Commonwealth Grants Commission – 2015 Review

South Australian Department of Treasury and Finance comments on:

- Staff Discussion Paper CGC2014-01S: Simplifying the interstate wages regression analysis
- Staff Discussion Paper CGC2014-02S: A capital cost index
- Other matters raised in the 3 April 2014 Telepresence meeting between the states and CGC staff.

Interstate wages assessment (including Staff Discussion Paper CGC2014-01S: Simplifying the interstate wages regression analysis)

South Australia does not consider that the issues raised at the recent Telepresence and in Staff Discussion Paper CGC2014-01S are central. South Australia is concerned that the context of that discussion was presumed to be the capital cities based analysis, and that mere refining of regression analysis reflects Commission thinking in this area.

An assessment of interstate wage differences for the purpose of fiscal equalisation is deeply problematic in concept and implementation. Whichever way you go there are problems.

Clearly an assessment based on public sector wages is not possible because of policy contamination.

There would also be major problems with basing an assessment on private sector wages for public sector type employees because of indirect policy contamination. An assessment based on wage differences for this group, couldn't be relied on given the likelihood of relative interstate public sector wage differentials driving apparent private sector differentials – a situation of reverse causality.

However, turning to general private interstate wage differentials, there are still major problems.

A correlation was obtained in the 2005 SET dataset between private sector and public sector differentials. But this could still be, to some extent, the public sector influencing the private sector result (Victoria and South Australia could especially be in this position), rather than the private sector analysis capturing intrinsic interstate differences of relevance to both private and public sector.

The 2009 SET dataset provides a classic test case for the proposition that private sector differentials measure intrinsic differentials which drive public sector wages. As pointed out in the Victorian submission, *the WA private sector differential increased massively from 2005 to 2009, but the public sector differential was virtually unchanged.*

The reason for this is that Pilbara type compensating differentials affected the 2009 measured WA private differential. *But Pilbara compensating differentials by definition* *are not relevant to the employment of public and private employees in non-Pilbara locations.*

A capital cities based analysis reduces the Perth private sector differential compared with the whole of state WA differential, *but the point is Pilbara compensating differentials are still present in the Perth data to a greater extent than in other capitals with relatively fewer resident FIFO workers.*

This problem is also still present in respect of the influence of the finance and business services industry on the NSW differential. The finance and business services industry recruits from the best and brightest on a *nationwide* basis. The influence of that industry on standardised wages is still present in the CGC assessment which is not of particular relevance to intrinsic differences pertaining to the recruitment of teachers, nurses and police in that state from a *state* labour market pool.

The conceptual case for moving to a 'capital cities plus regional private sector add on' methodology in preference to a whole of state analysis is unclear. (Is there potential for double count of intra state remote area public sector costs?)

A move to a capital cities approach seems an ad hoc rationalisation to reduce the Western Australia/Victoria gap, as a result of which South Australia sustains significant collateral damage, when the deeper problem is the influence of non-intrinsic wages differences in the data not of relevance to public sector wages.

A targeted compression of the Western Australian and Victorian relativities could be indicated based on the Pilbara compensating differentials and Victorian 'reverse causality' issues, *while retaining the whole of state analysis.*

In the face of many concerns about the assessment methodology and problems whichever way you go, including with both the whole of state or capital cities approaches, abandonment is a genuine option.

Alternatively, as proposed in the SA submission, given the general concerns at the conceptual level of a model of the labour market integrated across occupations but separate across states, and whether the SET analysis captures only truly intrinsic differences relevant to public sector wages, a very substantial discount overall is indicated; and also discounts targeted at smaller states reflecting lesser sample survey confidence for the econometric results obtained for those states.

Staff Discussion Paper CGC2014-02S: A capital cost index

South Australia is open to the application of a capital cost index in the infrastructure assessments based on the use of Rawlinsons indices.

It is acknowledged that Rawlinsons Capital City Index may be more applicable to the construction of major buildings rather than road/bridge construction. As a consequence, the Commission should give consideration to using Rawlinsons indices in respect of all non-road infrastructure and select an alternative/specific index for road and road-related infrastructure.

We have not been able to ascertain the reason for differences between the Riders Digest tender price index and the Rawlinsons Capital City Index.

Other matters raised in the 3 April 2014 Telepresence meeting between the states and CGC staff

Mining revenue assessment

South Australia can provide the mineral-by-mineral royalty and value of production data requested. Our resources and energy agency has advised that there are no confidentiality issues provided the data is only used by the Commission. Data for the 2013-14 financial year will not be available until October 2014.

Moving in the direction of commodity-by-commodity is likely to advance equalisation, subject to possible non-neutrality incentive effects. Some degree of grouping of commodities in the same or nearly the same royalty rate categories will limit neutrality effects.

As we understand the discussion at the Telepresence, Western Australia is advancing a proposition that it is evident that there are different policies of support across the states for mining activities. Western Australia cited the New South Wales approach to coal seam gas (CSG) compared to Queensland (and reiterated their previously stated material about a pro-active/pro-mining approach in Western Australia).

The difficulty is that apparent different degrees of mining regulatory support may reflect a fairly standard policy position which gets expressed differently when environmental social impact circumstances differ (like NSW farmland v Qld cattle backblocks).

Even if there were an element of policy difference in a particular situation, like CSG, it cannot be generalised in a way which implies deep policy contamination in respect of remote location iron ore and coal production levels.

South Australia does not accept that if there are concerns about differences in the policy environment *in some aspects*, somehow if those differences *can't* be reliably measured, it would be appropriate to recognise that by downscaling a whole assessment. At best a judgement based expansion of NSW CSG production data might be considered on the basis of the WA argument.

Because the skew in mining production is so extreme, unless a very large discount is applied, discounting does not materially mitigate alleged incentive effects in respect of either regulatory support or royalty rate setting.

The key to non-neutrality grant design concerns for both rates of royalty and regulatory environment is a designed aggregating of commodities so that State shares of production and revenues are evened out sufficiently.

Roads linking major economic activity

South Australia has provided additional information on the types of economic activity the additional roads are servicing (attached). We have not been able to provide mine output or precise tourist numbers for each road.

We have provided a South Australian Tourism Commission fact sheet that provides data on annual tourist numbers to the Flinders Ranges and Outback region of South Australia. Most of the additional roads listed are in this region.

State funding for non-government schools

In South Australia, prior to the NERA, State funding for non-government schools has been determined by applying an annual growth factor to a historically determined base. This funding did include components for educational disadvantage. Under the new funding arrangements, South Australia has agreed to maintain this base and adjust it annually by an agreed growth factor plus additional funding increments over the period 2014 - 2019.

The total State funding commitment will also be adjusted for student enrolment and variation in student characteristics of educational disadvantage, based on new disability loading factors within the Gonski funding model. The Commonwealth is, however, proposing to undertake a series of reviews of factors affecting funding for educational disadvantage. The outcome of these reviews may impact on total State funding to non-government schools in the period 2014-2019.

Public hospitals

As stated in our earlier submission, South Australia has major concerns about the proposed structure of this assessment for health expenditure. It is still our view that the data required for such an assessment will not be sufficiently mature to undertake a robust assessment until at least the 2020 Review. South Australia previously provided specific concerns about the IPHA methodology and data being proposed for use.

South Australian DTF has been advised that data for outpatient services is the least developed of all data sets with inconsistencies across jurisdictions.

South Australia re-iterates its concerns about the disaggregation of age into 5 groups instead of 7 groups. In the health sector, spending against age has a very steep gradient for those over 80 years of age. People 85 years of age and over have different service delivery needs to the age group who are under 85 years of age. With healthier lifestyles and improvements in medical care, the elderly tend to experience poor health at older ages. If 5 groups are preferred over 7, and uniformity across expenditure categories is required, South Australia suggests amalgamating the 25-50 age group in all cases.

Community health

As stated in our previous submission, South Australia does not support a direct assessment approach instead of a subtraction model approach unless the new methodology achieves the same outcome as was achieved by the subtraction method. To summarise:

- A direct assessment approach would need to be capable of ‘netting off’ the demand drivers of observed GP-type service levels and obtain the same outcome as is currently achieved by the subtraction method.
- South Australia does not agree with the Commission that there are similarities in the services provided by GPs and those provided in community health centres.

Community health includes dental health, home nursing, domiciliary care, alcohol and drug rehabilitation, as well as baby and child health clinics.

- There are data and definition inconsistences between the different types of community health services. There is often a lack of definition of what constitutes a service event and states do not fund community health services on activity or episodes of care.

Office for Aboriginal and Torres Strait Islander Health (OATSIH) grants

South Australian DTF has been advised that OATSIH grants would provide a reasonable estimation of Indigenous service use. However, these grants are provided in addition to state funding and if OATSIH grants were not provided to states, there would not be a default to the state having to provide the services being funded.

Urban transport infrastructure assessment

South Australia is unsure of the meaning of the reference to a 'holistic' assessment for urban transport in the Telepresence notes. South Australian Treasury and Finance officials did not use that term at the Telepresence meeting held on 3 April 2014.

There are three basic ways State governments acquire asset services

1. Lease
2. Lease net of third party user charges (including fares)
3. Own provision (including on balance sheet PPPs)

There are three elements involved whichever of the methods are used.

a. Depreciation/amortisation,
b. holding cost/financial cost of capital, and
c. user charges

Item (b) is not visible or reported in accounting statements in the case of own provision (3), but is imbedded in the lease payments for scenarios (1) and (2).

In the health function, for example, which is mainly own provision (scenario 3), current operating costs, depreciation, user charges and capital expenditure will be reported in financial statements. The Commission assessment approach is to assess operating costs (wages and medical consumables) net of user charges; and incorporate depreciation (usage of hospitals and multi-year life equipment) into a separate capital assessment, together with a non-replacement investment (capital expenditure less depreciation) assessment in lieu of (and possibly equivalent over time to) a holding cost item.

To the extent there are leased asset services (1), these are included in operating costs. There are probably only limited instances of (2) in health if any.

In the case of urban public transport there are significant instances of all three ways of acquiring asset services across and within states. Unlike health there are significant instances of scenario 2 – that is, subsidised private operations after retention of fare revenue.

Data previously available to the Commission in respect of own provision (PNFCs) seems to be largely net of user charges. The new data collection should permit identification of operating costs, depreciation and user charges separately for the transport PNFC sector.

The Commission refers to an operating subsidies assessment, but it is understood that an assessment of transport PNFC net operating deficit (before interest) is intended, whether that deficit is funded by general government subsidies, grants, advances, equity or financed temporarily by borrowings.

Identifying a separate user charges (fares) revenue curve in respect of the population served by a public transport system might only matter if the cost curves to be used by the Commission had different gradients as between operating costs and capital costs. The allocation of user charges in part to the operating costs assessment and in part to capital costs assessment might then have an effect (aside from timing effects) – but it may not be material.

However, probably the more important issue is the capturing of a policy neutral *exponential* fare revenue capacity curve in respect of city size even if imbedded in a *net* cost curve. The current net cost curves obtained by regression analysis (operating and capital) are heavily determined by the fare setting regime in the Sydney public transport system, and policy neutrality is thus questionable. By comparison with intra state remote location costs there are many fewer observations at the high cost end for public transport.

South Australia did not have in mind at the Telepresence meeting the possibility now raised by Commission staff in the Telepresence follow-up notes of adopting a holding cost approach for public transport as a way of avoiding issues associated with the mix of 1, 2 and 3 in this area.

There are disadvantages in adopting a different capital assessment methodology for different functions.

However, it is noted that if a holding cost approach *were* adopted for public transport, aggregate public transport PNFC physical assets (excluding land) could be subject to a simple population dilution assessment ‘add on’, while the non-replacement investment assessment incorporating the relativity weighted population growth ‘add on’ would be dispensed with.

Referring to the question about availability of asset holdings information by city, it is not clear whether that is meant to encompass private as well as PNFCs/general government. Assuming PNFCs/government, ideally additional data collection should encompass fare revenue, operating costs, depreciation for individual transport PNFCs and/or for separate city services not just asset holdings.