



**Australian Government**  

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**Commonwealth Grants Commission**

## **2015 REVIEW**

# **SIGNIFICANT CHANGES SINCE THE DRAFT REPORT**

## **COMMISSION POSITION PAPER CGC 2014-04**

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## SUMMARY

At this stage of our review, and without reducing the scope for us to make changes depending on new State contributions or data, we intend to make the following significant changes to draft report assessment methods.

- Mining related expenditure. We intend to introduce assessments of expenditure related to the planning and regulation of investment projects and capital grants to local governments relating to community development and amenities and culture and recreation.
- In the Health assessment, we intend to standardise for SES and age in the calculation of the economic environment factors. Consultant reports on the impact of private provision on State services will be sent to States as soon as they are available.
- In the Other general welfare component, we intend to use the relative proportions of the population in the bottom SEIFI quintile, adjusted for changes in the level of social disadvantage in each State between the 2006 and 2011 Censuses. This is measured by the changes in the relative proportions of Health Care Card holders in each State.
- We intend to calculate a general regional cost gradient (calculated as the simple average of the revised schools and police gradients) for extrapolation to other categories where a regional costs disability is assessed. The gradient derived from ACARA data will continue to be used for Schools education and the police gradient for Justice.
- In the Transport infrastructure assessment, we intend to estimate assessed investment using a simple city population based model.
- We intend to assess national needs in relation to roads and rail infrastructure, based on the distribution of 50% of the Commonwealth payments made for on-network road and rail projects. The advice of the Department of Infrastructure and Regional Development will be sought to determine relevant projects. No other needs of national significance will be assessed, unless instructed by terms of reference, because the Commission is not able to develop a suitable framework for identifying such needs reliably.

During our consultations we have also been asked to consider a more contemporaneous assessment, in particular of mining royalty revenue. We include this issue in this paper to invite State views to inform our decision making.

## BACKGROUND

- 1 The terms of reference for the 2015 Review ask the Commission to consult further with States if we expect to make significant changes following consultation on the draft report. This position paper sets out the method changes on which we have made decisions and seeks State views on them by the end of December this year. The paper attempts to provide sufficient information for States to understand the change and the reason for it. It does not attempt to respond to all State arguments concerning the issue. This will be done in the final report.
- 2 The paper does not provide details of every change the Commission will be making to draft report assessments. In a number of areas, we have not yet completed our consideration of State views and the analyses required to make informed decisions. For example, the treatment of the Water for the Future payments required data from the States and we have not yet been able to analyse them and make a decision. We are also still considering Western Australia's arguments about whether the Mining Royalties assessment should be more contemporaneous and if and how the inclusion of iron ore fines with the rest of iron ore is to be phased in.
- 3 In addition, changes relating to new data for all three assessment years, method changes that are not material, or any changes on which State views are very clear and further consultation is not required, are not covered. For example, State views have been received on matters covered in the New and Supplementary Issues paper, such as in relation to Schools and Justice, but this paper does not cover those proposed changes where they have been adopted by the Commission.
- 4 States should also be aware the Commission intends, at a late stage in the review, to re-examine all assessments, including all discounts, to ensure they pass a reality test and are internally consistent. This is consistent with our assessment guidelines.

## ISSUES

- 5 The paper discusses proposed changes to the following assessments:
  - Mining revenue assessment – contemporaneity and phasing
  - Mining related expenditure
  - Health assessment
  - Welfare assessment
  - Regional cost gradients
  - Urban transport infrastructure assessment
  - Treatment of nationally significant infrastructure projects.

## MINING REVENUE ASSESSMENT

- 6 Western Australia has stated that with a major fall forecast for iron ore royalties, using average royalties for 2011-12 to 2013-14 as the basis of the 2015-16 GST distribution would be inappropriate. It suggests that a distribution based on prospective 2015-16 conditions would be preferable. Its position is set out at page 20 of Western Australia's September 2014 submission.<sup>1</sup> We have also received comments on this proposal from a number of other States.
- 7 We have not finalised our position on this issue, but propose to give it further consideration before completing our report. In this section we note some matters that we propose to take into account and invite any further views of the States. We note that our only objective in recommending relativities is to achieve horizontal fiscal equalisation (HFE). Our supporting principles for the development of assessment methods are always to be read in the light of that single objective.
- 8 We have adopted a contemporaneity supporting principle which means that, bearing in mind our objective and other supporting principles such as policy neutrality and practicality, the distribution of GST provided to States in a year should reflect State circumstances in that year as far as possible. We consider that a 3 year lagged assessment is, at least in most circumstances, the most reliable practical approach to providing a reasonable estimate of State circumstances in the application year. In the June 2014 draft report, setting out our preliminary views, the Commission made reference to the limited exception to this principle, essentially in the case of backcasting major changes in Commonwealth-State financial arrangements, only where the change is reliably known. It noted the considerable difficulties in extending this approach beyond such cases.
- 9 We propose to maintain that general approach in this methodology review. If any adjustment is to be made to our general assessment approach it must improve the HFE outcome consistent with our objective and the supporting principles.
- 10 We do not consider that State, or independent, forecasts of revenues in the application year, for example for royalties, are sufficiently reliable for us to use as the basis of the GST distribution. In recent years, the errors in these forecasts have been very large. Such an approach raises a range of issues, including that it would almost certainly require consequent GST adjustments in future to compensate for errors which could itself then undermine the contemporaneity of future years GST distributions.
- 11 However, the Commission would like to seek a response from the States on to what extent CGC methodology should, or should not, respond to sudden or large scale shocks to revenue bases. Conceptually, there may be other options to smooth over a

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<sup>1</sup> [https://cgc.gov.au/index.php?option=com\\_attachments&task=download&id=2092](https://cgc.gov.au/index.php?option=com_attachments&task=download&id=2092)

greater number of years, or to otherwise ameliorate, the impact of expected major changes in State circumstances. This may be appropriate if it is practical and its result is to improve HFE outcomes.

- 12 To pursue such adjustments would require us to establish an appropriate mechanism, and guidelines and processes to identify when and what level of adjustments should be made.
- 13 We welcome State views on the general principles, guidelines and processes which should surround any such adjustment process. For example, these would need to address:
  - How to identify exceptional circumstances warranting an adjustment, recognising that forecasts of prospective conditions are subject to large errors.
  - Avoiding any possibility for a State to game the system, or generate other policy neutrality concerns.
  - The impact in each year, and over time, on other States.
  - The appropriateness of having any adjustment processes dealing symmetrically with exceptional changes in State circumstances.
- 14 At this point we have made no decisions on whether to make any adjustments. We are exploring whether, and if so under what conditions, any adjustments might improve HFE, consistent with the supporting principles we have adopted in the review.

## **MINING RELATED EXPENDITURE**

- 15 The Commission intends to introduce assessments of expenditure related to the planning and regulation of investment projects and capital grants to local governments relating to community development and amenities and culture and recreation. These relate not only to support for the mining industry but to where private investment and population growth requires differential spending by States.

### **Planning and regulation of investment projects**

- 16 The Commission considers there is a conceptual case for including a disability reflecting the additional planning and regulation costs incurred by States to facilitate investment projects. States with expanding mining or other industries usually have higher levels of construction activity that result in higher project planning and approval expenses, including environmental assessment costs. We have decided to assess these expenses using State shares of private non-dwelling construction expenditure. This will allow us to recognise the higher costs of mining States but not discriminate between industries.

- 17 We will use State provided data to determine the national average net State expense on planning and regulation of investment projects. Using State provided data for 2010-11 to 2012-13, we have set this amount at \$18 per capita in 2011-12, the first year of the 2015 Review assessment period. This amount will be indexed in following years, based on real growth in private non-dwelling construction and the price index for State and local government final consumption expenditure. This will capture growth in both the quantum of services and cost of providing the services.
- 18 The impact on the GST of assessing State spending on planning and regulation of investment projects for 2012-13 is set out in Table 1.

**Table 1 GST impact of assessing State spending on planning and regulation of investment projects, 2012-13**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
\$m	-62	-71	37	103	-15	-8	-4	20	160
\$pc	-8	-13	8	42	-9	-15	-9	85	7

Source: CGC calculation.

## Capital grants to local government

- 19 The Commission considers there is a conceptual case for including a disability reflecting the additional costs incurred by States to support local government infrastructure provision relating to community development and amenities and culture and recreation. The current assessment of these expenses recognises the impact of population growth but only to the extent that increased population results in greater population shares of the GST. We consider local governments experiencing rapid population growth will undertake more investment, requiring more than a per capita share of capital grants from State governments to maintain their per capita levels of infrastructure. We have assessed these grants using population growth rather than population shares.
- 20 The impact on the GST of assessing capital grants to local government relating to community development and amenities and culture and recreation for 2012-13 is set out in Table 2. Since the population growth disability is already material elsewhere, we propose to include this assessment.

**Table 2 GST impact of assessing capital grants to local government, 2012-13**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
\$m	-15	0	5	19	-6	-4	0	1	25
\$pc	-2	0	1	8	-4	-7	0	3	1

Source: CGC calculation.

## HEALTH ASSESSMENT

- 21 The Commission is not considering changes to the structure of the Health assessment. Health will be assessed as outlined in the draft report, using a direct approach based upon administrative data on State provided services, with economic environment factors used to reflect the effect of private provision on State provided services.
- 22 In the calculation of the economic environment factors for each component, the Commission intends to standardise bulk billed services by Indigeneity, remoteness, SES and age (the draft report standardised just for Indigeneity and remoteness).
- 23 In relation to the level of State provided services affected by private provision (substitutability) we are awaiting the final reports from the two consultants looking into this issue. These reports will be made available to States once they have been received. States may wish to comment on the findings of the consultants. In particular we draw States' attention to the consultants' comments on the level of substitutability in admitted patient services, and what might be an appropriate indicator of the impact of the non-State sector on State provision of these services.

## WELFARE ASSESSMENT

- 24 The Commission intends to assess other general welfare expenses using the relative proportions of State populations in the bottom quintile of the 2006 Census SEIFI. This will be adjusted by the change in the relative proportions of State populations with Health Care Cards between the 2006 and 2011 Censuses to account for changes in social disadvantage over that period. The Commission will continue to use this measure, pending the availability of a household level index from the 2011 Census.
- 25 We consider SEIFI an appropriate measure because it is a broad indicator of social disadvantage. However, the 2006 SEIFI measure could not be used unadjusted because State circumstances have changed. We intend to use the change in relative levels of Health Care Card holders to measure those changes in circumstances because the 2006 measure correlated well with the 2006 SEIFI measure.
- 26 Table 3 shows the 2006 SEIFI and how it would be adjusted. The main change is a reduction in the relative measures for Western Australia and the Northern Territory.
- 27 SEIFA or NISEIFA and IRSEO, as proposed by some States, are not appropriate alternatives because these are area-based measures of socio-economic status and we do not have service user data to estimate how many people in each type of area would use general welfare services.

**Table 3 Relative proportions of State populations in bottom 2006 Census SEIFI quintile, adjusted for change in the relative proportions of State populations with a Health Care Card**

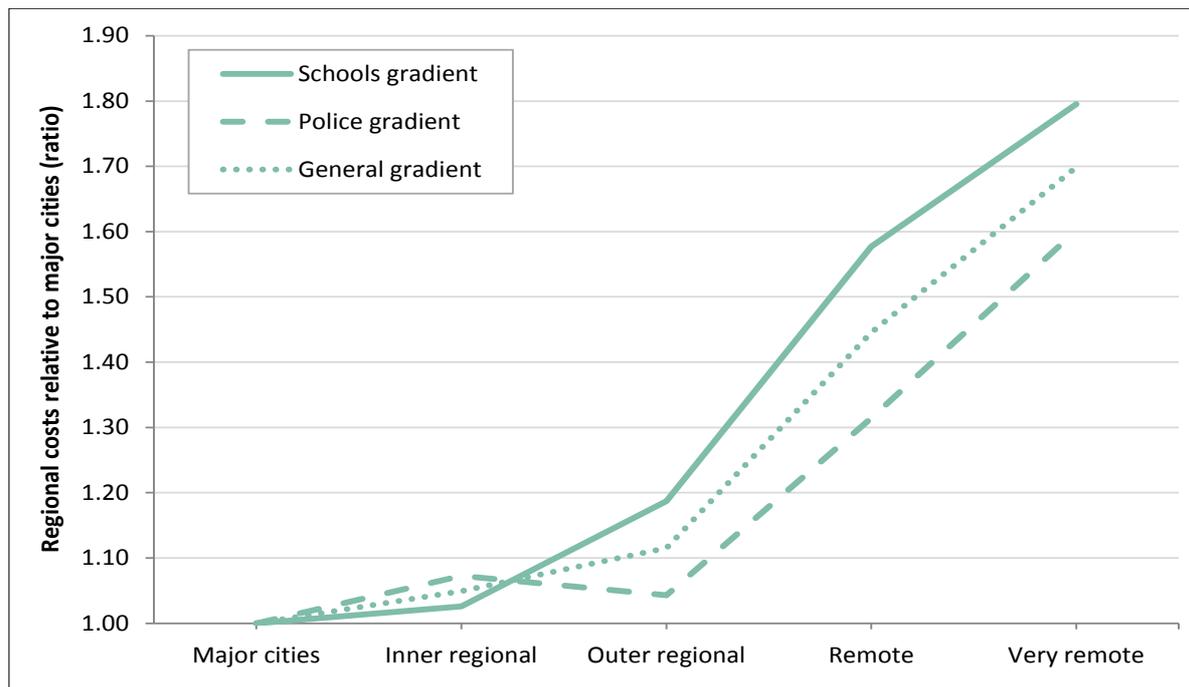
Relative proportions of State populations	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	%	%	%	%	%	%	%	%	%
2006 SEIFI bottom quintile (a)	96	91	99	88	116	137	63	156	100
2006 HCC holders	94	110	97	87	106	130	58	181	100
2011 HCC holders	95	111	101	80	108	125	55	133	100
% change in HCC holders (b)	0	2	4	-9	2	-4	-6	-27	0
2006 adjusted SEIFI measure (a) scaled by (b)	96	92	103	80	118	131	59	114	100

Source: Commission calculation, derived from ABS 2006 Census SEIFI data and Centrelink Health Care Card data.

## REGIONAL COST GRADIENT

- 28 The Commission intends to use a general regional cost gradient where a regional cost disability is to be extrapolated to categories other than Schools education or Justice. This general regional cost gradient has been calculated as the average of the Schools education and Police gradients, derived respectively from ACARA and State provided data. This approach draws on two different service delivery models, creates a smoother gradient and assists in reducing the sensitivity of the gradient to changes in ACARA data over time.
- 29 The schools education, police and a general (average) gradient are shown in Figure 1.
- 30 The Regional cost factors for all categories other than Schools education and Justice have been derived using the general cost gradient and a client base or expense base applicable to the category.
- 31 Table 4 shows the assessments in which the regional costs disability is applied and the data used. A 12.5% discount has been applied to the regional cost factors for all categories in which the general cost gradient has been used.

**Figure 1 Schools education and illustrative police Regional costs gradient**



Source: Commission calculation using ACARA data, 2010-11 and State provided data, 2008-09.

**Table 4 Regional costs client or expense base and gradient used for each assessment**

Category or component	Client base	Gradient
Health – outpatients (a)	Population	General
Housing	Population	General
Welfare	Population	General
Services to communities		
Community development	Use-weighted population	General
Community amenities	Population	General
Small communities utilities subsidies	Use-weighted population	General
Justice – police	Police use-weighted population	Police
Justice - courts and prisons	Police use-weighted population	Police
Transport services – non-urban subsidies	Non-urban population	General
Roads - rural roads (road length expenses)	Assessed rural road lengths	General
Services to industry – regulation	Use-weighted population	General
Other expenses – 50% of service expenses	Population	General

(a) Regional costs for other components in the Health category assessment are calculated within the socio-demographic composition disability.

## URBAN TRANSPORT INFRASTRUCTURE ASSESSMENT

- 32 Given State concerns about the quality and policy neutrality of the data on urban transport infrastructure by city, and the nature of the regression model used to capture the relationship in the draft report, the Commission intends, for this review, to adopt a simple population based model for the urban transport infrastructure assessment. The assessment of State urban transport infrastructure requirements in each year will be based on the sum of the square of the population of each urban centre above 20 000 in each State. The assessed investment will then be calculated by subtracting the opening stock required in each State from the closing stock. The calculation is set out in Box 1. A three year average of city populations will be used for each year to reduce any volatility in the stock disabilities.

### Box 1 Calculation of State shares of urban transport assets

State  $j$ 's share ( $\beta_j$ ) of urban transport assets is:

$$\beta_j = \frac{\sum_i^{all\ i} P_{ij}^2}{\sum_{ij}^{all\ j} P_{ij}^2}$$

where  $P_{ij}$  is the three year average of the population of State  $j$ 's  $i$ th city

State  $j$ 's investment ( $I_j$ ) in urban transport assets is:

$$I_j = \beta_{j1}K_1 - \beta_{j0}K_0$$

where subscripts 1 and 0 denote beginning and end of year observations.

- 33 We consider the conceptual case that larger cities require more assets per capita to deliver urban transport services has been established and is supported by the available data. This feature is retained in the simple population based model.
- 34 We also consider the data are good enough to establish a broad relationship between asset values per capita and city size. They confirm the relationship is upward sloping, linear and are very close to passing through the origin. Adopting the assumptions that the relationship between city size and asset values per capita are upward sloping, linear and passes through the origin simplifies the relationship. It can be shown that it is independent of the slope of the curve.
- 35 Table 5 shows the assessed investment under the two methods (with no discounting applied).

**Table 5 Assessed investment**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Draft report method no discount									
2010-11	3 064.7	2 703.0	737.5	504.0	256.7	10.6	24.2	6.2	7 307.0
2011-12	1 367.2	1 350.1	394.1	334.2	102.4	3.2	12.4	1.4	3 565.0
2012-13	1 658.2	1 619.2	731.1	565.7	205.4	30.1	47.8	12.5	4 870.0
Square of population									
2010-11	3 072.6	2 658.1	738.9	529.1	261.7	12.7	26.0	7.8	7 307.0
2011-12	1 380.2	1 322.4	390.0	348.2	104.6	3.9	13.7	1.9	3 565.0
2012-13	1 841.2	1 794.4	551.4	519.4	141.5	4.0	16.2	1.9	4 870.0

Note: Three year averages have not been used in the stock disabilities for either calculation but will be in the final 2015 Review assessment.

Source: Staff calculation.

- 36 Given the conceptual case is strong and concerns about the sensitivity and non-policy neutrality of asset data have been reduced, the Commission is inclined to reduce the placeholder discount of 50% adopted in the draft report. The Commission will be reviewing all discounts before the completion of the review.

## NATIONALLY SIGNIFICANT INFRASTRUCTURE PROJECTS

- 37 The Commission intends to treat all Commonwealth payments for projects which the Department advises affect the national road or rail networks in the same way. They will impact on the relativities and needs relating to their national significance will be assessed.
- 38 The Department of Infrastructure and Regional Development has advised that most rail infrastructure projects are not on the national rail network.<sup>2</sup> However, some payments are being made to States for projects on track which is part of the national network but not owned or under the control of Australian Rail Track Corporation (ARTC). For example, in 2013-14, the rail projects included.<sup>3</sup>
- \$336 million paid to New South Wales for upgrading freight rail facilities between Sydney and Newcastle. The State owns this track, but it is part of the national rail network and there is an agreement with the Commonwealth that benefits from the investment will flow to freight operators.

<sup>2</sup> Most of the national rail network is owned or leased by the Australian Rail Track Corporation (ARTC), which is a Commonwealth-owned company. But there are exceptions, such as the Sydney-Newcastle track and some track in Western Australia and Tasmania.

<sup>3</sup> In addition, \$45 million to be paid in 2013-14 for the Port Botany line was paid to the ARTC, not New South Wales, and will have no impact on the relativities.

- \$17 million paid to Western Australia for the Kewdale intermodal rail supply chain. This will be owned by the State but is on the national rail network.
- \$17 million paid to Tasmania for freight capacity improvements. The relevant track is part of the national rail network but owned by Tasmania.

- 39 We have therefore decided Commonwealth payments to the States which the Department of Infrastructure and Regional Development advises affect the national road and rail networks will impact on the relativities and national needs will be assessed in relation to 50% of them on the basis of their distribution among States. As a result, 50% of them will have no effect on the GST distribution. The treatment of road and rail payments will be consistent.
- 40 We consider the other investment assessments appropriately allow for the main factors driving on-going and relatively divisible investment needs of States (such as for schools and hospitals). We do not propose to recognise any other national needs unless instructed by terms of reference.
- 41 The impact on the GST of treating the on-network rail payments for 2013-14 as impacting on the relativities but with nationally significant needs assessed in relation to 50% of them is set out in Table 6. The department is to provide final advice on the relevant payments for all years.

**Table 6 GST impact of nationally significant rail payments made in 2013-14**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist
\$m	-106	48	39	12	14	-12	2	3	118
\$pc	-14	8	8	5	8	-24	8	8	5

Source: CGC calculation.

## SEEKING STATE VIEWS

States are invited to provide any comments they may have on the approach to assessments set out above by 29 December 2014.