



Australian Government

Commonwealth Grants Commission

**ASSESSING SUPERANNUATION EXPENSES
IN THE 2010 REVIEW**

STAFF DISCUSSION PAPER CGC 2007/29-S

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INTRODUCTION

- 1 In 2005, the Heads of Treasury undertook a review of horizontal fiscal equalisation. A conclusion of that review was that Commission processes could be simplified. The 2010 Review terms of reference ask the Commission to simplify its assessments, provided to do so is consistent with the principle of equalisation.
- 2 In its 2006 report to the Ministerial Council, the Commission said its aim was to implement equalisation using simpler methods. It believes simplification and equalisation can both be achieved and that simplification will improve the reliability and robustness of the processes and the acceptability of the outcomes.
- 3 The Commission considers that simplification can best be achieved through a rigorous application of its assessment guidelines. These guidelines require the 2010 Review assessment methods to:
 - establish a conceptual case for the assessment;
 - support the conceptual case with evidence, which is both comparable and reliable;
 - develop a reliable assessment method; and
 - demonstrate such an assessment would be material.¹
- 4 The Commission's intention is to develop these methods jointly with States. For that reason it has chosen an iterative process. This approach provides States with opportunities to contribute to the development of the final assessments.
- 5 In its Discussion Paper 2006/11 *Initial Views on Assessment Structure and Approaches*, the Commission outlined its views on assessment categories and approaches for the 2010 Review. Those views provide the basis on which the Commission seeks to take the 2010 Review assessments forward in consultation with States.
- 6 The Discussion Paper indicated a Commission preference to distribute Superannuation expenses across the expense categories rather than assess them as a separate category. It said that Superannuation is an add-on to salary costs and could be treated in the same way as other labour costs.
- 7 The following paper outlines Commission staff's initial proposal for the treatment of Superannuation expenses in the 2010 Review. State views are sought on the proposal. State suggestions for progressing the assessment, which are consistent with the assessment guidelines, will be considered in the next iteration.

¹ The assessment guidelines specify a materiality threshold of \$10 per capita for disabilities. The threshold is applied to the impact of a disability across all expense categories. In this paper we use the \$10 per capita threshold to determine whether a proposed disability is material in this category. If it moves more than \$10 per capita for any State it is considered to be material. There may be cases where a proposed disability fails the threshold in this category, but we believe that it would satisfy the threshold when its impact on other categories is taken into account. If this happens, the disability is retained in this category.

DESCRIPTION OF SUPERANNUATION EXPENSES

- 8 The ABS Government Finance Statistics (GFS) treats superannuation expenses as an Economic Type Framework (ETF) transaction. It asks States to allocate these expenses across all GPCs, but four States do not do this. They allocate them to a single general GPC. Staff and ABS are discussing this issue with these States.
- 9 GFS classifies superannuation expenses as expenses provided for employees in the current period to finance future superannuation payments. Superannuation expenses comprise four parts.

Funded superannuation expenses (ETF 1211)

- 10 GFS defines these as expenses accrued under a funded scheme for services provided by employees in the current period.
- 11 A funded scheme is a separately constituted legal entity into which an employer contributes, on a regular basis, an amount actuarially determined to fully fund future superannuation liabilities. The employer therefore does not carry the superannuation liability on the balance sheet.
- 12 Funded superannuation expenses include amounts payable by employers to funded superannuation schemes, in respect of services provided by employees in the current period, to finance future superannuation payments. They exclude amounts not relating to services provided by employees in the current period arising from actuarial reviews and reassessments. Such amounts are treated as either revaluations or reallocated to their appropriate time period.

Unfunded superannuation expenses (ETF 1212)

- 13 GFS defines these as expenses accrued under an unfunded scheme for services provided by employees in the current period.
- 14 An unfunded scheme is one in which the employer carries the superannuation liability on its balance sheet as it does not contribute to a separately constituted legal entity, on a regular basis, amounts actuarially determined to fully fund the superannuation. The employer liability for superannuation is usually not matched by specifically earmarked assets and payments to superannuants are met on an emerging basis.
- 15 Unfunded superannuation expenses include amounts payable by employers to unfunded superannuation schemes, in respect of services provided by employees in the current period, to finance future superannuation payments. They exclude amounts not relating to services provided by employees in the current period arising from actuarial reviews and reassessments. Such amounts are treated as either revaluations or reallocated to their appropriate time period.

Nominal interest (ETF 1261)

- 16 In an unfunded scheme, the employer is considered to be compulsorily borrowing from employees the increase in superannuation liability each period. The cost of this borrowing, referred to as nominal interest, is excluded and classified to ETF 1261.

Administration costs

- 17 These are expenses incurred in the administration of superannuation schemes, whether funded or unfunded. They are classified to GPC 0190 Other General Public Services.

Table 1 Superannuation expenses per capita, 2005-06, 2007 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Avg
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Actual expenses	577.03	687.59	745.12	636.96	789.57	938.10	1 301.33	1 521.69	688.97

THE TREATMENT OF SUPERANNUATION EXPENSES UNDER AN ACCRUALS FRAMEWORK

- 18 In the 2001 Update, the Commission decided that the Superannuation category should be based on an accrual based standard and method of assessment. Transitional arrangements were required to ensure that the substantial State unfunded superannuation liabilities were appropriately taken into account in the move from a cash to an accrual based standard. These transitional arrangements brought into the assessment process States' unfunded liabilities and nominal interest on those liabilities. 2007-08 is the last year of the transitional period.
- 19 Under these transitional arrangements, the Superannuation category comprises:
- accrued expenses. Expenses under funded or unfunded schemes for services provided by employees and holders of public office whose salaries are included in the Commission's adjusted budget in the current period;
 - outstanding liabilities. One tenth of all unfunded superannuation liabilities as at 1 July 1998;
 - Nominal interest on unequalised unfunded liabilities. Imputed interest on the unfunded superannuation liabilities; and
 - Nominal interest on equalised unfunded liabilities. The balance of imputed interest. It is the imputed interest accrued during the period on unfunded superannuation liabilities less that part treated as imputed interest on the unfunded equalisation liabilities as at 1 July 1998.
- 20 Table 2 shows the weights, size and the method of assessment for each component in the current assessment.

Table 2 Superannuation, assessment structure for the 2007 Update, 2005-06

Expense Component	Component Weight	Average expense \$pc	Factors	Basis of calculation
Accrued expenses	39.67%	273.31	Accrued expenses	Based on the level of assessed wages which each State is required to finance and on which it incurs a superannuation liability. Also includes an adjustment for the higher costs incurred by the ACT and the Northern Territory as a result of their CSS responsibilities.
Nominal interest on equalised unfunded liabilities	19.87%	136.90	None	EPC
Nominal interest on unequalised unfunded liabilities	5.32%	36.65	Historical	Based on the average of the superannuation category factors for the period 1948-49 to 1997-98.
			Cost of borrowing	Based on bond rates.
Outstanding liabilities	35.14%	242.10	Historical	Based on the average of the superannuation category factors for the period 1948-49 to 1997-98

- 21 At the end of the transitional period (2007-08), superannuation expenses will comprise only:
- accrued expenses;
 - nominal interest; and
 - administration costs.

PROPOSED ASSESSMENT

Should transitional arrangements be assessed in the 2010 Review?

- 22 2007-08, the last year of the transitional period, forms part of the 2010 Review assessment period. One option would be to continue the transitional arrangements until such time as 2007-08 no longer forms part of an assessment period. If the assessment period is to remain five years, this would mean the transitional arrangements would continue until the 2013 Update.
- 23 However, in Discussion Paper 2007/12 *Principles, Interpretation and Scope of Horizontal Fiscal Equalisation*, the Commission concluded its objective is to assess equalisation in the application year. The transitional arrangements are concerned with achieving equalisation over time. If the objective is equalisation in the application year, transitional arrangements should not be assessed.

- 24 Table 3 shows the financial impact of the transitional arrangements for the last year (2005-06) of the 2007 Update. The impact is material for the two territories — they were assumed to have no unfunded superannuation liabilities prior to self-government.

Table 3 Financial impact of the transitional arrangements for 2005-06, 2007 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Redistribution (\$m)	0.8	6.3	2.0	4.4	5.0	2.4	-12.0	-8.9	20.9
Redistribution (\$pc)	0.11	1.23	0.49	2.14	3.20	4.96	-36.45	-42.66	1.01

Source: CGC assessment system.

- 25 Given the Commission’s objective is to achieve equalisation in the application year, staff propose not to assess transitional arrangements in the 2010 Review.

Assessing accrued expenses

- 26 States’ superannuation expenses are affected by the size of a State’s wage bill. This in turn is affected by:
- the average salary paid; and
 - the number of employees.
- 27 There is a conceptual case for applying only labour cost disabilities to superannuation expenses. Labour cost disabilities are those that affect either the average salary (labour location costs) or the number of employees (for example, administrative scale, socio-demographic composition, cross border etc). Non-labour cost disabilities (for example, non-labour location costs, national capital, native title, land rights etc) should not influence superannuation expenses.
- 28 Staff propose to apply only labour cost disabilities to superannuation expenses. This can be achieved by ensuring the expense weights that apply to labour disabilities reflect the inclusion of superannuation expenses in the category.² These weights will have to be carefully considered. The following example illustrates how the weights can change when superannuation expenses are included in a fictional category. It shows that including superannuation increases the expense weights of labour disabilities and reduces the weights of non-labour disabilities.

² Including superannuation expenses in a category affects the proportion of category expenses deemed to be labour related. It therefore changes the weights applying to labour cost disabilities and non-labour cost disabilities. When superannuation expenses are included, the weight applied to labour cost disabilities is larger and the weight applying to non-labour cost disabilities is smaller and vice versa.

Table 4 Expenses weights with and without superannuation expenses included

Factor	Excluding superannuation		Including superannuation of \$20m	
	Expense	Weight ^(a)	Expense	Weight ^(a)
	\$m	%	\$m	%
Category average	100.0		120.0	
Proportion of expense affected by:				
Scale	1.0	1.0	1.0	0.8
Socio-demographic composition	90.0	90.0	110.0	91.7
Labour location costs	70.0	70.0	90.0	75.0
Non-labour costs	5.0	5.0	5.0	4.2
Native title	0.5	0.5	0.5	0.4

(a) These are individual weights, they are not intended to sum to 100.0.

29 In the Schools education discussion paper, staff applied the category disability to superannuation expenses as an approximation. However it is a poor approximation. Table 5 shows the aggregate assessed labour cost expenses and the implied disability under each approach.³ The difference is material for the Northern Territory. This is because the Northern Territory is assessed to have a cost disadvantage for many of the non-labour cost disabilities, so applying the category disability inflates its assessed superannuation needs.

Table 5 Implied labour cost disability for Superannuation expenses, 2005-06, 2007 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
(a) assessed labour expenses (\$pc)									
Category disability	267.85	249.59	272.50	287.21	265.24	288.77	347.29	824.29	273.32
Only labour cost disabilities	269.29	253.66	272.21	283.87	268.08	292.60	351.19	678.12	273.32
Difference	-1.44	-4.07	0.29	3.34	-2.84	-3.83	-3.89	146.16	0.00
(b) implied disability									
Category disability	0.97999	0.91319	0.99700	1.05084	0.97045	1.05655	1.27066	3.01585	1.00000
Only labour cost disabilities	0.98526	0.92807	0.99594	1.03860	0.98083	1.07054	1.28490	2.48105	1.00000
Difference	-0.00527	-0.01489	0.00106	0.01222	-0.01039	-0.01401	-0.01427	0.53479	0.00000

Source: CGC assessment system.

Note: The results shown reflect current assessments. The results for the 2010 Review assessments are likely to differ.

Adjustments for the ACT and Northern Territory

30 In the 2004 Review, a conceptual case was made for recognising an additional disability faced by the ACT and the Northern Territory to recognise the impact of a Commonwealth influence. At the time of self-government, their employees were members of the Commonwealth

³ These were obtained by summing the assessed labour costs for each category.

Superannuation Scheme (CSS). The CSS is a more generous scheme than the schemes normally provided by State governments. The disability recognised that some of their employees are still members of the CSS scheme.

- 31 In the current assessment accrued superannuation expenses are increased by a factor 1.27 for the ACT and 1.21 for the Northern Territory.
- 32 Staff accept that a conceptual case exists for assessing a CCS disability for the territories. However, it will need to be determined if the impact of the CSS will be material by 2010. This will depend on the number of territory employees still contributing to the CSS and the difference in the employer contribution between the CSS and the average State scheme.
- 33 Staff are still investigating this issue. While staff accept that a conceptual case exists for assessing a CSS disability, it is expected that the impact of this disability will have diminished substantially since the 2004 Review. The CSS scheme was closed to new members in 1990. Staff are seeking evidence from the ACT and the Northern Territory, which would support the conceptual case for assessing a CSS disability. This evidence would need to satisfy the Commission's assessment guidelines, particularly its materiality guidelines.

Assessing nominal interest expenses

- 34 When superannuation expenses are accrued under an unfunded scheme, the ABS considers the employer to be compulsorily borrowing from employees the increase in the superannuation liability each period. The cost of this borrowing is referred to as nominal interest. The nominal interest expenses reported under GFS relates to all unfunded superannuation.
- 35 There is a conceptual case that States have different borrowing costs. The Commission's transitional arrangements apply a cost of borrowing factor to the nominal interest on unfunded superannuation as at 1 July 1998 but not to other nominal interest (that is, nominal interest on unfunded superannuation since 1 July 1998).
- 36 Staff propose to assess the nominal interest equal per capita because it mostly relates to unfunded superannuation as at 1 July 1998 for which disabilities have already been assessed.⁴
- 37 In addition, GFS classifies these expenses to Debt Charges. Staff propose to classify nominal interest expenses to the Other expenses category.

Assessing administration costs

- 38 These expenses are general government expenses, which are allocated to the Other expenses category.

⁴ The disabilities applying to the unfunded superannuation liabilities as at 1 July 1998 relate to a fifty year period. Unfunded superannuation liabilities from 1 July 1998 to 1 July 2115 relate to a 17 year period. In its latest Budget Paper No 1, the Australian Government notes that New South Wales, Victoria, Western Australia and South Australia have established funds to meet their unfunded superannuation liabilities by 2030, 2035, 2025 and 2034 respectively.

Issues for State comment

State views are sought on whether:

- transitional arrangements should continue to be assessed in the 2010 Review;
- only labour disabilities should be applied to superannuation disabilities; and
- equal per capita is the appropriate assessment for nominal interest expenses.

In addition, evidence is required from the ACT and the Northern Territory to support the conceptual case for assessing of a CSS disability.