bases when considered in the context of its primary role – to deliver recommendations on how the GST should be distributed in accordance with the "principle of HFE".

At its essence, the Commission's methodology is specifically designed to recognise innate differences (notwithstanding materiality thresholds), in States' actual revenues and expenditures to facilitate the recommendation of an appropriate distribution of GST revenue.

Following extensive consideration of this issue in the 2010 Review, the methodology was specifically structured to achieve a balance between being sufficiently contemporaneous to respond to changes in a relatively timely way, whilst delivering a level of stability through the use of three year averaging, effectively "smoothing" the impact of large movements in circumstances.

Tasmania considers the current balance between contemporaneity and stability is appropriate. In Tasmania's view, sudden or large scale shocks to revenue bases are able to be managed sufficiently within this established balance. Further, Tasmania considers that the current process of backcasting major changes in Commonwealth–State relations, and undertaking five yearly reviews enables sufficient scope for the Commission's methodology to be adapted, with appropriate consultation with States, where inadequacies in dealing with actual circumstances are recognised.

Tasmania would be opposed to changing this established balance without thorough consideration of the issue, similar to that which occurred during the 2010 Review.

A standardised adjustment mechanism

Tasmania finds it difficult to see how the establishment of a standardised adjustment mechanism could result in improved HFE outcomes. To the contrary, Tasmania expects that such a mechanism would:

- present great difficulty in its establishment and implementation;
- create further scope for debate about how the Commission should apply its methodology;
- potentially lead to the Commission being obliged to justify its use of judgement in some circumstances and the standardised adjustment principles in others; and
- undermine the Commission's ability to achieve a principles-based HFE outcome.

The current methodology calculates relativities based on actual evidenced circumstances experienced by States, within a range of accepted data quality and accessibility constraints. Where the Commission considers that an assessment is inadequate in assessing State circumstances effectively, they are able to make adjustments through the use of discounting or other methods as they judge appropriate within a process that appropriately involves consultation with States.

Tasmania questions the need for a one-size-fits-all adjustment mechanism to replace the adaptable and (arguably) historically effective application of Commission judgement in such circumstances.

Tasmania has always considered Commission judgement and discretion to be an important element of the current equalisation process and supports the use of judgement in the Commission's decision making processes on a first principles basis. Tasmania fails to see how a standardised adjustment mechanism can materially improve the Commission's processes.

Appropriateness of adjusting to ameliorate sudden or large scale impacts

Tasmania notes that, in reference to the Commission's role regarding Commonwealth–State agreements, the Commission states (point 13 of the Draft Report):

> We are not asked, nor given the discretion, to decide when other policy objectives or agreements between the Commonwealth and the States should moderate the achievement of HFE, unless explicitly directed in our terms of reference. Nonetheless, in adopting the definition, and in developing its methodology, the Commission is conscious of the desirability of minimising any adverse impacts of HFE on the operations of government and the economy generally.

Tasmania considers the inclusion of any mechanism within the Commission's methodology for the purpose of ameliorating the impact of the outcomes of the assessment goes beyond the scope of HFE and would thereby inappropriately moderate the achievement of equalisation. We suggest that the Commission's position regarding its role in decisions relating to Commonwealth-State payments can be broadly applied in the context of an assessment adjustment process also. That is, recognition that the Commission's role is, and should be, limited to that of delivering recommendations in accordance with the principle of HFE, and as such, developing processes within its methodology that lead to the moderation of achievement of HFE are beyond its remit.

Tasmania considers it the responsibility of governments to consider and negotiate an appropriate way to ameliorate any adverse impacts that result from the Commission's assessment process from, for example, sudden or large scale shocks to revenue bases if it were to be necessary.

Use of projections or forecasts in the Commission's methodology

Tasmania is strongly opposed to the use of projections or forecasts within the Commission's methodology, including Western Australia's proposal to "implement HFE without lags".

At its simplest, a non-lagged assessment would require "the CGC to make projections of the circumstances in the grant year" and a subsequent "correction for actual data in the following year.[1]" Tasmania is of the opinion that contemporaneity achieved by estimates or projections of circumstances in the application year would:

- substantially increase complexity;
- increase the level of judgement required of the Commission beyond what is considered reasonable;
- reduce stability and predictability of GST revenue shares; and
- increase volatility – especially when the impact of subsequent corrections for actual data are added to increased volatility in GST shares for the application year.

Tasmania is pleased to note the Commission rejected Western Australia's proposal, in-principle, in the paper, titled, *Significant Changes since the Draft Report Commission Position Paper CGC 2014-04*, stating:

- a three year lagged assessment is the most reliable, practical approach to providing a reasonable estimate of State circumstances in the application year;
- State or independent forecasts of revenues in the application year are not sufficiently reliable for use as the basis of the GST distribution; and
- consequent GST adjustments in future could undermine the contemporaneity of future years GST distributions.

Tasmania strongly supports the Commission's position on this issue.

[1] Western Australia's Submission to the CGC's 2015 Methodology Review, September 2014, page 22.

Adjusting for "expected" major changes in State circumstances

Tasmania would be greatly concerned by any move to adapt the Commission's methodology to smooth or ameliorate the impact of "expected", that is, "future" changes in State circumstances. To attempt to establish a mechanism that can ameliorate the impact of expected circumstances asks that the methodology be modified to allow for adjustments based on prospective conditions, as opposed to actual circumstances.

Tasmania does not support the modification of the Commission's methodology beyond what is necessary to accurately assess actual circumstances. The impact of changes in circumstances cannot be accurately anticipated. While certain changes may well impose the need for methodological adjustments, the adaptations required can only be properly considered once the impact of the major change is clear and quantifiable. The Commission's processes of back-casting of major changes in State circumstances and five-yearly reviews enable sufficient scope for this to take place when circumstances are "actual" and impacts are known and can be evidenced.

Practicality of agreeing and applying a set of principles for an adjustment process

The above issues aside, at a practical level, Tasmania considers that it would be difficult for a set of principles to be developed that could be applied consistently and transparently within or across assessments. This is a similar issue to trying to identify and define what are "nationally significant" Commonwealth payments, and the development of a standardised adjustment process is likely to generate debate about what is, or is not, an "exceptional circumstance". Tasmania considers it inappropriate for the Commission to have to arbitrate between differing State views on how "exceptional circumstance" should be defined.

Further, Tasmania notes that, even if a set of defining principles could be agreed, the symmetrical application of such principles is unlikely to deliver an appropriate response in all cases given the wide range of issues that could be considered for such an adjustment. This could lead to the need for the Commission to apply further judgement in individual adjustment cases and in effect rendering the process discretionary and thereby negating the purpose of the adjustment mechanism altogether.

Other issues in the Mining Revenue Assessment

Tasmania also wishes to address the following issues in relation to the Mining revenue assessment:

- discounting; and
- profitability adjustment.

Discounting

Tasmania reiterates its support of the Commission's policy in relation to the application of discounts, as stated in paragraphs 67-72, page 33, of the Draft Report on State Revenue Sharing Relativities 2015 Review. Tasmania agrees that discounting is appropriate as a means to achieve the best estimate of HFE where there is uncertainty within an assessment. Tasmania considers that the mining revenue assessment is not subject to uncertainty and concurs with the Commission's position in the draft report to not apply a discount.

On a first principles basis, Tasmania refutes other State arguments that the application of a discount within the mining revenue assessment is appropriate to recognise unassessed mining related expenditure needs. In line with the first principles approach applicable to any methodology review, Tasmania considers that if "gaps" are substantiated within specific expenditure assessments within the 2015 Review process, these should be addressed within those expenditure assessments where possible. Tasmania notes that, outside of the changes currently proposed by the Commission to the mining expenditure assessment, other "gaps" have been unable to be adequately substantiated. For this reason, a discount to the mining revenue assessment is not warranted.

Tasmania also refutes that a discount is necessary for the purpose of improving policy neutrality as argued by some States. Tasmania shares the Commission's views regarding the difficulty in isolating the net impact of State effort on production levels from other influences. Tasmania considers that assessments should only be discounted where differences are clearly quantifiable and to do so improves HFE outcomes.

Tasmania considers that no legitimate reason for a discount in the mining revenue assessment has been demonstrated and encourages the Commission to stand by its conclusion that a discount should not be applied.

Profitability adjustment

In our submission in response to the Draft Report, Tasmania requested that the Commission make a state-specific adjustment to our revenue base to reflect Tasmania's reduced capacity to raise mining revenue. We argued that the Commission's use of value of production data is inadequate in that it does not account for differences across States in the cost of production and the profitability of mining activity and therefore considerably overstates Tasmania's capacity to raise royalty revenue from its mining operations.

Tasmania considers that such an adjustment would better achieve HFE in that it would recognise a disability faced by the State that is not otherwise recognised within the assessment due to the unavailability of a robust profitability-based data source.

Tasmania considers this an example of an adjustment that demonstrates the value of the Commission's process of using its discretion and applying judgement on a case-specific basis.

Tasmania notes that we are flexible on how the Commission might apply such an adjustment within the assessment. Further evidence and annual data updates can be made available to support the application of an adjustment if required.

Chapter 2 Mining Expenditure

Tasmania supports the inclusion of mining related expenditure if it is material and there is a robust conceptual case for its inclusion. This is no different to the consideration of any other new expenditure assessment in accordance with the principles of HFE.

The Commission has, in accordance with its Terms of Reference, considered a broad range of mining related expenditure that is not already captured by existing assessments.

Having examined a broad range of mining related expenditure, the Commission concluded in its Draft Report that, in most areas, States with significant mining sectors face no higher expenses per capita than States with a different industrial composition and therefore no basis for its inclusion.[2]

The Commission has advised in the Significant Changes paper that it intends to introduce two new assessments within the Services to community category relating to:

1. planning and regulation of investment projects; and
2. capital grants to local government relating to community development, amenities and culture and recreation.

Planning and regulation of investment projects

This assessment is ostensibly designed to address higher regulation and planning costs faced by State Governments as a result of rapid growth in investment projects such as mining.

Tasmania supports the Commission's approach of applying this assessment to all industries and not just mining provided that it is material in its own right.

In the draft report, the Commission show estimates of State expenses of planning, development, and approvals based on State provided data. The Commission concluded that, based on the data provided by the States, it cannot justify an assessment in relation to regulation and planning costs of mining related activities.[3]

However, in the Significant Changes paper, the Commission now considers there is a conceptual case for including a disability reflecting the additional planning and regulation costs incurred by States to facilitate investment projects. It is not clear from the Significant Changes Paper what has changed the Commission's thinking as to the materiality and reliability of the data to include the disability in its assessment.

[2] Draft Report on State Revenue Sharing Relativities 2015 Review – Main Report Chapter 5 Priority Issues, para 23, page 66.

[3] Draft Report on State Revenue Sharing Relativities 2015 Review – Attachment 15 Services to Communities, para 79, page 281.

Data materiality and accuracy

Tasmania is concerned that the basis of this assessment going forward will be the indexation of baseline data supplied by the States for 2010–11 to 2012–13 through a data request. This places a heavy reliance on the accuracy of the State figures upon which indexation will occur. In Tasmania's case, it had reservations about the accuracy of the data. Commission staff sought ABS GFS data and recognised that they are likely to be recorded in a number of different government purpose classifications. Staff also noted that if using GFS data was not possible then States should seek the data directly from relevant planning and regulatory agencies. This was the case for Tasmania as it was unable to identify cost and revenue breakdowns by GPC code as the data were not originally classified to this level of detail. The expenditure and revenue breakdowns were based on estimates provided by the relevant State Government agencies.

In addition to the concerns about the reliability of the data, Tasmania has concerns about the potential lumpiness of investment projects, and as a consequence, planning and regulation costs, particularly for small States which could lead to a significant variation in expenditure from one year to the next should a major project emerge.

The Commission proposes to assess spending on planning and regulation of investment projects based on State supplied data for 2010–11 to 2012–13, which as noted in Tasmania's case may be deficient or unreliable, and for this data to form the basis for future indexation using real growth in private on-dwelling construction and the price index for State and local government final consumption expenditure. Given the concern regarding data reliability and volatility, Tasmania recommends that the CGC should exercise appropriate caution and consider an appropriate discount to allow for data quality issues.

Capital grants to local government to support community development

In the Draft Report, under the Services to communities assessment, the Commission did not think a conceptual case had been established for mining related development placing greater per capita expense burdens on relevant States for community development.

The Commission examined capital grants provided by State Governments for community development and found it was a small part of total State spending and it was not convinced that a separate assessment was warranted[4].

However, in the Significant Changes paper, the Commission now considers there is a conceptual case for a disability reflecting the additional costs incurred by States to support local government infrastructure provision. This is due to the impact of rapid population growth leading to increased State Government capital grants to local government so that it can maintain infrastructure at per capita levels.

[4] Draft report on State Revenue Sharing Relativities 2015 Review – Attachment 15 Services to Communities, para 76, page 280.

It is not clear why the Commission has changed its view on the conceptual case for the proposed disability and it has not provided the States with any evidence of this or the sources of data. Tasmania also concurs with the comments raised by the ACT in response to the Significant Changes Paper that it is not clear to what extent capital grants to local government experiencing rapid population growth needs are already addressed through grants paid by State Grants Commissions.

Chapter 3 Health

Assessment structure

Tasmania supports the Commission decision to not make further changes to the structure of the Health category since the Draft Report, notwithstanding changes outlined in the recent paper, titled, *Health Substitutability*, which are discussed below.

Adjustments for SES and Age

Tasmania has, in previous submissions, argued that the adjustments for SES and age to Medicare bulk-billing data should be undertaken if accurate data were available. As the Commission has now found workable data, Tasmania supports the use and inclusion of SES and age in the standardised bulk billed services, along with the existing Indigeneity and remoteness adjustments.

Substitutability of the private provision of health services

Emergency Departments

Tasmania notes the Commission's analysis in the Health Substitutability paper of the various issues influencing the level of substitutability of ED services. In the absence of the provision of any compelling evidence to the contrary by other states, Tasmania accepts the staff's proposed recommendation that the Commission adopt a substitutability level within the range of 10-20 per cent of ED component expenses.

Non-admitted patients

Tasmania notes the Commission's analysis in the Health Substitutability paper of the various issues influencing the level of substitutability of non-admitted patients. Tasmania notes that staff intend to recommend that the Commission adopt a level within the range of 40-45 per cent substitutability of non-admitted patients component expenses. As stated in previous submissions, on a first principles basis, Tasmania is of the view that there is a general sliding scale in which, on average, health services with a lower complexity have a higher degree of substitutability. Tasmania considers it appropriate that the level of substitutability for this category is higher than the substitutability range proposed for the more complex ED component (10-20 per cent), but lower than that proposed for the less complex community health services component (60-75 per cent). As such, in the absence of the provision of any compelling evidence to the contrary by other states, Tasmania accepts the staff's proposed recommendation.

Community Health

Tasmania notes the Commission's analysis in the Health Substitutability paper of the various issues influencing the level of substitutability of Community health category. Tasmania notes that States and the two consultants were unable to offer any evidence to support an alternative level of substitutability. In line with our previous submissions on this issue, Tasmania accepts the staff's intention to recommend that the Commission adopt a level in the range of 60 to 75 per cent substitutability for the community health services expenses component.

Admitted patients

In considering the level of substitutability between private and public admitted patients' health services, Tasmania supports the conclusion drawn by the Commission in the 2015 Draft Report that substitutability should not be separately assessed within the admitted patients component.

Tasmania is of the view that the Commission is currently assessing substitutability adequately within this component through the use of remoteness within the assessment of SDC. Tasmania considers that the use of remoteness adequately addresses the substitutability of public and private hospital services by recognising that public hospital admissions increase as remoteness increases, in part, because of the lack of private hospital service availability in regional locations.

Tasmania has considered the findings of the consultant reports on the admitted patient services. Tasmania agrees with Downie's opening statement that the current approach adopted by the CGC for admitted patient services is sound. Further, Downie states "per capita private hospital separation rates vary considerably by both remoteness area and socioeconomic status"[5]. Tasmania supports this statement, and notes that these factors are already taken into account within the methodology.

Downie suggests that there would be merit in considering the substitutability of inpatient services between public and private hospitals. To support this position, he refers to the Round 16 Private National Hospital Cost Data Collection data, noting it "shows that only 22 out of 708 diagnosis-related groups were not performed in private hospitals in 2011–12"[6]. Downie uses this as evidence that the majority of admitted hospital services are available in both the public and private sectors (suggesting a high rate of substitutability).

Tasmania is supportive of the consideration of whether the current assessment adequately recognises the substitutability of services. However, Tasmania questions whether Downie's analysis of DRGs is truly representative of the reality of the breadth of services offered across private hospitals. Analysis by the Tasmanian Department of Health and Human Services suggests that the statement "only 22 out of 708 DRGs were not performed in private hospitals" is misleading in that it is from a national aggregate perspective. That is, whilst the statement may be true when considered nationally, many of the "performed" DRGs could only be being offered in one or two private hospitals across the country. For this reason, Tasmania does not consider this high level analysis to be a safe basis for assuming broad substitutability across all regions of all states and territories.

Tasmania notes Savage was more conservative in her comments in this area, stating only that she thinks there are State differences in private and public hospital rates within major cities and the Commission should undertake further work to test for this.

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[5] Downie, J, *Conceptual Review of the Commonwealth Grants Commission Methodology for Health Assessment for the 2015 Review*, page 2.

[6] Ibid.

Tasmania acknowledges the Commission staff have endeavored to undertake a further level of analysis within the Health Substitutability paper. However, Tasmania does not consider that the analysis undertaken has been of a depth to fully understand the drivers influencing private hospital service provision and the complex interactions between the private and public hospital sectors.

For example, Commission staff contend that the data provided in Table 3 of the Health Substitutability paper suggest there may be some level of substitutability of services. However, Tasmania would argue that these raw data have not been adjusted for the SDC factors already applied within the assessment and are therefore not reflective of residual differences that the commission is attempting to recognise. Even if residual differences were to be evidenced once the SDC factors were applied, Tasmania contends that the underlying reasons for those differences is yet to be analysed sufficiently. It is possible that any residual differences could be simply the result of State policy differences.

Tasmania draws attention to discussions of the issue of substitutability in admitted patients during the 2010 Review. In their position paper, Commission staff found that "while there may be some overlap between services provided by public and private hospitals, they do not provide the same mix of services[7]". They also concluded that "a range of state policies influence the level of private hospital services and that there are differences between states in those policies[8]". The position paper noted the then Commission's view was that:

> The case of lower private provision of admitted patient services leads to higher public provision is difficult to sustain. The case is questionable on conceptual grounds because there is evidence that private hospital services are more than substitutes for public ones and differences between States in the extent of private provision are at least partly attributable to policy differences. In addition, data are not available to measure the differences between States in public and private provision on a comparable and policy neutral basis[9]

In the 2010 Review Final Report, the Commission concluded that:

> apart from the Northern Territory, we cannot conclusively say for the other states whether private health services differ to an extent beyond the influences from their population characteristics and State policies[10].

Tasmania recognises that the data available may have improved in the interim, but we also note that the issue was considered to a greater level of detail in the 2010 Review. Tasmania does not consider that the issue has been considered to the same (nor an adequate) depth in this Review.

Tasmania does not dispute that there may be differences in the availability of private hospital services in comparable areas of different states, nor that there may be a level of substitutability of

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[7] CGC 2008/18, *2010 Review Admitted Patient Services Position Paper*, page 20.

[8] Ibid, page 22.

[9] Ibid.

[10] CGC, *Report on GST Revenue Sharing Relativities – 2010 Review*, Volume 2, Chapter 12, Page 203, point 46.

services. However, Tasmania notes it is yet to be established that any differences not already recognised by the application of the remoteness disability are not the result of other factors such as state policy, including licensing policies.

Tasmania considers that there are many influences on the provision of private hospital services across states, and significant complexity in the intricate interactions between these and public hospital services. Tasmania does not consider that these factors have been adequately investigated to reliably establish that the commission needs to adjust further for substitutability within the context of their HFE based methodology.

Tasmania considers a significantly more disaggregated analysis of the actual service-case mix available in each region of each jurisdiction, including significantly more state consultation and input, would be required to justify a further adjustment. Tasmania does not consider there to be sufficient time for this analysis to be undertaken within the 2015 Review.

Given the current method has been independently reviewed and is considered sound, and the absence of sufficient time for an appropriate level of critical analysis of this complex issue, Tasmania is of the view that no change should be made to the existing assessment methodology.

Chapter 4 **Welfare**

Tasmania has previously supported the use of SEIFI within the General welfare component of the Welfare category (refer Tasmania's January 2014 and September 2014 submissions).

Subsequently, the Commission advised in the paper, titled, *Update and Supplementary Issues for the 2015 Review Staff Discussion Paper CGC 2014-03-S*, that the ABS would not be issuing a 2011 SEIFI index and canvassed several alternative measures in the absence of a direct SEIFI index.

Tasmania supports the revised proposal to use the 2006 SEIFI, adjusted for proportional changes in Health Care Card holders between the 2006 and 2011 Censuses, in preference to the alternatives canvassed in the Update and Supplementary Issues paper. Consistent with earlier submissions, Tasmania considers that a SEIFI-based measure of the 20 per cent of the population with the lowest SES, adjusted as described, better captures the broad target profile of users of general welfare services.

Chapter 5 **Regional Costs**

The Commission intends to use a general regional cost gradient where a regional cost disability is to be extrapolated to categories other than Schools education or Justice. A discount of 12 per cent has been applied to the regional cost factors for all categories in which the general cost gradient has been used.

Tasmania supports the use of a general gradient for those categories where a specific gradient could not be derived due to lack of appropriate data and notes that this is consistent with the current approach.

Chapter 6 Urban Transport Infrastructure

In the paper, titled, *2015 Review Proposed Assessments Staff Discussion Paper CGC 2013-07S*, Staff stated that, for simplicity, a linear form was chosen for the asset per capita by city size relationship to derive the urban transport quantity of stock disabilities.

In the Draft Report, the Commission stated that it has used a linear model instead of a quadratic model because it will help minimise the possibility of one State influencing the results too much.

In a separate paper, the Commission's consultant highlighted that the functional form is dependent on a couple of data points given that the sample size is small.

In the Significant Changes paper, the Commission states that, given State concerns about the quality and policy neutrality of the data on urban transport infrastructure by city and the nature of the regression model used to capture the relationship in the Draft Report, the Commission intends to adopt a simple population based model for the urban transport infrastructure assessment. However, the simple population based model is valid only if the data are sound and the relationship between per capita assets required and city populations is linear and close, or through, the origin.

Tasmania considers that a tapering off at the high end, i.e. some form of quadratic equation, is conceptually appealing as the share of trips on public transport cannot increase ad infinitum, and should a data point move year-to-year, such an equation may be more appropriate. The Commission's consultant suggested that a quadratic function may be more appropriate and fit the data better. The consultant suggested that, between a linear and quadratic function, a simple t-test of the second order term or a comparison of adjusted R-squared may give an indication of whether the quadratic function fits the data better. However, no evidence has been presented by the Commission that such tests have been carried out.

Chapter 7 Nationally Significant Infrastructure Projects

The Commission intends to treat all Commonwealth payments for projects which the Department of Infrastructure and Regional Development advises affect the national road and rail networks in the same way with a 50 per cent discount. This is because the Commission believes that part of the Commonwealth support for these networks, and the consequent investment, is influenced by Commonwealth considerations which are not captured in the State-based disability measures. This is an extension of the decision made in the 2010 Review to treat Commonwealth payments for National Network Roads as 50 per cent exclusion.

Commonwealth considerations or "national benefit" arguments can be made in relation to a broad range of other Commonwealth payments and is not limited to just rail infrastructure or transport infrastructure. Tasmania is concerned that extending the existing roads treatment to rail could become a "slippery slope" in this context.

There has been a longstanding general consensus as to the appropriateness of including Commonwealth payments to States. The 50 per cent discount is arbitrary and is not based on any evidence. Tasmania considers that all Commonwealth payments should be included unless otherwise directed by Terms of Reference.

Chapter 8 Wages

The reality of public sector wage setting for Tasmania, and other states, is that private sector wages are not used as a basis for negotiation. Negotiations revolve around what other States are offering nurses, teachers, paramedics and so on. Tasmania understands that the Commission cannot simply take that as given and must analyse data and derive a national approach should a disability be evident. However, looking at the data, the 2005 and 2009 SET results show a weakening in the correlation between public and private sector wages. In fact, Queensland has shown that the 2009 SET results are not statistically different from zero.

Using AWE data, the Commission has shown that 2009 SET did not pick up the increase in public sector wages in WA. The Commission also shows that public sector wages in WA started to trend towards the national average – lagging the strong private sector increases. The Commission suggest that this public sector lagged response explains, in part, the weakening in the relationship and that the relationship is long term (the Commission also used AWE data for NSW as evidence of lags). However, Removing WA from the 2009 SET private-public sector wages scatter diagram results in an R-squared that is still very low (0.37). The relationship remains weak as other State data have changed in a manner inconsistent with the theory that public sector wages are linked to private sector wages.

This weakening in the correlation between public and private sector wages occurred after the decision was made to apply a low discount of 12.5 per cent.

Looking at all the states AWE and SET data, a clear explanation for the weakening in the correlation is not evident (whether that be a move to more of a national market or that public sector wages always respond with a lag to private sector wages).

In response to the 2009 SET results, the Commission stated that it considers the relationship in individual years could be affected by lags, policy choices and other factors, which would not invalidate the underlying relationship. However, the Commission cannot be certain that the correlation between public and private sector wages will return in the future.

Furthermore, the Commission's approach is not the "optimum approach" where wage differences of private sector employees with characteristics similar to public sector employees are measured (such an approach would mean that the assessment would reflect the pressures faced by States on wages for the types of people employed by states). As Victoria noted, it is likely that interstate private sector wage differences between this cohort of employees will be less than for the private sector as a whole – as evidenced by the smaller variance of underlying public sector wages. Constructing the regression to include all private sector employees will likely materially overstate the wage pressures faced by State Governments assuming there is a link between private and public sector wages.

Tasmania is of the view that the discount applied in the 2010 Review is too low and that a higher discount should be applied due to a significant increase in the uncertainty surrounding the assessment as discussed above.

Tasmania welcomes a re-examination of the Wages assessment once new Compensation of Employees data are available.

Chapter 9 **Investment**

This assessment was first introduced in the 2010 Review.

It was introduced to address the issue raised by the faster growing states that spending need on infrastructure to meet its growing population was not adequately recognised.

The Commission developed a new methodology based on the view that there is strong evidence that population growth is a major driver of State infrastructure spending and States with above average population growth must spend more on infrastructure.

The Commission's method equalises investment need so as to provide each State with the average per capita stock of infrastructure required to deliver the average level of service. Thus, a State with a faster growing population effectively dilutes its stock of infrastructure per capita and so in order to maintain that average, requires more stock of infrastructure.

The Commission's method also recognises infrastructure need as it arises (that it is equalised upfront) rather than recognising the cost of capital in the period it is used.

Tasmania acknowledges that population growth is a key factor that influences infrastructure investment. However, the Commission's approach of equalising a State's infrastructure need to the State average per capita infrastructure stock assumes that its need is directly related to its relative population growth compared to the national average. That is, if a State's population is growing faster than the national average, then the Commission considers that there also needs to be positive and direct growth in its investment in order to maintain its investment per capita at the national average.

The Commission's methodology does not recognise new capital needs in the year in which needs arise. It recognises *new* capital needs, measured in the year in which differential population growth occurs. That is, it simply assumes a one-to-one relationship between population growth and infrastructure need and it is argued that this does not reflect reality and "what states do".

A linear relationship between population growth and investment in physical assets does not take into account the changing intensity of use, changes in technology, or the more efficient use of existing assets as an alternative to simply building more infrastructure as the population grows. That is, it effectively assumes that there is a constant capital to labour ratio to deliver services for the faster growing states.

There can be many reasons why relative growth in investment in capital infrastructure varies between the States other than because of relative population growth. For example, it could be due to the relative economic circumstance each State faces which enables the funding of more or less infrastructure expenditure, differences in the lumpy nature of Commonwealth Government assistance for capital infrastructure, policy choices such as decisions about the privatisation or the acquisition of assets, and the impact of natural disasters.

The method does not recognise the historic acquisition of assets and the age profiles. While the depreciation assessment reflects the need to replace existing assets, a State may have a greater need to invest in new infrastructure despite low population growth because it has an older stock of infrastructure than other growth States.

As the method does not recognise the historic acquisition of assets and the age profiles of infrastructure between States it can only equalise in terms of the incremental infrastructure need from a States starting position. This is not to say that States that have under-invested in the past should be equalised to the national average, but it does highlight that the method addresses only part of the infrastructure need.

Population growth does not necessarily require a proportionate increase in the amount of infrastructure to provide the same level of service. Assets such as roads may require additional maintenance from population growth but not necessarily an increase in the road stock.

Infrastructure can be over-utilised and under-utilised to deliver services until a decision to build replacement or new capital stock is made. The relationship between population growth, capital stock and service delivery is overly simplified in the current assessment

Tasmania and other States such as NSW and Victoria have argued in its submissions that there is not a strong relationship between relative population growth and investment need as has been assumed in the current methodology. Tasmania has suggested that the Commission should consider applying a discount factor to the Investment assessment to account for the uncertainty that higher population growth is a fiscal disability in the provision of infrastructure.