

# **Victorian Response to 2015 Methodology Review Draft Report**

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# 1. Introduction

Victoria welcomes the Commission's Draft Report of the *2015 Methodology Review*. This Review has been conducted under different circumstances to previous Reviews. It was preceded by the GST Distribution Review which both reduced the timeframe for the *2015 Methodology Review* as well as providing a number of recommendations for the Commission to consider.

Timelines have been further tightened by the delay in the release of the Draft Report.

Since the release of the Draft Report, the Commission has released the Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* (CGC 2014-03-S). Victoria has responded to issues covered in both the Draft Report and this discussion paper in this paper.

Victoria acknowledges the efforts made by the Commission and its staff in conducting the *2015 Methodology Review*. Despite the challenging timeframe a comprehensive review of the assessment methodology has been conducted. The Commission has given a reasonable amount of consideration to the recommendations of the GST Distribution Review which has covered some issues that the Commission might not have otherwise considered. Victoria is supportive of many of the Commission's proposals as it recognises that these are methodological improvements or the best that can be developed with the information available. However, Victoria has concerns with some of the proposed approaches and treatments.

Victoria notes that some of the changes to the assessment methodology proposed in the Draft Report were not canvassed in Staff Discussion Paper *Proposed Assessments* (CGC 2013-07S). While that discussion paper noted that its proposals were not final, it gave the impression that any changes would be the result of the states and territories submitting proposals that would result in better methodological approaches. However, the Draft Report contains a number of changes to methodology proposed by the Commission that were not canvassed in the Staff Discussion Paper *Proposed Assessments*. Victoria would appreciate some discussion indicating the considerations made by the Commission that led to changes in methodology not proposed in the Discussion Paper.

Another concern is that the Commission has unilaterally decided to change the principles underlying horizontal fiscal equalisation (HFE). The terms of reference of the *2015 Methodology Review* require the Commission to review the methodological approach to implementing HFE, not to review HFE itself. HFE is there to serve the interests of the states and territories and no changes should be made to its definition and supporting principles unless requested by them. It is noted that some of the proposed changes to the supporting principles do not have the unanimous support of the states and territories. In these circumstances the Commission should not push ahead with these proposals.

While Victoria has responded to all the proposals presented in the Draft Report there are a number of proposals which Victoria regards as being important and should be further considered by the Commission. These are:

- the treatment of fire and emergency services levies—Victoria considers that these should continue to be assessed as user charges in the Other revenue category;
- the assessment of interstate wages differentials—Victoria considers that there is no justification of continuing the current approach, but if it were to continue then differentials should be based only on capital city wages;

- the treatment of iron ore fines—Victoria considers that a phasing in of a change to a component of a revenue category is not warranted and would set an undesirable precedent;
- the substitutability of health services provided by the states and territories with those of general practitioners and private providers—Victoria considers that the degree of substitutability should be evidence based and that any judgement by the Commission needs to be based on the available evidence;
- the assessment of public transport policing—Victoria considers that this a sufficiently established form of policing that requires an examination by the Commission as to the materiality of a separate assessment;
- the treatment of taxes that were to be abolished under the Inter-Governmental Agreement (IGA) on Federal Financial Relations—Victoria considers that the revenue from these taxes should be assessed on an APC basis, but acknowledges that the Commonwealth should be providing guidance to the Commission on the appropriate treatment;
- the assessment of investment needs—Victoria considers that investment needs should not be assessed, but if the Commission continues to assess investment needs then the 50 per cent discount applied to national network road (NNR) construction should be applied consistently to other types of projects; and
- the assessment of culturally and linguistically diverse (CALD) populations—while Victoria acknowledges that the information available is incomplete it considers that the Commission should maintain an allowance for CALD expenses in the Other expenses category.

The Commission has also requested views on the best process for developing and modifying the methodology. Victoria considers that it would be preferable to have the effort of reviewing the methodology spread evenly over a five year period rather than just over a year. To a certain extent this occurs through the data working party. In principle, Victoria would support a rolling program of reviews of specific assessments.

## 2. The Equalisation Objectives and Supporting Principles

### 2.1 Objectives of the GST Distribution

Victoria notes that the Commission intends to use the same definition of HFE that was used in the *2010 Methodology Review*. While the Commission may consider that this definition is appropriate, some legitimate issues have been raised in the submissions made by the states and territories. The forthcoming White Paper on the Reform of the Federation should provide the opportunity to more fully consider what HFE should embody.

Victoria notes that the Commission acknowledges that it can only achieve proximate rather than precise equalisation. However, Victoria is concerned that the Draft Report gives the impression in some of the assessments that a higher degree of precision is being achieved than is warranted. This issue will be explored further in the discussion of individual assessments.

### 2.2 Supporting Principles

Victoria notes that the Commission intends to use the supporting principles from the *2010 Methodology Review*. While Victoria supports these principles it is concerned that the Commission appears to be unwilling to consider other principles that are considered important by at least some of the states and territories.

For example, the Commission is dismissive of predictability and stability as objectives without undertaking a rigorous analysis of what they might imply for assessments or HFE. Victoria acknowledges that a stability principle may at times come into conflict with the principle of delivering relativities to the application year. However, in practice the Commission has to arrive at a balance between the supporting principles, so the potential for conflict should not automatically rule out a principle.

Victoria considers that a predictability principle could support the principle of delivering relativities applicable to the application year. This point will be expanded later in the section dealing with data revisions.

### 2.3 What Collectively States Do?

Victoria notes that the Commission proposes to expand the coverage of state activities to include the operation of public non-financial corporations (PNFCs) providing public housing and urban transport. Victoria understands the reasoning behind this move and is supportive of it.

In the Draft Report the Commission proposes to change the way in which average state policy is determined by considering any tax imposed or service provided by any state or territory to be part of what is collectively done. The Draft Report claims that better HFE outcomes will be achieved by this approach compared with the approach adopted by the *2010 Methodology Review*. However, there was not unanimous support for this change by the states and territories and the support given was qualified.

By allowing the actions of one state or territory to determine 'what states collectively do' the Commission is implicitly assuming that government action is desirable. There can be sound public policy reasons for most states and territories not raising a particular form of

revenue or providing a particular service. The Commission is effectively providing a bias for government action irrespective of its policy soundness.

Victoria is of the view that the states and territories 'own' HFE and the role of the Commission is to implement HFE. If the states and territories are not convinced that the proposed change represents an improvement then the Commission should not adopt it.

## 2.4 Policy Neutrality

Victoria agrees that equalisation should be neutral to state and territory policies. However, if the Commission persists with the use of its proposed revised definition of 'what states do' then it is possible that policy neutrality can be compromised.

Victoria is not entirely convinced by the Commission's arguments against using a 'policy free' approach. It is stated that the use of an external standard would not be consistent with 'the what states do' principle. However, this inconsistency only results from how the Commission has chosen to implement that principle and not from the existence of that principle.

Victoria supports the Commission's proposal not to adjust the revenue assessments for potential second round impacts of policy changes nor to discount tax bases.

## 2.5 Practicality

Victoria notes that specific issues will be covered in later parts of the Draft Report and comments will be provided in the relevant sections of this paper.

## 2.6 Contemporaneity

Victoria notes the Commission's views. However, Victoria is concerned that the Commission has not appropriately considered some of the issues raised by the states and territories. This point will be expanded later in the appropriate sections.

## 3. Implementing Equalisation

### 3.1 How Do We Equalise Fiscal Capacity?

Victoria appreciates the serious consideration given by the Commission to recommendation 6.3 of the GST Distribution Review's *Final Report*. However, Victoria is disappointed that the Commission has kept its existing assessment of capital needs.

Victoria supports returning to an operating statement approach to equalisation, as suggested by other states. This includes an assessment of depreciation allowing states to replace capital and providing states and territories with the capacity to provide new infrastructure over time. It will also include all the additions to capital stock that states make overtime, including additions to capital stock for population growth.

### 3.2 Using the Supporting Principles

#### 3.2.1 Determining average policy

Victoria's views on this issue have been presented in Section 2.3

#### 3.2.2 Equalisation of interstate costs on a 'spend gradient' basis

Victoria is concerned that its position has continued to be misrepresented in the Draft Report. The Draft Report states that '...Victoria considers that a spend gradient should be applied to regional costs. It argued a maximum discount which increases with remoteness should be applied'.

In its first submission Victoria stated 'one way in which the GST Distribution Review recommendation and policy neutrality concerns could be addressed is to discount the cost gradients, with the discount increasing with remoteness.' Note that Victoria did not state that this discount *should* be applied, but rather offered a suggestion as to how the recommendation *could* be implemented.

Later in Victoria's first submission the statement was made that 'this would require the Commission not to use a general cost gradient, or if it were to use one, to apply the maximum discount to the resultant location factors'. This mention of the maximum discount does not correspond with that claimed in the Draft Report.

#### 3.2.3 Materiality thresholds

Victoria is concerned that its position in regard to increasing materiality thresholds has been misrepresented in Draft Report.

In its first submission Victoria stated that it did not consider the GST Distribution Review's proposal to have a four-fold increase in materiality thresholds would result in greater simplicity. However, in response to the Staff Discussion Paper *Implementation and Methodological Issues*, Victoria's second submission supported the recommendation to increase materiality thresholds for disabilities to \$30 per capita and data adjustments to \$10 per capita, and to remove the category structure and redistribution thresholds.

The Draft Report suggests Victoria does not support the proposed changes to materiality thresholds. Victoria considers the final report should note Victoria's support of the specific recommendations.

### 3.2.4 Discounting

Victoria supports the maintenance of a uniform set of discounts. It would have been helpful if this section made reference to Box 2 of the Draft Report (p 39) which sets out the criteria for the discounts.

However, Victoria is concerned that there is an inconsistent application of discounting across assessments. Some assessments have serious data quality and appropriateness concerns, but only the minimum discount is applied. In other cases the level of confidence associated with a disability or uncertainty about the data would appear to warrant the application of at least the minimum discount.

This point will be expanded later in the appropriate sections.

### 3.2.5 Contemporaneity

Victoria is concerned that the Commission's consideration of the use of non-annual and lagged data appears to have been solely in the context of recommendation 3.2 of the GST Distribution Review's *Final Report* and has ignored the wider issue that was highlighted in Victoria's submissions.

The Draft Report states '...the latest data best reflects States' circumstances in the year of application, unless it were in some way compromised, reflecting temporary influences'.

As Victoria noted in its first submission, there tends to be significant data revisions for each year from one Update to the next, particularly for the most recent assessment year's data. This would indicate that these data are continuously subject to temporary influences.

Victoria spent some effort in its first submission identifying this issue and how it could be addressed. It is disappointing that the Commission appears not to have seriously considered Victoria's contribution.

Later in this section the Commission provides some reasons why GST relativities change from year to year. However, it has not recognised that data revisions are also an important source of changes in relatives.

### 3.2.6 Backcasting

Victoria is concerned that the Draft Report states 'we consider reflecting major changes in State budget' is desirable if the relativities are to give meaningful and contemporary outcomes'. Victoria noted in its first submission that recent examples indicate that there has been an arbitrary selection of changes in state budgets and where the Commission attempted to account for these changes it actually worsened HFE rather than improved it.

Victoria considers that the Commission should acknowledge the dangers associated with reflecting major changes in state budgets relevant to the application year and to acknowledge its experiences with the treatment of non-real property transfer duty.

## 4. Treatment of Commonwealth Payments

### 4.1 Overview

Victoria notes that the Commission intends to assess Commonwealth payments according to the guidelines adopted for the *2010 Methodology Review*. While there is general support for these guidelines, the Commission has not always been able to implement them. Some Update or Review terms of reference direct that specified Commonwealth payments are not to have an impact on relativities.

In addition, it is apparent that states and territories are becoming increasingly aware of the GST impacts of Commonwealth payments and that a feature of a number of bilateral agreements with the Commonwealth is the requirement that the payment will not affect GST relativities.

Victoria supports the Commission's decision not to adopt a materiality threshold for Commonwealth payments.

Victoria notes that the Commission's approach to backcasting is essentially unchanged.

### 4.2 National Health Reform Funding

Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes to backcast the National Health Reform funding using the 2014–15 National Health Reform distribution in MYEFO, adjusted for cross-border payments. Victoria accepts that this proposal might be the best compromise between reflecting the situation in the application year and data accuracy.

### 4.3 Treatment of Payments Not Made in the Application Year

The Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes to not backcast any of the payments made in the assessment years but not made in the 2015–16 application year. The reasons outlined for not backcasting these terminated payments are not completely convincing. In total the termination of the payments could be regarded as a major change in Commonwealth-State financial arrangements.

It should be possible to determine whether backcasting would have a material impact on relativities.

### 4.4 Treatment of Other Commonwealth Payments

The Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes that the Commission should only exercise its discretion in relation to the treatment of Commonwealth payments if doing so will have a material impact. Victoria supports this proposal.

### 4.5 Treatment of Commonwealth Payments Commencing in 2013–14

The Draft Report proposes the following guideline for the treatment of Commonwealth payments on a case by case basis: 'payments which support State services, and for which expenditure needs are assessed, will impact on relativities'. This appears to be similar to the guideline developed in the *2010 Methodology Review*, that Commonwealth payments will

have an impact on relativities unless ‘needs have not been able to be assessed for the State expenditures to which the payment relates’.

Staff Discussion Paper *Update and Supplementary Issues for the 2015* proposes (Table B-1 of Attachment B) the treatment of each Commonwealth payment that commenced in 2013-14. Victoria supports this treatment as it is consistent with the guideline proposed.

However, the current methodology does not adequately cope with large Commonwealth funding contributions in advance of the expenditure profile of the infrastructure project to which they relate, and introduces short-term fluctuations that are difficult for states to manage. Under the current methodology, the pre-payment of a Commonwealth contribution is assessed as increasing fiscal capacity in the year for which it is made. In Victoria’s view, such a payment should not be assessed as increasing fiscal capacity when it is made, as pre-payments can only be applied to the specific project for which they are agreed. The overall outcome detracts from the achievement of HFE as states and territories true fiscal capacity is not being recognised.

Victoria considers that a better recognition of its fiscal capacity and an outcome more in keeping with HFE would be for the Commission to assess the Commonwealth's funding for major infrastructure in line with project expenditure.

#### 4.6 Treatment of Commonwealth Payments Commencing in 2014–15 and 2015–16

The Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes that Commonwealth payments commencing in 2014–15 and 2015–16 not be backcast as they are not the result of major change in Commonwealth-State financial arrangements. It could be argued that the Infrastructure Growth Package would constitute a major change in Commonwealth-State financial arrangements, but Victoria notes that the Commission anticipates that an amendment to the terms of reference for the *2015 Methodology Review* will require the Commission to payments for assets recycling will have no impact on relativities.

#### 4.7 Water for the Future

The Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes that the Commission retain the current approach to all three components of the program. Victoria supports this proposal.

## 5. Priority Issues

### 5.1 The Mining Revenue Assessment

The terms of reference required the Commission to develop a new mining revenue assessment. Victoria's response to the Commission's proposals in the Draft Report are presented in Section 11.

### 5.2 Mining Related Expenditure

The terms of reference required the Commission to consider the appropriate treatment of mining related expenditure. Victoria notes that the Commission proposes not to make changes to assessments in regard to most of the issues that were raised by states and territories in their submissions.

Victoria's response to the Commission's assessment proposals are presented in the sections relating to the expense categories concerned.

### 5.3 National Education Reform Agreement

Victoria notes that the circumstances surrounding the National Education Reform Agreement (NERA) have changed since the terms of reference were issued, particularly in regard to the 'no windfall' requirement. Although Commonwealth funding levels will also be changed after 2018 the *2015 Methodology Review* will have to deal with the arrangements until then.

Victoria is concerned that the Commission appears to be proposing to take into account additional factors to those contained in the funding agreements, such as the interstate wages adjustment. Victoria considers that the base of the funding agreements negotiated by the states and territories would cover costs such as wages and that no further adjustment is required. Victoria considers that any other approach would constitute 'unwinding' of the NERA loadings for disadvantage, in contravention of the terms of reference.

### 5.4 National Disability Insurance Scheme

Victoria notes that the Commission's approach will follow that outlined in Staff Discussion Paper *Proposed Assessments*. Victoria's views were expressed in its second submission and has no further comments to make.

### 5.5 Transport Infrastructure

The Commission is of the view that its guidelines for the treatment of Commonwealth payments are appropriate and do not need to be amended to include projects that may be of national importance. It rightly states that if the Commonwealth did not intend its funding of a project of national significance to be subject to equalisation then such a treatment could be specified in terms of reference. However, the Commission has effectively imposed a national significance treatment through the 50 per cent discount given to payments for NNR construction.

The justification of the NNR discount is that the Commonwealth payment may not fully reflect the needs assessed by the Commission in the Investment category, despite no

specification by the Commonwealth that there were any national significance considerations to these payments.

Victoria considers investment needs should not be assessed and if investment needs were not assessed there would be no need to consider national importance or to apply the 50 per cent discount to payments for NNR construction. However, if the Commission chooses to maintain the assessment of investment needs, Victoria considers that Commonwealth payments for road and rail infrastructure payments should be treated consistently. While the Commission continues to apply a 50 per cent discount to NNR construction, it should be applied to other projects. This issue is discussed further in the Section 24.

Victoria notes that there is a shortcoming to the Commission's approach to the treatment of Commonwealth funding for NNR construction projects. If the Commonwealth makes a pre-payment is for a new road construction project then there may be a lag in time before a decision is made to include the new road in the national network. This could result in a road being declared a NNR after the Commonwealth payment has been assessed. The state concerned would have the payment fully assessed rather than discounted. Therefore, the NNR discount is biased towards existing roads over new roads.

The Draft Report uses Box 1 (p 78) to demonstrate the impact of the assessment of investment needs and a Commonwealth payment for an infrastructure project. This example covers a ten year timeframe. It is not clear as to how the GST over a ten year period is consistent with the principle of '...delivering relativities that are appropriate to the application year.'

The example is confusing because it attempts to combine two distinct aspects of the assessment methodology—how the assessment methodology provides funds for investment and how Commonwealth payments are treated. While it is recognised that a number of simplifying assumptions are required for the illustrative example, Victoria considers that too many have been made.

The example is misleading when it refers to the net impact on GST. The impact the assessment of investment needs and Commonwealth payments has on the amount of GST received by a state or territory will depend on its GST relativity and the size of the GST pool. The GST relativity will depend on the per capita values of the assessed investment needs and Commonwealth grant for the hypothetical state relative to the national average per capita values. The example only provides absolute values and gives no indication of the national values or of the relevant populations.

As noted by the Commission, the actual GST outcome will depend on appropriately recognising the relative per capita investment needs of a state or territory. Leaving aside the funding of the investment by a Commonwealth grant, it is feasible that the current assessment of investment needs will result in a particular state or territory receiving less GST that would have been the case if investment needs were not assessed. Therefore, it is not necessarily the case that the assessment of investment needs will result in a state or territory receiving additional GST to fund its actual investment.

## 5.6 Indigeneity

Victoria's response is provided in Section 29 of this submission.

## 6. Payroll Tax

Victoria argued in its second submission that the small business tax-free threshold adjustment added unnecessary complexity and compromised the policy neutrality of the assessment. It is noted that the Commission proposes to retain the threshold adjustment. Effectively the *2010 Methodology Review* methodology will be retained.

On this basis Victoria does not support the proposed assessment methodology.

## 7. Land Tax

### 7.1 Category Structure

In Staff Discussion Paper *Proposed Assessments* it was proposed to include metropolitan improvement levies as a land taxes and differentially assess them. The Commission proposes to designate two components of land tax:

- all property—this includes metropolitan improvement levies and the property based fire and emergency levies; and
- income producing property—this is the component previously designated as land tax.

### 7.2 All Property Component

Victoria had been concerned as to how the Commission was intending to assess metropolitan improvement levies with land tax. The Draft Report clarifies how these levies are to be assessed.

While the proposed assessment is consistent with the proposed new definition of ‘what states do’, Victoria is not convinced that there would be a material difference to the current EPC assessment.

In the *2010 Methodology Review*, the Commission excluded fire and emergency services levies collected by insurance companies from the assessment of insurance taxes as these levies are more in the nature of a user charge than a transactions tax.

However, the Commission now proposes to differentially assess property-based fire and emergency levies. Victoria considers that these property-based levies are no different in nature to the fire and emergency services levies collected by insurance companies—the only difference is the base on which they are levied.

Victoria draws the Commission’s attention to the nature of Victoria’s property-based fire services levy. The levy rate is set at that required to generate the revenue required to fund the expenditure on fire and emergency services. The value of the base has no influence on the amount of revenue generated so the concept of a national average levy rate is not appropriate. The way in which the levy operates means that it is inappropriate to consider the allocation of funds from Victoria’s property-based fire services levy as the hypothecation of a land tax.

Furthermore, the fire and emergency levies funded by insurance is to be differentially assessed in the Insurance taxes category. This raises the issue that the method chosen by a state to fund its fire and emergency services will have an influence on its GST share. This outcome is contrary to the Commission’s policy neutrality principle:

*‘This principle aims to ensure a State’s own policies or choices, in relation to the services it provides, or the revenues it raises, do not directly influence the level of grants it receives. It also aims to ensure the GST distribution methodology creates no incentives or disincentives for States to choose one policy over another.’*

While the Commission claims that its methodology can never be completely policy neutral, the proposal to change the assessment of fire and emergency services levies moves the assessment from one of policy neutrality to one to where policy can have an influence. It is not clear that foregoing policy neutrality in this case will lead to a better HFE outcome.

An alternative approach that the Commission might consider is to assess fire and emergency services expenses on a net basis, that is, deduct the fire and emergency services levies revenue from the expenses.

### 7.3 Income Producing Property Component

Victoria has no comments on this component as it appears to be unchanged from the current assessment methodology.

## 8. Stamp Duty on Conveyances

### 8.1 Category Inclusions

Victoria notes the Commission proposes to include stamp duty on vehicle sales and transfers in this Revenue category. This gives rise to two observations:

- the inclusion of vehicle stamp duty was not mooted in Staff Discussion Paper *Proposed Assessments* and appears to be merely cosmetic; and
- if the Commission persists with the inclusion of vehicle stamp duty then this category should be renamed 'Stamp duty' to provide a more accurate indication of what is being assessed.

### 8.2 Property Component

The Commission has sought state and territory views on the appropriate treatment of IGA taxes which continue to be levied by some states.

Victoria has clearly stated its views on this topic. States and territories that continue to impose IGA taxes, after the agreed deadline of 1 July 2013, have a higher revenue raising capacity than the those that do not impose them and this needs to be recognised in the assessment methodology. In Victoria's view the appropriate recognition is APC.

It should be noted that it is quite difficult for a state to reimpose a tax that has been abolished. The collection infrastructure may need to be re-established and the bases of some of the IGA taxes may have been diminished. The Commission would be mistaken to consider that states and territories that have abolished their IGA taxes could react to the continued imposition by other states and territories by reinstating these taxes.

Victoria would have preferred the Commonwealth to address this issue in the terms of reference as the Commonwealth should be concerned as to whether the terms of the IGA are being met.

## 9. Insurance Tax

### 9.1 Workers' Compensation

Victoria supports the proposal to include workers' compensation premium duties as Insurance tax revenue, but exclude them from the revenue base given it does not pass the proposed disability materiality threshold and is simpler.

### 9.2 Fire and Emergency Services Levies

In the *2010 Methodology Review* the Commission excluded fire and emergency services levies collected by insurance companies from the assessment of insurance taxes as these levies are more in the nature of a user charge than a transactions tax. In the Draft Report the Commission states that it considers these levies to be similar to an insurance tax.

Victoria notes that there was no mention in Staff Discussion Paper *Proposed Assessments* to change the method of assessing fire and emergency services levies. As noted in response to the Land tax assessment (Section 7), Victoria considers that these levies are a user charge and should continue be assessed in the Other revenue category.

## 10. Motor Taxes

Staff Discussion Paper *Proposed Assessments* proposed the continuation of the Motor taxes assessment methodology from the *2010 Methodology Review*. The Draft Report proposes two changes to the assessment methodology:

- stamp duty on transfer of registration to be assessed in the Stamp duty on conveyances category; and
- fire and emergency services levies previously assessed in the Other revenue category to be assessed in this category.

As noted previously, Victoria considers the change in category for the assessment of stamp duty on transfer of registration to be cosmetic.

The *2010 Methodology Review* considered fire and emergency services levies to be a user charge and assessed as such. As stated above, Victoria considers that these levies are a user charge and should continue be assessed in the Other revenue category.

# 11. Mining Revenue

## 11.1 Category Inclusions

Victoria continues to support the mining revenue assessment in its current form. However, given that the terms of reference required the development of a new mining revenue assessment, Victoria supports the mineral by mineral assessment proposed by the Commission. Victoria also supports the Commission's decision to not apply a discount to the Mining revenue assessment. The proposed assessment will continue to fully assess each state's capacity to raise mining revenue. As noted in the Draft Report, the Commission's objective is to achieve HFE and primacy should be given to achieving that objective with supporting principles such as policy neutrality being second order.

## 11.2 Iron Ore Fines

Victoria does not support the proposal to phase in the introduction of the impact of higher royalty rates for iron ore fines. Victoria notes that unlike the terms of reference for the *2011 Update* and subsequent Updates, the terms of reference for the *2015 Methodology Review* are silent in regard to the treatment of iron ore fines. Accordingly there is no obligation on the Commission to phase in the assessment of royalty revenue of iron ore fines in recognition of its previous assessment methodology.

The impact of the adjustment from the current assessment methodology to the proposed methodology should not be of concern to the Commission, especially as the current treatment has been imposed by Update terms of reference. Western Australia has had the benefit of receiving higher GST shares over the past four years than that warranted by its revenue raising capacity.

The contemporaneity supporting principle states that 'equalisation should reflect State circumstances in the year the funds are used.' In 2015–16, the application year for the *2015 Methodology Review*, the Western Australia's royalty rate for iron ore fines will be the same as that for lump iron ore. In this situation it is appropriate to apply the proposed methodology without any phasing in.

The proposed mineral by mineral assessment will result in the average royalty rates being applied to the various minerals separately being different to those applied in the previous Updates using the two royalty rates assessment. The Commission has appropriately not proposed a phasing in treatment for those minerals.

The Commission has applied the phasing in of a methodology change only in rare situations where the change has been significant and affected all states and territories, such as the assessment of superannuation liabilities when the move to accrual-based accounting was made. The situation regarding iron ore fines is nowhere as significant and the use of phasing in would set a precedent that would not be in accordance to the principle of HFE.

## 12. Other Revenue

Victoria supports the proposal to continue the method adopted in the *2010 Methodology Review* and maintain a residual Revenue category that is assessed EPC for revenue where a reliable or material assessment can not be developed.

Victoria considers that fire and emergency levies should be continued to be assessed in this category.

## 13. Schools Education

### 13.1 Enrolments

Victoria supports the proposed use of actual enrolments for all year levels as basis of the school education assessment. This approach most simply and accurately captures the costs faced by states and territories.

### 13.2 State funding of non-government school students

Victoria supports the proposed changes to the assessment of non-government student costs. The use of Australian Curriculum and Reporting Authority (ACARA) data to derive separate cost loadings for non-government students is much more closely in line with 'what states do' than the Commission's previous approach.

### 13.3 'No Unwinding' of NERA loadings

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. Victoria does however have some concerns with the way in which this approach has been implemented.

With respect to the assessment of wage costs, the Commission notes that 'these differences are not captured in the SRS amounts and we consider their assessment to complement, but not unwind, the measures of educational disadvantage.'

Victoria considers that in designing the NERA, it would have been possible for the Commonwealth to vary the SRS amounts paid to individual jurisdictions based on an assessment of their underlying labour costs. The Commonwealth chose not to adopt such an approach.

By applying the interstate wages disability to this component of the assessment, the Commission would effectively be significantly reducing the loadings for disadvantage paid to states like Tasmania. This would to a large extent unwind the intent of the NERA, which was to provide this funding in full to Tasmanian students. Such an approach would clearly contravene the relevant direction in the terms of reference.

The Commission is effectively drawing an artificial distinction between 'unwinding' based on a conflicting assessment of a factor covered in the NERA loadings, and 'unwinding' based on a factor outside of the NERA loadings. In either case, the effect is the same - to second-guess the NERA allocation of funding for disadvantage and partially negate the impact of the NERA loadings.

Victoria considers that in order to comply with the terms of reference, the Commission must not unwind the NERA loadings through the application of distortionary adjustments.

### 13.4 Socio-Demographic Composition

Victoria notes the changes made to the econometric modelling used to estimate differences in spending on students with different characteristics using ACARA data.

It is noted in the Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* that whether the high costs for remote Indigenous students are allocated to Indigeneity or remoteness is sensitive to the exact specification of the model. One way in which this issue could be resolved is to have Indigeneity and remoteness interaction terms. Further input from the consultant could be worthwhile.

Victoria noted in its second submission that there appeared to be significant cost differences between primary and secondary schools. The Commission should investigate alternative specifications of the model such as separate regression models for primary and secondary students or the inclusion of a secondary school dummy. Data from ABS *Schools, Australia* (Cat. No. 4221.0) indicate that the split between primary and secondary students varies between the states and territories. The Commission should examine whether allowing for differences in costs between primary and secondary students makes a material difference to the schools education assessment.

### 13.5 Influences not Assessed

The Draft Report states that the Commission is ‘...not convinced adding an LBOTE indicator would lead to a better equalisation outcome so the variable was excluded’. Victoria is concerned that the Commission has made an apparently arbitrary decision and has not provided any supporting evidence that not including this indicator would result in a material difference.

It is noted that the consultant engaged by the Commission did not recommend the inclusion of a LBOTE indicator as these students are a heterogeneous group and their composition varies from school to school. It was considered that their impacts on school funding would vary from school to school. However, it is student funding rather than school funding that is being modelled so this concern may not be relevant. It would be better to include this variable in the model and use statistical tests to determine its validity. Victoria still has concerns regarding misspecification bias in the estimated parameters.

## 14. Post-Secondary Education

### 14.1 Separate Assessment of VET expenses

Victoria supports the proposed changes to the assessment of post-secondary education, including the transfer of vocational education and training (VET) expenses from the Services to industry category. When the Commission is in a position to do so, Victoria would appreciate further information on the derivation of the cost weights for remoteness and Indigeneity.

The shift by state governments towards demand driven approaches to VET funding, means that post-secondary education is increasingly funded on a flat, per-course basis, with no allowance made for the location or socio-economic status of students accessing training places. Accordingly, Victoria expects the changing nature of VET funding will be reflected in any new cost weights.

To maintain the contemporaneity of the assessment over the review period, cost weights should be updated on a yearly basis, on the basis of state service delivery data.

### 14.2 Socio-Demographic Composition

Victoria would have preferred that the Commission examine all the sub-groups identified in the National Centre for Vocational Education Research (NCVER) data to determine those that had a material impact rather than choosing a restricted number of sub-groups.

Victoria, however, agrees with the Commission that disaggregating remote areas by socio-economic status does not appear to be necessary based on observable use patterns.

### 14.3 Registered Training Organisations

Victoria supports the proposed treatment of private provision of services by registered training organisations (RTOs). This is clearly not a disability, but reflects the policy choice of state governments. Rates of RTO use have moved significantly in recent years as policy positions have changed. Victoria agrees with the Commission's assessment that the relative incidence of private provision of post-secondary education by RTOs is largely driven by the choices of state and territory governments as to the best way in which to deliver these services.

### 14.4 User Charges

The current treatment of user charges is to assess them on an EPC basis in the Other revenue category. It is proposed in the Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* to deduct user charges from expenses and differentially assess the net expenses.

Victoria accepts the arguments made for this approach and supports this proposed change. However, the Commission should obtain the user charges data directly from the states and territories in their data returns rather than from NCVER data.

## 15. Health

### 15.1 What is Included in the Health Category?

In the Staff Discussion Paper *Proposed Assessments* it was proposed to restructure the Admitted patients and the Community and other health categories into a Public Hospitals and Community health categories. The Commission now proposes a single Health category.

Although on the surface this may appear to be a simplification of expense categories there has been no change in the number of sub-categories that are separately assessed. As a result, Victoria is indifferent between the proposals in the Draft Report and the Staff Discussion Paper *Proposed Assessments*.

Victoria has some concerns with the robustness of the Emergency Department National Weighted Activity Unit (NWAU) data proposed for use by the Commission, but given the Commission proposed methodology, Victoria is broadly supportive of this approach. Victoria is also supportive of limiting disaggregation by age only to that level currently proposed by the Commission in the Draft Report.

### 15.2 Admitted Patients

#### 15.2.1 Socio-demographic composition

Victoria notes that the Commission devotes some discussion to the impact of CALD status and the varying impact birthplace can have on cost and usage. However, the Commission's discussion of socio-demographic composition is stated to be in the context of cost drivers only. The Commission needs to clarify the nature of the drivers it is considering in this section.

### 15.3 Emergency Departments

#### 15.3.1 Impact of the non-state sector

Victoria does not support the placeholder rate of 40 per cent substitutability between GPs and emergency departments. Critically, the Commission appears to have arrived at this rate by a misreading of the relevant ABS data.

Victoria agrees with the Commission's assessment that the ABS's *Patient Experiences in Australia* survey provides the best measure of substitutability between GPs and emergency departments. This is because a patient's appraisal of the seriousness of his or her condition is the relevant factor in determining whether he or she attends an emergency department or a GP.

However, the Commission appears to have made errors in its reproduction and interpretation of the ABS survey data. The Draft Report notes:

*'the ABS Patient Experiences in Australia study found that 23% of people that presented at the ED thought care could have been provided by a GP. In addition to this, another 15% who thought that the care could not be provided by a GP cited the time or day as the main reason for not seeing a GP.'*

The figures the Commission appears to have summed to arrive at a substitutability rate of 38 per cent are not additive. The Commission also appears to have misreported the proportion

of survey respondents citing time of day as the reason for attending an ED—the actual figure is 25.5 per cent. For clarity, Table 15.1 reproduces the headline survey results in full:

**Table 15.1: Experiences of those attending emergency departments**

Patients thinking of care provider	Proportion of patients
Thought care <b>could</b> have been provided by general practitioner for most recent visit to emergency department	22.6 per cent
Thought care <b>could not</b> have been provided by general practitioner for most recent visit to emergency department	74.8 per cent

Source: ABS, *Patient Experiences in Australia: Summary of Findings, 2012–13*, Cat No. 4839.0, Table 17.2

The ABS data indicate that around 75 per cent of patients presenting to an emergency department believed that the required care could not have been provided by a GP. This means that the number of bulkbilling GPs in a particular state will have no impact on 75 per cent of emergency department presentations. The ABS data suggest that 22.6 per cent of total presentations may be affected by the level of GP provision in a particular state or territory.

However, 22.6 per cent is the maximum rate of substitutability that would be appropriate—there is significant evidence to demonstrate that the actual rate of substitution is significantly less than this. The ABS survey data provide detailed information on the reasons why patients presenting at emergency departments did not attend GPs as presented in Table 15.2:

**Table 15.2: Main reason went to emergency department instead of general practitioner on most recent occasion**

Main reason	Per cent
Condition was serious / life threatening	49.6
Time of day / day of week	25.5
Sent to emergency by GP	6.7
GP does not have required equipment / facilities	6.1
Waiting time for GP appointment too long	2.5
Other	9.7

Source: ABS, *Patient Experiences in Australia: Summary of Findings, 2012–13*, Cat No. 4839.0, Table 17.2

Just under half of all emergency department presentations did not attend a GP because of the presumed severity of their condition, while a further 12.8 per cent of patients were either directed to attend an emergency department by their GP, or believed their GP lacked the required facilities or equipment to provide care.

Patients do not spend several hours waiting to be seen at a hospital emergency department if it can be avoided. As indicated in the survey data, around a quarter of patients presented at an emergency department because a GP was unavailable. However, the reason for this unavailability is important.

The Commission assumes that the relative number of bulkbilling doctors in a state reduces the pressures on emergency departments and, accordingly, state budgets. This presumes that as the number of GPs in a state declines, the number of emergency department presentations rises as it becomes more difficult to obtain a GP appointment. However, just 2.5 per cent of patients appear to attend emergency departments because the waiting time for a GP is too long. Conversely, 25.5 per cent of patients attended an emergency department instead of a GP because of the time of day, or day of the week. This suggests

that almost all patients presenting at emergency departments who could have gone to a GP do so because their local GP is closed—either because it is the weekend, or after business hours. The level of bulk billed GP throughput in a state provides little information about whether or not GPs are open very late at night. There is no reason to believe that additional GPs will in any way affect demand for hospital services among those who require care outside of regular GP hours.

The best available data suggests that the rate of substitutability between GPs and emergency departments is not 40 per cent, but around 2.5 per cent. As an upper limit, the evidence does not support a rate of substitutability any higher than 22.6 per cent. Victoria considers a substitutability rate of 2.5 per cent would best reflect the true effect of non-state service provision on state fiscal capacity.

### **15.3.2 Economic environment factor**

Victoria broadly supports the Commission’s approach to deriving an economic environment factor emergency departments, outpatients and community health. However, Victoria notes that the Commission would have preferred to standardise the socio-demographic composition (SDC) assessment for age and SES, but could not due to lack of data. Accordingly, there cannot be full confidence in the SDC assessment and the minimum discount should be applied.

Victoria is also unsure as to why the outpatients factor is the highest for the ACT. The Commission might investigate whether cross-border usage is being captured in the data.

## **15.4 Outpatients**

### **15.4.1 Impact of the non-state sector**

Victoria agrees that the level of substitutability is likely to be below 50 per cent, in line with the proportion of outpatient visits without a previous admission. However, it is not reasonable for the Commission to assert that ‘in the absence of information on the similarity between the cost and availability of individual services, we have assumed most are substitutable’. Without evidence of substitutability, it is not appropriate to simply assume this to be the case. Indeed, there is good reason to doubt the substitutability of state and non-state outpatient services, because many private outpatient services are unlikely to be bulkbilled.

Without good data to support an assumption of substitutability, the Commission should take a conservative view of the likely rate of substitution, in light of the issues around cost and availability of non-state services. While acknowledging the difficulty facing the Commission in this area, a rate of substitutability of around 25 per cent would appear to be more appropriate.

## **15.5 Non-hospital Patient Transport**

Victoria supports the Commission’s proposed approach to the assessment of non-hospital patient transport costs, including the proposal to fix relevant cost weights for the duration of the review period.

## **15.6 Community Health**

Victoria supports the Commission’s proposed approach to the assessment of community health services. In particular, use of emergency department triage category 4 and 5 appears to be a reasonable proxy for community health services, given the incomplete nature of other data in the sector.

The Commission's proposal to apply a 25 per cent discount to this category is appropriate in light of the uncertainty surrounding the application of emergency department NWAU data to the community health setting.

### **15.6.1 Impact of non-state sector on community health**

Victoria notes the Commission's proposal to use 75 per cent as a reasonable estimate of the substitutability of community health services. While determining an appropriate factor is difficult in the absence of relevant data, Victoria considers that a broader view should be taken as to the substitutability of community health services. While many individual elements of community state funded health services might also be performed by GPs or the private sector, there is a reason that state governments are involved in this sector.

Rather than duplicating services available elsewhere, community health services are designed and funded to provide these services in a coordinated, comprehensive way to maximise patient outcomes, particularly with regard to patients with chronic conditions. It is therefore unlikely that increases in GP provision of family planning, well-baby and drug rehabilitation services will lead to a significant reduction in the need for deliberate, coordinated delivery of these services through state community health organisations.

Given the rationale for government involvement in this sector and the absence of reliable data, Victoria considers that the Commission should err on the side of caution and apply a more conservative rate of substitutability. A substitutability rate of 50 per cent is suggested as a more reasonable estimate.

### **15.6.2 Grants for indigenous community health organisations**

Victoria is supportive of the proposed approach for assessing the substitutability of Indigenous and Rural Health Division grants.

## **15.7 Impact of the Non-State Sector on Admitted Patients**

Victoria supports the Commission's proposal not to separately assess substitutability between public and private hospitals. The relevant data on separation rates clearly indicate that there is no obvious relationship public and private hospital patient days, with an  $R^2$  value of just 0.21.

Victoria also supports the Commission's decision to discontinue the adjustment for private provision in Darwin. With the move to the ABS standard of remoteness classification, Victoria agrees that this adjustment is no longer necessary.

## 16. Welfare

### 16.1 What is Included in the Welfare Category?

The new Welfare category is derived from the welfare part of the current Welfare and housing category. Apart from the use of different data sources, the main changes to the current methodology are incorporating the transfer of aged care services to the Commonwealth (except for Western Australia) and the introduction of the National Disability Insurance Scheme (NDIS). Concessions that are currently included in the Services to communities category are proposed to be included in the Welfare category.

### 16.2 Aged Care Services

Victoria accepts the proposed treatment of Western Australia's expenditure on aged care services. This means that Western Australia will be neither advantaged or disadvantaged relative to other states and territories by its decision to not transfer these services to the Commonwealth.

Victoria notes that the Commission has appeared to have foregone the opportunity to apply its new measure of average state policy. As Western Australia provides aged care services then this would be average state policy. A differential assessment should be undertaken to examine whether it produces a materially different outcome to the proposed assessment.

### 16.3 Disability Services

Victoria has no further comments to make in this area.

### 16.4 General Welfare

Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* notes that the ABS's Socio-Economic Index for Individuals (SEIFI), which was to form the basis of the SDC factor, will not be updated for the 2011 Census. A number of alternative indicators have been suggested with the proportion of one parent families with dependants being the preferred indicator.

Victoria is concerned that the proposed indicator is too narrowly based and will not capture all the demand drivers for general welfare services. It is claimed in the Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* that the index of Indigenous Relative Socio-Economic Outcomes (IRSEO) nor the Non-Indigenous Socio-Economic Index for Areas (NISEIFA) area is not considered to be a good indicator as it is not a good measure of general relative disadvantage. However, differences in state and territory shares of populations in the more disadvantaged areas as measured by IRSEO/NISEIFA would provide an alternative indicator of relative needs for general welfare services.

Regardless of the indicator chosen by the Commission, it is unlikely to provide a complete measure and accordingly at least the minimum discount should be applied to the SDC factor.

The Commission states that it recognises differences in wage costs between the states and territories on the cost of providing concessions and other general welfare services. Victoria does not consider that there are any location aspects associated with the provision of concessions and, therefore, there should be no application of a location factor to concessions.

## 16.5 Influences Not Assessed

Victoria notes that an allowance for refugees has not been made due mainly to data issues. Victoria considers that the Commission should keep the issue of refugees under review, together with CALD populations.

## 17. Housing

### 17.1 What is Included in the Housing Category?

The new Housing category is derived from the housing part of the current Welfare and housing category. Victoria supported this split when proposed in the Staff Discussion Paper *Proposed Assessments* and has not changed its view.

### 17.2 Service Expenses

Victoria considers that the case for variations in maintenance costs between demographic groups needs to be demonstrated. If policies are applied consistently across demographic groups then it would be expected that maintenance costs would be driven more by physical factors, such as the age of the housing stock. The Commission should be convinced that there are no policy influences driving the cost weights for demographic groups.

### 17.3 Revenue

Victoria does not consider it appropriate to assess revenue in this category. Revenue should be assessed in a revenue category and not an expense category. Revenue from user charges, where they have not been netted off, has been included in the Other revenue category. There does not appear to be any compelling reason for housing user charges not to be assessed as other revenue.

However, Victoria supports the assessment methodology proposed for revenue.

### 17.4 First Home Buyers

In Victoria's second submission, it suggested that the Commission examine ABS data on housing finance to determine the number of first home buyers. Victoria appreciates the Commission exploring this data source. Victoria accepts that an EPC assessment is the most appropriate option.

### 17.5 Treatment of the Remote Indigenous Housing NP

The Commission sought state and territory views on the period that should be covered by the 'no impact' treatment.

Victoria considers that the impact years should be determined by reference to the 2013–14 Indigenous community housing organisation (ICHO) share of permanent dwellings. Data from the *Report on Government Services 2014* indicate that the ICHO share of permanent dwellings is similar for all the assessment years applicable to the *2015 Methodology Review* and so there should not be any 'no impact' treatment.

## 18. Services to Communities

### 18.1 What is Included in the Services to Communities Category?

Some of the concessions currently assessed in this category are proposed to be assessed in the new Welfare category. Victoria supported this transfer when proposed in the Staff Discussion Paper *Proposed Assessments* and has not changed its view.

### 18.2 Utilities Subsidies

Victoria notes that the proposed assessment of utility subsidies corresponds to that outlined in the Staff Discussion Paper *Proposed Assessments*. Victoria supports this assessment.

### 18.3 Influences Not Assessed

Victoria supports the Commission not assessing mining related expenses due to the lack of supporting data.

## 19. Justice

### 19.1 Police

Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes to derive Indigenous use rates for police by adjusting the Australian Institute of Criminology (AIC) 2007 age and gender profile to match the offender rates from State provided data for 2010–11 to 2012–13. Victoria recognises the data deficiencies in this area and accepts that the proposed approach is preferable to using the AIC 2007 offender rates.

It is also proposed to form SES groupings based on the two most disadvantaged quintiles, the middle quintile and the two least disadvantaged quintiles. This grouping is representative of the data and is supported by Victoria. The use of separate SES use rates for police and courts is also supported. While it is reasonable to fix the groupings until the next Review, the weights should be updated as new data become available.

Victoria supports continuing the discount of the specialised police SDC factor.

### 19.2 Courts

The Commission intends to apply the police regional cost weights to the courts assessment. Victoria considers that the regional cost weight should be subject to at least the minimum discount. Courts are not provided in all areas in which police services are provided so there is the likelihood that that the police regional cost weights will be an overstatement. While many smaller towns may have a dedicated police presence, it is likely that courts will be found in relatively larger centres. Such a discount is appropriate as the Commission cannot be fully confident about the size of the effect.

Victoria supports the proposal in Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* to derive Indigenous use rates for courts based upon State provided data for 2010–11 to 2012–13 on defendants. However, as the data can only be obtained from four states the derived SDC factor should be subject to at least the minimum discount as the Commission cannot be fully confident that the use rates are completely representative.

It is also proposed to hold constant the Indigenous use rates until the next Review. If data are available from states on an annual basis then these should be used to update the rates.

### 19.3 Prisons

In the Draft Report, the Commission proposes to apply the police regional cost weights to the prisons assessment. Victoria considers that the regional cost weight should be subject to at least the minimum discount. Prisons are not provided in all areas in which police services are provided so there is the likelihood that that the police regional cost weights will be an overstatement. These should be subject to at least the minimum discount as the Commission cannot be fully confident about the size of the effect.

Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes to apply the courts SES use rates in prisons. While it might be the case that court defendants have a similar SES profile to prisoners, the SES factor should be subject to at least the minimum discount as the Commission cannot be fully confident that the courts use rates are completely representative of prison use rates.

## 19.4 Remote Specialised Policing

Victoria notes that the Commission has not given consideration to Victoria's proposal to cease assessing remote and very remote location costs for specialised policing. The Commission notes that specialised policing is largely conducted from regional centres, with officers relocating to more remote areas only as needed in the conduct of cases.

The derivation of regional cost gradients includes factors such as increased wages and employee housing. However, while police officers may be required to travel to remote areas in the course of their investigations, much of the costs purportedly captured in the regional cost gradient are specific to the location where the service is based. Accordingly, there is a strong case for ceasing to apply the remote and very remote elements of the location disability to the specialised police component.

## 19.5 Influences Not Assessed in this Category

The Commission has decided not to assess the costs involved with public transport policing. Victoria draws the Commission's attention to its new proposed approach to deciding what states do: 'If even one State does something (raises a revenue or provides a service), that is part of what States do collectively and the materiality of its impact on State fiscal capacities will be tested'.

If the Commission is to adapt its proposed treatment of 'what states do' then it should test the materiality of assessing public transport policing. Its argument that '...other States' operations are on a significantly smaller scale' is not a valid reason for not doing that.

Victoria understands that other states with large urban transport networks also incur significant policing expenses in ensuring that these networks are safe. These costs are discrete, identifiable, and are a direct consequence of the need to operate large urban transit networks. They should properly be considered as part of the Commission's assessment of justice services.

## 20. Roads

### 20.1 Mining Related Expenditure

Victoria maintains its position that roads servicing towns with significant mining activity should not be singled out for unique treatment. Mining is like many other industries which result in states and territories incurring road maintenance costs. Other economic activities can impact on road maintenance, for example the tourism and agricultural industries (in Victoria's case an example would be the tourism related maintenance of the Great Ocean Road and the Great Alpine Road). The costs associated with the maintenance of roads for specific industries should not be recognised in the Roads category.

The Commission notes that Queensland and Western Australia have provided information that would enable the Commission to develop an adjustment to the Roads category assessment. Victoria understands that these data have not yet been analysed by the Commission. Any analysis needs to investigate the extent to which the private sector meets the need for roads to mining towns. The Commission also needs to establish that any expenditure associated with mining related roads is materially different to expenditure incurred on other industries.

### 20.2 Other Services

These expenses relate to expenses such as corporate services, driver licencing and vehicle registration. The Commission has decided to assess these expenses on an EPC basis as they are not correlated with road length. However, data on vehicle registration are available and are used for the Motor taxes assessment. State and territory authorities should be able to provide data on the number of licences issued.

The availability of such data means that the Commission should be able to differentially assess these expenses and determine whether such an assessment would be material.

### 20.3 Other Issues

Victoria supports the Commission's proposals to use ABS Urban Centre and Localities to distinguish between areas served by urban and rural roads, and not to apply a physical environment factor to the assessment.

## 21. Transport

### 21.1 Scope and Structure of the Assessment

Victoria supports the Commission's proposal to assess the consolidated operating expense of the general government and PNFC sectors.

Victoria, however, maintains its position that the assessment of urban transport expenses should be undertaken as a gross assessment as the drivers for expenses and revenue for public transport are quite distinct.

### 21.2 Urban Net Operating Subsidies

Victoria supports the proposal to maintain the simple model used put forward in the *2010 Methodology Review*. Victoria also supports the Commission's decision to update the regression model underpinning the urban net expenses assessment.

### 21.3 Non-Urban Subsidies

As noted in Victoria's second submission, Victoria does not consider that a change to the non-urban assessment is required and does not support the application of regional costs to the Transport assessment.

The Commission proposes to use a regional cost factor for the assessment of non-urban subsidies. Victoria does not consider that there is a conceptual case for the application of regional costs to non-urban transport. Unlike other industries that require a skilled workforce, such as nursing and teaching, the majority of tasks involved in delivering transport services can be sourced locally from less skilled labour. There is no need to attract staff to locate from capital cities.

The Commission needs to provide some analysis that the current assessment is not accurately reflecting differences between urban and non-urban subsidies. Until evidence is provided, there should be no change to the assessment.

## 22. Services to Industry

### 22.1 What is Included in the Services to Industry Category?

Victoria supports the transfer of VET expenses attributable to private training providers to the Post-secondary education category.

### 22.2 Regulatory Expenses

The Commission has found that a separate assessment for net mining regulation is not material, but has included a separate assessment ‘...on the assumption that in aggregate, mining related expenditure assessments across all categories may be material’.

Victoria is concerned that the Commission has adopted such an approach when:

- there is insufficient evidence to support the assumption made; and
- the Commission is applying a standard that is not applied to any other expenditure.

Victoria restates its position that a separate assessment for mining related expenditure in the Services to industry category should only be made if it is material. The Commission should be consistent in its application of materiality.

### 22.3 Discounting

In the Staff Discussion Paper *Proposed Assessments*, the Commission proposes to continue to use the *2010 Methodology Review* state survey data as the basis for determining expenses and disability weights and continue to apply a low level discount (12.5 per cent).

In the Draft Report, the Commission notes the concerns about the quality of the survey data used to calculate component and sub-component expenses remain. The Commission states however, ‘in keeping with the Commission’s decision not to discount estimates of total national expenditure, we have removed the discount. We consider the survey provides the best available data for disaggregating category expenses.’

The effect of this discount is to reduce the value of expenditure differentially assessed as business regulation and increase the value of expenditure assessed EPC as business development. Victoria considers that if there is uncertainty about the split of expenses between these two components then there should be more weighting given to the EPC assessment.

If the Commission does not wish to discount the expense weight then Victoria suggests that as an alternative, to allow for the uncertainty about the expense shares, to discount the economic environment factor for business regulation expenses. Victoria is concerned that the data to determine the expense shares are now five years older and perhaps even more unreliable.

## 23. Other Expenses

Many of the components of the Other expenses are covered in separate sections and Victoria has provided comments in the relevant sections.

## 24. Infrastructure Assessments

### 24.1 Investment

The Commission states 'A State which must provide a 10% above average quantity of services is also likely to need 10% above average infrastructure'. Victoria considers that this is an overly simplistic approach. Such a relationship is unlikely to be observed in a single assessment year or even over three assessment years.

A state's capital stock may have the capacity to absorb short-term growth before investment occurs. The investment that then occurs would be greater than what a single year measure would indicate.

The Commission needs to consider whether this assessment is achieving what the Commission intends it to and whether it is consistent with the contemporarily supporting principle.

### 24.2 Road Quantity of Stock Disabilities

Victoria considers that investment needs should not be assessed and does not support allowing for national needs. As discussed in section 5.5, the Commission has effectively imposed a national significance treatment through the 50 per cent discount given to payments for NNR construction.

Victoria argues that investment needs should not be assessed. However, if the Commission continues to assess investment needs then the 50 per cent discount applied to NNR construction should apply consistently to other types of projects.

The Commission notes that it '...found no relationship between State shares of NNR payments and any of the State based drivers of road investment...'. Victoria suggests that this finding could indicate that the drivers of road investment chosen by the Commission may not fully explain state and territory investment decisions.

### 24.3 Depreciation

The Commission notes that it adjusts assessed depreciation to '...allow for interstate differences in the cost of infrastructure'. Victoria is concerned that this approach may introduce an element of double counting as the depreciation charge is based on the value of assets. Differences in the cost of acquiring assets is recognised in the Investment assessment.

### 24.4 Urban Transport Quantity of Stock Disabilities

The Commission has applied a placeholder discount of 50 per cent to the relationship between assets per capita and city size due to concerns raised by states and territories until the consultant's report was received.

The consultant has endorsed the modelling approach of the Commission while noting the issues associated with the small sample size. Given the findings of the consultant Victoria regards a 50 per cent discount as being too high. If the Commission considers that a discount is warranted then it should be the minimum discount as this is the discount that the Commission has typically applied.

## 25. Wages Costs

### 25.1 Overview

Victoria is disappointed that the Commission declined to use the opportunity presented by the 2015 Methodology Review to address the critical problems with the interstate wages disability. The current interstate wages disability is the most speculative and fundamentally unsound element of the Commission's methodology. While the Commission recognises many of the serious issues with both the conceptual basis and measurement of this disability, it extraordinarily elects to leave both the assessment, and its associated discount, unchanged until after 2016. In Victoria's view, this is not acceptable. In light of the fact that many of the issues are known and thoroughly understood further deferring changes to this assessment cannot be reasonably justified. To do so would perpetuate the misallocation of well over a billion dollars of GST revenue every year.

Whatever the longer-term case for an assessment of underlying differences in interstate labour costs, this assessment has now become completely unmoored from its conceptual underpinnings. Victoria remains firmly of the view that until there are data to support the theoretical basis for this disability, it cannot credibly continue to be applied.

If the Commission determines that this assessment should be retained, there are changes that must be made now to address the most egregious elements of the interstate wages disability. At a minimum, this must include moving to a regression model based on capital city wages, rather than a whole of state measure. The difficulties with the interstate wages disability are however significantly deeper than this. To this end, this submission explores the most compelling explanations for the observed movements in underlying public and private sector wage levels, and provides options for significantly improving the current methodology. Were the assessment retained, Victoria's preferred approach is the adoption of a scaling adjustment to more accurately reflect the true relative wage pressures faced by state governments in delivering key services.

### 25.2 Conceptual Problem

The Commission's proposed approach is predicated on an assumption that state and territory governments face underlying private sector wage costs when delivering services. If a state's underlying private sector wages are five per cent higher than the national average, the Commission effectively assumes that the labour component of every government service in that state is five per cent more expensive than the national average.

In reality, state and territory governments are not forced to pay private sector wages, and do not set public sector wages at these levels. In response to concerns raised by several states, the Commission has argued that the significant divergence between underlying public and private sector wage levels is the result of policy choice. Commission staff have characterised the effect of underlying private sector wages as a 'pull' factor on public sector wages.

The conceptual validity of this approach only holds so long as there is a reasonably strong relationship between public and private sector wages. If the Commission is attempting to equalise for the pressure private sector wages exert on public sector wage policy, this pressure needs to actually exist. If the scope for state and territory governments to exercise policy choice over wage levels is so great that there is no longer any relationship between underlying public and private sector wage levels, then the pressure the

Commission is measuring cannot be said to manifest itself in any meaningful form. In reality, either it is not great enough to have any measurable impact on state wages policy, or it is average state policy to ignore it.

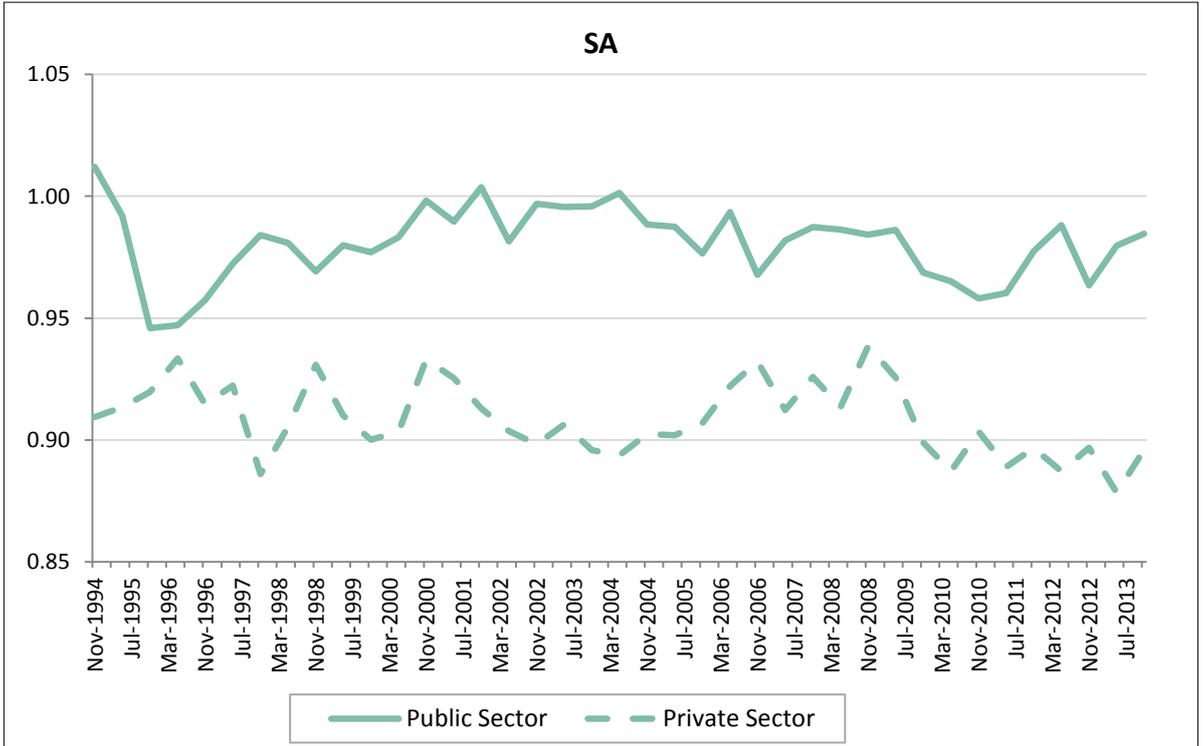
With respect to underlying public and private sector wages, the Commission notes that ‘...the relationship has declined in recent years’. This is perhaps an understatement. More accurately, as highlighted by Queensland in its second submission, there is no statistically significant relationship. Victoria remains firmly of the view that until there are data to support the theoretical basis for this disability, it cannot credibly continue to be applied.

However, even setting aside issues associated with the 2009 ABS *Survey of Education and Training* (SET), there remain deeper conceptual problems with the Commission’s approach. The Draft Report has usefully presented time-series ABS Average Weekly Earnings (AWE) and SET results for all states and territories, in an effort to demonstrate a longer term relationship between rates of public and private remuneration. While Victoria accepts that the relationship between underlying public and private sector wages has been stronger in previous years, this does not change the fact the relationship is now non-existent. However, even were the relationship between wage levels to have remained as strong as in previous years, the presentation of this longer-term data only serves to highlight a critical conceptual flaw in the Commission’s approach.

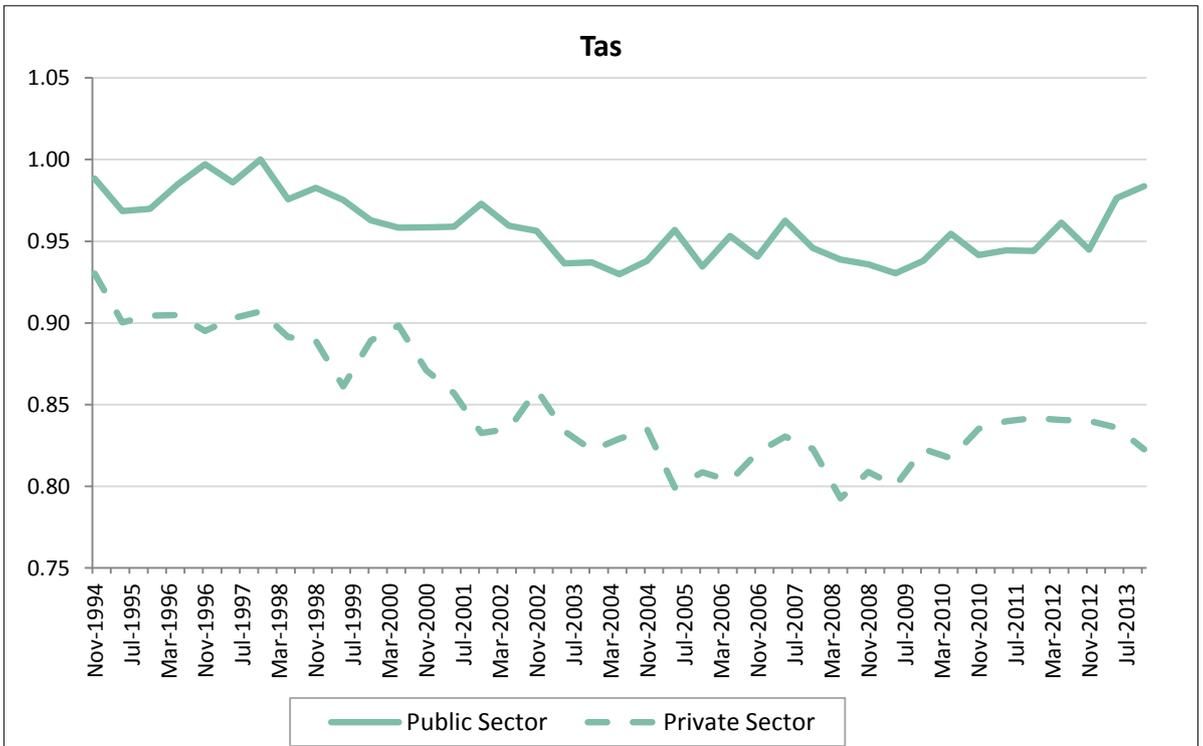
Were deviation from private sector wage levels simply a policy choice, it would be expected that the divergence would be relatively random. States would set wages subject to a number of competing policy considerations (including the need to attract and retain high-quality staff while managing expenditure growth), and the outcomes of individual enterprise bargaining negotiations, with the result that some states would pay more or less relative to underlying private sector remuneration.

However, that is not borne out by the data. The AWE and SET data clearly indicate that there is consistently far less interstate variation in public sector wages than in private sector wages. States with relatively low wages such as South Australia, Tasmania and Victoria consistently pay their public sector workers more than their private sector counterparts. Conversely, states with high underlying private sector wages like Western Australia consistently pay their employees less than comparable workers in the private sector.

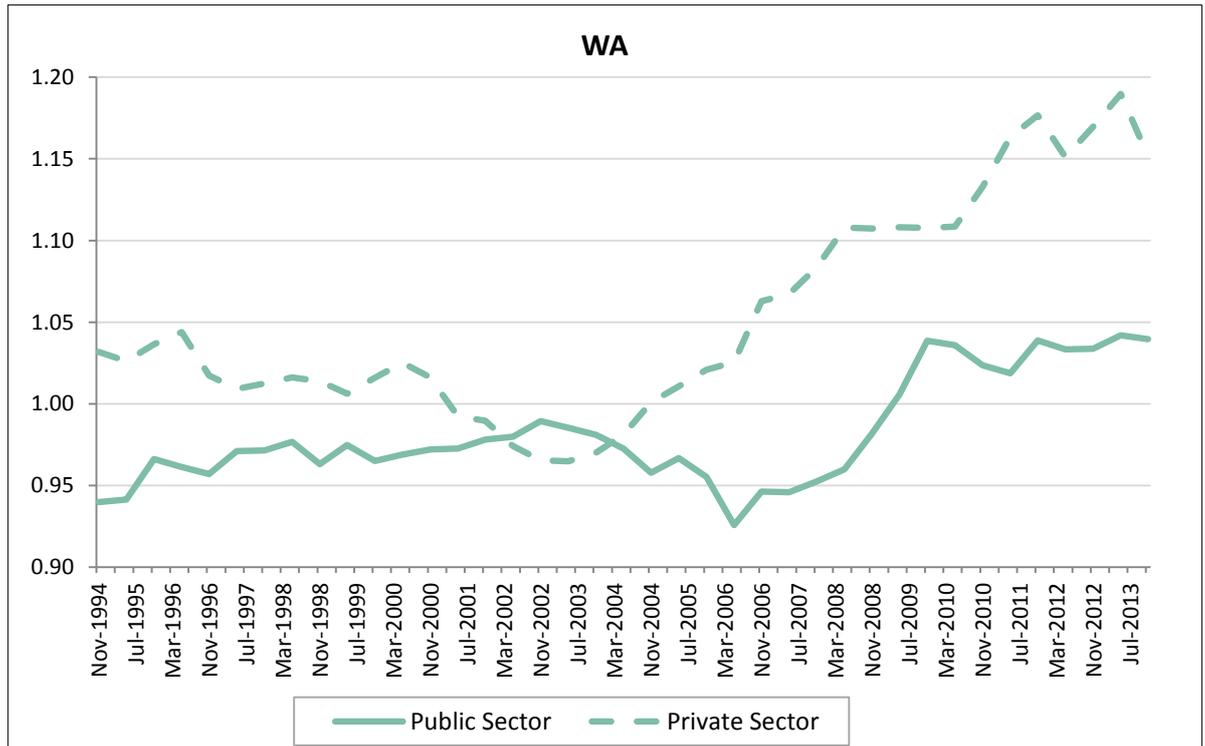
**Figure 25.1: Public and private sector average weekly earnings relative to national averages, selected states**



Source: Draft Report – Attachment 23 (p 420) : ABS, Average Weekly Earnings Australia, November 2013, Cat No. 6302.1.



Source: Draft Report – Attachment 23 (p 420): ABS, Average Weekly Earnings Australia, November 2013, Cat No. 6302.1.



Source: Draft Report– Attachment 23 (p 419): ABS, Average Weekly Earnings Australia, November 2013, Cat No. 6302.1.

For the Commission’s interpretation to be correct, it would have to be assumed that in exercising their policy discretion over a 20 year period, governments in South Australia and Tasmania were inherently profligate, while governments in high wage states like the Western Australia were by their nature innately prone to control their expenditure. Victoria considers such an interpretation does not conform with reality.

The much more compelling explanation for the observed data is that there are forces acting on public sector wage policy beyond state-specific private sector wage levels, which tend to cause differences in public sector wage levels to be significantly less than the levels assessed by the Commission. The result has been that the Commission’s methods have for many years systematically overstated the cost of delivering services in high wage states, and understated the cost of service delivery in low wage states.

The data strongly suggest that actual wage pressure faced by state and territory governments is significantly less than that assessed by the Commission. There are several good conceptual reasons to explain why this might be the case.

### 25.2.1 National labour market

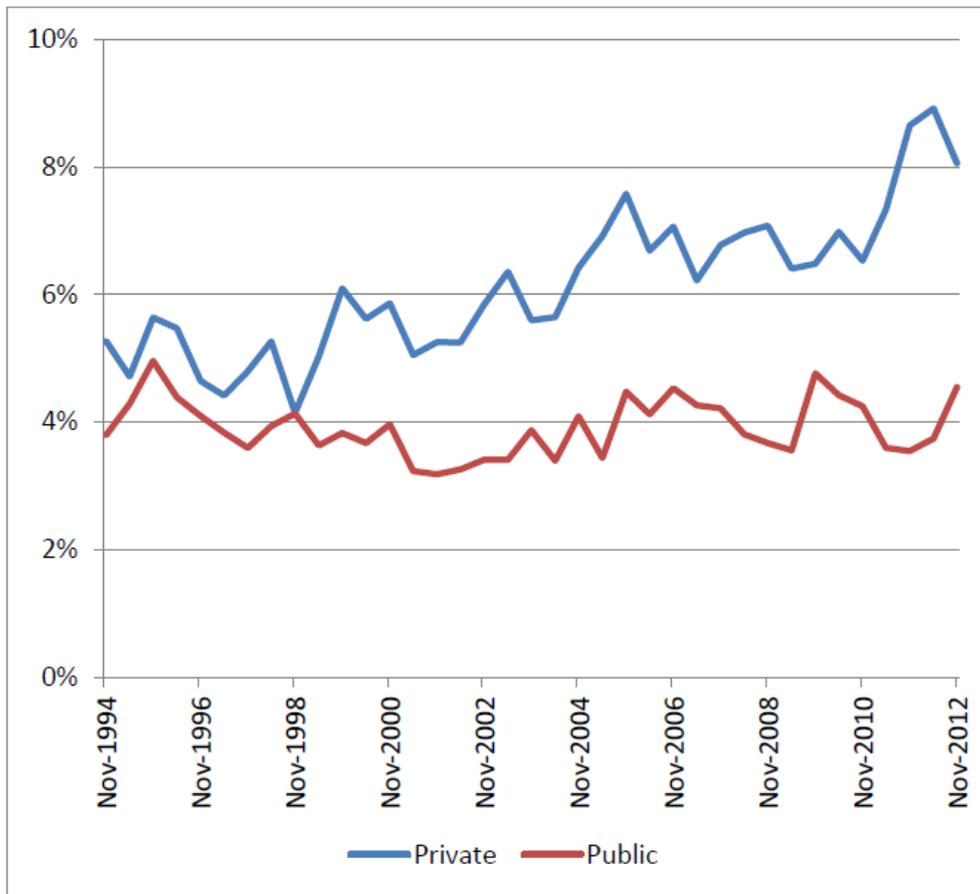
The Draft Report discusses issues surrounding a potential national market for public sector employees at some length. In the course of this discussion, the Commission observes that there has been a convergence in public sector wages in key professions. Victoria considers that the Commission has erred in its overall approach to this issue. The Commission has framed the existence of a national labour market as an either/or proposition. The Commission has argued that for a national labour market to exist, public sector wages for particular professions must be equal in all states. If this condition is not satisfied, the Commission has asserted that there is no national market for public sector workers.

However, it is also true to observe that underlying public sector wages are not equal to private sector wages within each state. This does not mean there is no state market for labour. Rather, particularly in the period prior to 2009, it is likely that both state private

sector wages, and public sector wages in other jurisdictions, both exert some pressure on public sector wage setting decisions. States have previously provided information on the key role played by relative interstate pay levels of teachers, nurses, police and paramedics in enterprise bargaining negotiations. There is significant evidence that how wages in these professions compare to the national public sector average is a key pressure faced by state and territory governments in setting wages.

If this explanation were correct, it would be expected that interstate differences in public sector wages to be systematically less than variance underlying private sector wages over a long period of time. This is precisely what is evident from the data presented by the Commission.

**Chart 25.2: Average variance in interstate wage levels from national sector average**



Source: ABS, *Average Weekly Earnings, Full Time Adult Total Earnings*, Cat. No. 6302.0.

As noted in Victoria’s first submission, interstate public sector wage variance has been relatively stable since 1994, while interstate private sector variance has increased significantly, while remaining consistently higher than public sector wage disparity. This has indefensibly led to an tenfold increase in the level of redistribution associated with this disability since its introduction in 1992–93, despite relative public sector wage levels remaining essentially unchanged.

A likely explanation for consistency of underlying public sector wage variance over time is the pressure exerted by interstate competition for public sector employees on state government wage setting decisions. The recent convergence in public sector wage levels in key vocations is consistent with a move to a national labour market, helping in part to explain the deterioration in the relationship between underlying public and private sector wages.

## 25.2.2 Other influences

The Commission notes that:

‘Conceptually, the optimum approach would be to measure wage differences of private sector employees with characteristics similar to public sector employees. 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.’

While the Commission is unable to adopt this approach due to issues around sample size and policy neutrality, this issue should be a relevant consideration when interpreting the conceptual validity of the interstate wages assessment.

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.

## 25.2.3 Relevance of a ‘lag’ in public sector wage setting decisions

Victoria does not accept that any reading of the data supports the inference of a lag between movements in public and private sector wage levels. Should the Commission choose, it could test whether there is a relationship between current underlying public sector wages and underlying private sector wages recorded in a previous SET collection. However, Victoria strongly doubts that this relationship would prove to be statistically significant.

More fundamentally, the Commission examined the SET results in an attempt to discern the actual costs faced by states for service provision *in the assessment year*. It would not be appropriate for the Commission to assess that Victoria faces labour costs six per cent below the national average in 2012-13 - and apply this to 2012-13 service delivery data – simply because it believes this may be the case in 2016-17. The Commission’s discussion of potential lag effects does not lend credibility to the continued use of the interstate wages disability.

## 25.3 Proposals for a More Conceptually Sound Assessment of Interstate Wages

To summarise the discussion above:

- conceptually, there is good reason to think that factors other than private sector wages exert pressure on public sector wages policy;
- this is borne out by data that show variance in underlying public sector wages has been significantly and consistently lower than variance in private sector wages; and
- the most reasonable inference to draw from this information is that the current approach overstates the true cost pressures faced by state and territory governments in setting wages.

At best, the current interstate wages assessment could be said to be characterised by considerable uncertainty as to the magnitude of the effect the Commission is trying to measure, but that the current approach is almost certainly significantly overstating the outcome. Faced with this information, Victoria considers that there are two courses of action open to the Commission:

- scale the interstate wages assessment by the relationship between average underlying public sector wage variance and average underlying private sector wage variance; or

- discount the interstate wages assessment by 50 per cent, approximating the scale of the uncertainty.

### 25.3.1 Scale the interstate wages assessment by the relationship between average underlying public sector wage variance and average underlying private sector wage variance

Under this approach, the Commission would scale the magnitude the wages disability as follows:

$$\begin{array}{rcccl}
 & & \text{Average} & & \\
 & & \text{variance in} & & \\
 & & \text{underlying} & & \\
 & & \text{public sector} & & \\
 \text{Relative} & & & & \text{Raw interstate} \\
 \text{private sector} & \times & \text{-----} & = & \text{wage cost factor} \\
 \text{wage levels} & & & & \text{(prior to} \\
 & & \text{Average} & & \text{adjustments and} \\
 & & \text{variance in} & & \text{discounting)} \\
 & & \text{underlying} & & \\
 & & \text{private sector} & & 
 \end{array}$$

This approach would be policy neutral, because the disability would be scaled by average variance in underlying public sector wages, not by a state’s actual relative underlying public sector wages. Importantly, this approach would provide a much more accurate estimate of the true variation in service delivery cost between states.

### 25.3.2 Discount the interstate wages assessment by 50 per cent, approximating the scale of the uncertainty.

In recent years, private sector wage variance has been double that of underlying public sector wages. A discount of 50 per cent would provide a rough approximation of the likely scale of overestimation caused by the Commission’s current methods.

## 25.4 Capital City or Whole of State

Victoria urges the Commission to reconsider its decision in the Draft Report to abandon the proposed move to a regression model based on capital city wage levels outlined in Staff Discussion Paper *Proposed Assessments*. This shift represented a significant improvement in the interstate wages model, by bringing the assessment much more closely in line with what states actually do. In Victoria’s view, the Commission had presented a compelling argument for why an assessment based on relative capital city wages was much more closely aligned to the actual considerations affecting enterprise bargaining negotiations, which in the first instance tend to be set on a whole of state basis, based on wages in each state’s capital city. The consultant who reviewed the wages regression did not indicate that it was inappropriate to have a regression model based on capital city wages or to use a dummy variable for regional wages.

Victoria is also concerned that the current approach may effectively lead to the double-counting of a significant portion of regional costs. This is because the effective wage loadings paid by both the public and private sector to attract labour to regional locations are already included in the average relative underlying public and private sector wage levels calculated by the Commission. While the private sector typically does not pay formal

'loadings' for remoteness, there exist equivalent private sector wage premiums to attract skilled labour to difficult-to-staff areas.

A wages regression based on whole of state wages effectively already allows states the fiscal capacity to pay increased regional wage costs, without the need for a further adjustment through the regional cost gradient. This is because the current methodology based on a whole-of-state average provides states like Western Australia less than the fiscal capacity required to pay private sector wages in regional areas, but much more than the fiscal capacity required to match private sector wage levels in Perth. The net effect is that Western Australia is already likely to be provided with the fiscal capacity to pay regional wage loadings, should it choose to do so.

However, the current methodology takes this base wage adjustment, which already includes the effects of regional wage costs, and then applies a further loading for regional wage levels on top. This is effectively counting regional costs twice – once in determining the average variance in wage levels, and again when the regional cost gradient is applied.

If this interpretation is correct, either the Commission should move to an assessment based on capital city wage levels, or discontinue the wages component of the regional cost gradient. Victoria's preference is for an assessment based on capital city wage levels, because this is much a closer reflection of what states do.

The Commission has previously examined the issue of the double-counting of regional wage loadings, and concluded that any double-counting is not likely to be material. Victoria believes that there are significant reasons to question this conclusion. Firstly, the Commission's analysis of this issue is quite dated. It is likely that the effect of the mining boom on wages in regional Queensland in particular has significantly changed the picture on regional wages since the Commission's paper on this topic was prepared.

The Commission has previously noted that there are differences in regional wage setting between the public and private sectors that are not evident in the capital cities. The Commission has also noted that the SET did not cover the more remote locations. This indicates that if movements in private sector wages are to be used to indicate the pressures on public sector wages then this should be based only on capital city wages. If it does turn out to be the case based on a more contemporaneous analysis that private sector wages in regional and remote areas behave differently to public sector wages, all this demonstrates is further justification for only using capital city wages. This is because such a result would point to a complete disconnect between regional pressures on private and public sector wages.

More fundamentally, the results of the Commission's analysis of private sector regional wages is also likely to be affected by declining to focus only on wages in professions comparable to public sector employees. This is because while private sector regional wage levels for unskilled workers may be lower in some regional areas than in capital cities, it is likely that highly skilled workers will still need to be paid a premium to relocate to regional and remote locations. Whether or not retail assistants in regional Queensland are paid less than retail assistants in Brisbane tells one little about whether the private sector needs to pay skilled workers more to relocate to Birdsville.

Accordingly, in addition to updating their analysis, the Commission could also usefully examine the effect of only focussing on the regional wages of skilled labour. Until this is done, Victoria is not confident that the Commission is able to satisfactorily rule-out double counting between the interstate wages disability and the regional cost gradient. This uncertainty lends further weight to the already strong conceptual case for moving to an interstate wages disability based on capital city wage levels.

In Victoria's view, the Commission has not satisfactorily explained why they have elected not to pursue a move to a regression model based on capital city wage levels. The release of an expanded COE dataset by 2016 is not sufficient justification for delay. The reasons for or against using capital city wages rather than whole of state wages are not directly related to whether or not the SET or another measure is used as the basis for the regression analysis. If the Commission is of the view that use of capital city wages is more conceptually appropriate, then a potential change in the underlying data source is no reason to delay making that change now.

Importantly, in 2014-15 the interstate wages assessment will redistribute over a billion dollars, with a significant portion potentially tainted by concerns about regional costs and conceptual problems with a whole-of-state assessment. It is not tenable to postpone addressing a known issue with the methodology when doing so will in a single year lead to hundreds of millions of dollars of inappropriately redistributed GST revenue.

## 25.5 Applying the Proposals

Victoria's view remains that until the relationship between underlying public and private sector wage levels improves, the assessment of an interstate wages disability must be discontinued. However, were the Commission to retain this disability, the approaches outlined above would significantly improve upon the current approach.

Once the Commission decides on the most conceptually reasonable basis for conducting the assessment, the Commission must also determine an appropriate econometric model to inform the approach. Victoria accepts the Commission's view that there is no compelling case to simplify the regression model for its own sake, and supports retention of the 219 explanatory variables.

However, there remain two significant issues with the regression model that must be addressed if the interstate wages disability is to be retained.

### 25.5.1 Commonwealth Superannuation Scheme adjustment

Victoria does not support the Commission's proposal to continue to apply a the Commonwealth Superannuation Scheme (CSS) adjustment to the assessed wage cost factor of the two territories. Victoria considers that making meticulous, piecemeal adjustments to uncertain estimates derived from old data cannot be justified. The Commission should reconsider its approach to this issue.

### 25.5.2 Discounting

In justifying a proposal to apply only a minimal discount to the assessment of the interstate wages disability, the Commission noted that 'We share States' concern that the 2009 SET data are quite dated, but consider there is no better alternative.' The lack of an alternative does not make the 2009 SET data any less dated, nor their use more conceptually robust. Victoria considers that this is not a valid reason to refrain from applying a more appropriate discount.

In support of its proposed approach, the Commission also highlighted a perceived lack of evidence for why the relationship between public and private sector wages has deteriorated. Victoria considers that the reason for the decline is largely immaterial. From the 2009 SET onward, the data are clear—private sector wages have no impact on public sector wage setting decisions.

As noted in Victoria's previous submissions, the very large deviation in the territories' assessed wage levels from the national average is almost wholly within range of being statistically insignificant. The Commission cannot confidently say whether or not some

jurisdictions have above or below average underlying wage levels. It is difficult to imagine any other element of the Commission's methodology that is subject to greater uncertainty.

In these circumstances the Commission should apply the maximum discount for uncertainty, as there is significant doubt about the magnitude and nature of the effect the Commission is attempting to measure.

## 25.6 Conclusion

Victoria trusts that the Commission will consider Victoria's proposals to either discontinue the interstate wages assessment until better data become available, or to significantly improve its accuracy in measuring the impact of private sector wage levels on state wages expenses.

This issue is too important to leave unresolved until 2016, especially when it is far from clear in advance that the release of the expanded ABS Compensation of Employees (COE) survey will resolve these issues, or demonstrate any stronger relationship between public and private sector wage levels.

## 26. Regional Costs

### 26.1 Measuring Regional Costs

Victoria stated in its second submission that the evidence of regional costs for expenses other than schools education and police services was lacking. The Commission's response was 'we don't agree', but no supporting evidence has been provided in the Draft Report.

Victoria still considers that the nature of schools education is relatively unique. Schools are provided in more population centres than other government services (with perhaps the exception of police) and have a lower client to provider (student to teacher) ratio than health, housing or welfare services. In addition, the profile of school students which has an impact on school costs, will differ to the profile of clients of other services.

The Commission should explore other datasets that are more relevant to the expense category being assessed. For instance, the possibility of Independent Hospital Pricing Authority (IHPA) data being used for the Health category should be examined.

The Commission later asserts that 'we do not consider that removing or increasing the discount for Regional costs would result in better equalisation outcomes'. Victoria does not consider this to be a valid reason for not changing the discounts.

## 27. Service Delivery Scale

### 27.1 Measuring Service Delivery Scale

In the Staff Discussion Paper *Proposed Assessments* an urban centre of 5,000 or more was selected as the appropriate base as regression using this definition gave consistently higher  $R^2$  values. It is noted that the consultant considered the use of  $R^2$  values do determine the specification of urban centre size was not appropriate. However, there was no appropriate technique for determining urban centre size as it is a conceptual, rather than data, issue.

Given this, Victoria considers that on the basis of the analysis presented in the Staff Discussion Paper, the choice of an urban centre of 5,000 or more is an appropriate base for service delivery model (SDS) scale.

However, using the  $R^2$  value is not the appropriate test for selecting the distance from the urban centre. It appears that the advice of the consultant was not sought on this issue.

It is assumed that the regression model that the Commission employed is of the form

$$Y = \alpha X + \beta D$$

Where: Y is the dependent variable;  
X is a vector of explanatory variables other than distance;  
D is the distance from the urban centre; and  
 $\alpha$  and  $\beta$  are estimated parameters.

In the case of the distance being more than 10 kilometres this equation would be:

$$Y = \alpha X + \beta D_{+10}$$

However, as the distance being more than 10 kilometres includes being between 11 and 20 kilometres plus between 21 and 30 kilometres and so on this equation could be rewritten as (assuming 20 kilometre intervals):

$$Y = \alpha X + \beta_0 D_{11-20} + \beta_1 D_{21-40} + \beta_2 D_{41-60} + \beta_3 D_{61-80} + \beta_4 D_{81-100} + \beta_5 D_{+100}$$

This specification could enable a number of statistical tests to be conducted. If the appropriate distance is more than 20 kilometres, then parameter  $\beta_0$  would be statistically insignificantly different to zero while the remaining parameters would be statistically significant. In addition statistical tests could be conducted to determine if parameters have the same value.

This suggested approach would yield results that are statistically more robust than just examining  $R^2$  values. Victoria encourages the Commission to have its consultant review this suggestion if it requires an independent assessment.

Victoria is concerned that the cost difference attributed to SDS may be picking up some scale economy impacts independent of the location of schools. It may be better to compare the costs of comparable sized schools in both areas to obtain an indication of the true impact of being in a SDS area.

Victoria considers that more work needs to be done in regard to SDS and further engagement of a consultant may be warranted.

## 27.2 Application of Service Delivery Scale

The Commission proposes to apply SDS to the Welfare category despite there being no appropriate data to measure SDS for that category. Table 1 of the Draft Report (p 145) states that police SDS factors will be used for Welfare SDS, although the section on the Welfare assessment indicates that the schools education factors will be used. The Commission needs to remove this confusion.

Although there may be a conceptual case for SDS factors to be applied to the Welfare assessment, no evidence has been presented to demonstrate that it is appropriate to use either the police or schools education SDS factors. Victoria restates its position that in the lack of such evidence that at least the medium discount should be applied.

## 28. Administrative Scale

As indicated in the Staff Discussion Paper *Proposed Assessments*, the Commission will retain the existing quantum and index it using the State and local government final consumption expenditure (SLGFCE) deflator. Victoria previously supported this approach but argued that the maximum discount should be applied to recognise that the data on which the expenses are determined will be over 10 years old in 2015.

The Commission rejected applying a discount as it considered that discounting would not produce an outcome closer to achieving HFE. As noted earlier, Victoria considers that the decision in regard to discounting should be based solely on the criteria stated for discounting, namely confidence about the size on an effect or the level of uncertainty about information.

As there must be some uncertainty about the data due to its age it is appropriate that a discount be applied.

## 29. Indigeneity

### 29.1 Overview

Victoria would reiterate its concerns about the further weighting of the Commission's methods towards funding for Indigenous disadvantage. Victoria considers that this problem is best addressed outside the current model of equalisation. This said, Victoria is aware that the Commission must comply with the terms of reference, which have directed this Review to examine ways of better capturing the changing characteristics of the Indigenous population.

Within these constraints, Victoria supports the Commission's proposed use of IRSEO, in conjunction with a Non-Indigenous SEIFA, to best give effect to the direction contained in the terms of reference. Victoria considers that use of non-Indigenous SEIFA is a critical precondition to giving effect to the terms of reference without the inadvertent double-counting of indigenous disadvantage in the application of the Commission's methods.

### 29.2 Application to assessments

Victoria supports the proposed application of the new measures to the health assessment, including the proposed SES and remoteness classifications. Victoria also supports the Commission's proposed approach to applying IRSEO and NSEIFA to post-secondary education and family and child welfare.

## 30. Impact of Population Growth on Fiscal Capacities

Victoria appreciates the efforts of the Commission to examine the impact of population growth on the assessment of investment and net lending. The conclusion of the Commission is that there is no evidence available that would require the Commission to change its current methodology.

Victoria noted in its second submission that the direction of the impact of population growth was uncertain. The Commission's decision not to change its methodology is accepted. However, Victoria does not accept that the Commission's methodology for assessing investment needs is appropriate.

## 31. Other Disabilities

### 31.1 National Capital Allowances

Victoria is concerned that the Commission appears to uncritically accept that the Australian Capital Territory (ACT) 'has no practical alternative to use the Australian Federal Police (AFP) as the provider of policing services'. It is now some 25 years since the ACT gained self-government and it could be considered that the continued use of the AFP is a policy choice. The Northern Territory which has a smaller population but covers a much larger geographic area has its own police force. It would assist the ACT's case if evidence to support the continued use of the AFP was provided.

It is also claimed that the AFP pays above average salaries to its employees. Again it would be helpful to have this documented. Until the reasons for these above average salaries are established it is difficult to state that the ACT would pay lower salaries if it did have its own police force.

Victoria considers that more effort is required to establish the continued validity of the national capital allowance for police.

### 31.2 Cross Border

The Commission asserts that 'there is no evidence to suggest the net impact of other cross-border flows is material.' Victoria considers that if such an assertion is made then there should be some discussion of the evidence that would support it.

In the Staff Discussion Paper *Proposed Assessments*, the Commission stated that it did not intend to change the approach to this assessment due to the short timeframe for the *2015 Methodology Review*. It was on that ground that Victoria supported the proposal to not change the current approach to this assessment.

### 31.3 Cultural and Linguistic Diversity

The Commission has decided not make an assessment in relation to CALD due to the available data indicating that while CALD populations had higher costs than the general population they had lower use rates. It is stated that it is uncertain whether having a larger CALD population increases or decreases the cost of delivering state services. However, the conceptual case that higher costs are associated with CALD populations is accepted. Victoria notes that in some other assessments a disability is included on the strength of its conceptual case despite limited evidence.

In the *2010 Methodology Review* the Commission estimated that the Australian average expenses on CALD populations was \$15 per head in 2006–07 (the minimum amount required for materiality). As was the case with the administrative scale assessment if a more suitable quantum cannot be obtained then the Commission should continue to use this quantum, appropriately indexed. This expense should continue to be included in the Other expenses category.

Victoria appreciates that there are difficulties in quantify the impact of CALD populations on service expenses and will continue in its attempt to gather the required evidence.

## 32. Population Data Supporting the Assessments

Staff Discussion Paper *Update and Supplementary Issues for the 2015 Review* proposes to adjust disaggregated 30 June estimated residential population (ERPs) in proportion to match 31 December state and territory population totals. The change in population from June to December is the outcome of births, deaths, net interstate migration and overseas migration. It is unclear as to the impact this proposal will have on the population structure of each state and territory. It might be the case that the structure is unchanged resulting in no impact.

Victoria suggests that more consideration be given to this proposal and a closer examination as to whether it would achieve its intended objective.

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