



**Department of Treasury and Finance**

**Victoria**

**Submission on Architecture of HFE and  
Contemporaneity**

to the

**Commonwealth Grants Commission**

as part of the

**2010 Review**

**June 2006**

## Introduction

To assist in matching Victoria's views with the issues that the CGC has sought feedback on, comments are presented under each issue that the CGC has raised for discussion in its Issues Paper CGC 2006/03 *Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation*. In doing so, this submission also covers issues raised in the Issues Paper CGC 2006/04 *Contemporaneity*.

The key points raised in Victoria's submission are:

- increasing the robustness of both methodology and data, via simplification and aggregation, will produce a more reliable equalisation outcome;
- instituting a pillar dealing with simplicity will assist in maintaining simplification over time; and
- once simplification is achieved, a more contemporaneous assessment can be done.

### ***The Definition of Equalisation:***

*States might wish to comment on the desirability or otherwise of changes in the definition of the equalisation principle, including those aspects of it that relate to:*

- *whether the objective should be 'equality', 'not appreciably different from', 'reasonably comparable', assistance for only the financially weakest States or something else;*
- *whether equalisation should be about equalising financial capacity or performance;*
- *whether equalisation could encompass other considerations such as efficiency and how that might be achieved — could the concepts of efficiency and equalisation be part of an internally consistent definition or are they to a greater or lesser extent incompatible; and*
- *any other aspects of the definition.*

*Comments should consider the conceptual and the practical issues that might be associated with changing the definition. For example, how might 'not appreciably different from' be implemented?*

To begin with, it should be noted that the definition of HFE is not set in legislation, nor has it been endorsed by all States: it has evolved over time based upon the interpretation and practice of the CGC alone. Consequently, as stated by the Chairman of the CGC at the November 2005 Conference, "... there's nothing sacrosanct about the current definition of HFE...".

There may well be benefits to changing the definition of the equalisation principle: whether to provide a more suitable description of what the CGC currently does, or whether to reflect a desirable change in what the CGC does.

However, as a first step, many improvements in what the CGC does can be accommodated within the current (broad) definition of the equalisation principle. These should be addressed as a priority. Such improvements that the CGC should implement as a first step, for example, include: elimination of unreliable assessments; aggregation of categories and factors; elimination of usage of unreliable, detailed data; and the elimination of policy influences within the measurement of disability factors. Many of these issues are being addressed as part of the 2010 Review process.

Equalisation could potentially encompass other considerations such as efficiency (as is the case in most areas of public policy) – however, for the same reasons as outlined above – other improvements in what the CGC does are of higher priority.

Note that the concepts of efficiency and equity need not be incompatible. Efficiency gains (such as evidenced by a reduction in the bureaucratic and regulatory burden, more streamlined service delivery with associated reduced taxation levels and so on) may well improve economic activity and GST revenue. Many would consider that equity is improved via a ‘smaller share of a larger pie’ provided that it equates to a larger grant than the previous ‘larger share of a smaller pie’ grant.

### **Interpreting the Equalisation Principle:**

#### ***The Three Pillars of Equalisation:***

##### *Capacity Equalisation*

*The Commission seeks views on whether capacity equalisation should be interpreted as the capacity of State governments or the capacity of State governments, State communities and other governments to provide services that are broadly the responsibility of States. If the interpretation should be broadened, how might it be done?*

If anything - consistent with the simplification directive of the terms of reference - the scope of capacity equalisation should be narrowed, not broadened.

*Currently, capacity equalisation is implemented by equalising the per capita deficit on the operating accounts of State governments. Would it be possible to equalise on the basis of other concepts, such as the net debt or the net wealth of State governments?*

It would potentially be possible to equalise on the basis of other concepts, however the desirability of doing so is not apparent. In any case, as outlined previously, there are many improvements that the CGC can make within the current conceptual basis for the equalisation principle, and these should be implemented as a priority.

## *Internal Standards or What States Do*

*The Commission seeks views on:*

- *Whether the current interpretation of standards as an average of the policies of all States should be changed to standards based on what some States do or to external standards based on a desired level of service or tax policy or a desired level of efficiency in service delivery. What might be the implications of such changes and how might decisions on the appropriate standard be made?*
- *Should ‘what States do’ be interpreted very broadly, in terms of State policy objectives or in terms of the many services States provide to achieve those policy objectives? How might the Commission establish the policy objectives? How might cost differences States face in achieving a policy objective be measured?*

There are benefits to changing the current definition of the standard – and such changes could be used to accommodate efficiency issues, for example. Looking at ‘what States do’ (both with regard to expenditure and revenue) in a broader sense, should help reduce the policy influence that presently exists in the CGC’s more detailed assessments (such as the influence of the payroll tax regime and other business development policies on the payroll tax base, as well as outsourcing policies which impact on the payroll tax base).

However, there are many improvements that the CGC can implement whilst still retaining the current definition of the standard, and retaining the current approach to looking at what States do: and the Terms of Reference for the 2010 Review direct the CGC to examine such improvements.

These improvements should be arrived as a priority before consideration is given to the more fundamental reforms of addressing the notion of the definition of the standard, or the interpretation of ‘what States do.’

The current approach of computing the standards as an average of the policies of all States is also difficult when a service is only provided (or fundamentally only provided) by a minority of States. There is the risk of data bias, and the difficulty of auditing such data. There is also an increased risk of unreliability in the assessment, as judgement may be used to fill gaps in the data. This could be reduced if the service needed to be provided in the majority of the States before it was included in the standard.

Finally, the Terms of Reference directives towards aggregating categories, components and factors, as well as reviewing the use of more general indicators of revenue capacity and expenditure need, should effectively result in a broader examination of ‘what States do.’

- *Currently, the ‘same effort to raise revenue’ is interpreted as applying the same definition of the revenue base and the same rates of tax, but should it be interpreted broadly to encompass the same policies for creating or growing the tax base as well as those for taxing it? If so, could that be done in a simple and robust way?*

It is not clear how ‘the same policies for creating or growing the tax base’ could be defined, nor the benefits to the equalisation process (especially given the directive towards simplification) of implementing this approach. Perhaps the CGC could elaborate on this.

There are many other areas for improvement of the CGC’s methodology which should be addressed as a priority before any examination along these lines is considered.

- *The current average standard approach implies all States notionally provide services in the same way. Is this appropriate given their different circumstances? Are there practical alternatives?*

There are many other areas for improvement of the CGC’s methodology which should be addressed as a priority before any examination along these lines is considered.

#### *Policy Neutrality*

*The Commission seeks views on the pillar of policy neutrality. Should a concept of policy free be applied? Is there evidence that equalisation creates incentives for particular behaviour by States? If there is, what alternative approaches might be adopted to remove the incentives? Conversely, should equalisation provide positive incentives for States to act in a particular way and, if so, what behaviours should be encouraged and how might it be achieved?*

The very design of the current equalisation methodology provides a financial disincentive to economic reform. Whereas in the NCP reform agenda States received financial rewards for undertaking economic reform (and within the forthcoming NRA reform agenda there is in-principle support from the Commonwealth to do likewise), within the CGC’s methodology, States may actually face a financial penalty (via reduced grants) in undertaking reform designed to strengthen their economies.

On the revenue side, for example, the impact of any policy which encourages growth by increasing business competitiveness (such as a lower payroll tax regime, or pro-business regulatory policies) will be captured by the CGC’s current revenue base measurement methodology (which is intended to be policy neutral). It effectively ‘penalises’ the State. The movement towards broader categories, the aggregation of factors, and the examination of the use of broader indicators should reduce the impact of this policy contamination.

Similar policy contamination exists within the CGC’s methodology for measuring cost disabilities. Poor policy choice by States can manifest itself within a disability under the methodology used by the CGC (despite the fact that disabilities are intended to refer to ‘influences beyond the control of individual States’), and be rewarded with

GST grants higher than they otherwise would be. A good example of this occurring is within the disability that has the largest contribution of all expense disabilities to the overall redistribution of GST funds – namely indigenous influences.

There has been much press coverage, and many examples given, in recent times of how poor government policy has contributed to the situation that indigenous people – especially those in remote settlements – currently find themselves in. This attention has focused on the situation of remote indigenous settlements located in the NT, where the majority of such settlements in Australia exist.

However, the CGC points to the situation of these people<sup>1</sup> – such as evidenced by morbidity and mortality rates, level of educational attainment, level of overcrowding in housing, level of access to essential services infrastructure and so on – as indicators of disabilities. However, as reflected in recent press coverage, it is quite clear that these factors are in part indicators of ineffective policy choice and service delivery.

At the broadest level, insufficient spending by the NT on policy programmes implemented in remote indigenous communities is an obvious contributor to the sub-standard showing of indigenous community residents (the majority of whom are in the NT) with regard to the above mentioned indicators. By the CGC's own calculations,<sup>2</sup> the NT's actual expenditure is only just over half what the CGC assesses it would require to be spent to achieve the Australian standard (whereas the other States have actual expenditure at levels of around double that of the CGC's assessed standardised expenditure).<sup>3</sup>

The CGC points to the poor showing of indigenous people as evidence of disabilities – that is, as being situations 'beyond the influence of government policy.' But State policies are clearly influencing the factors which the CGC is using to measure disabilities, so then the 'disabilities' so measured are not in fact consistent with the definition.

### *Should There Be More Pillars?*

*The Commission seeks views on:*

- *whether any of the following should be included as pillars of equalisation?: efficiency, simplicity, robustness, transparency and stability or predictability. Why? How?*
- *whether including efficiency as a pillar (based on either the broad interpretation of allocative efficiency or the narrower interpretation of the technical efficiency of service provision), would be consistent with fiscal equalisation? If so, how might it be done in a simple and reliable way?*

Simplicity - and possibly also robustness - are principles which would serve well as pillars within the CGC's methodology. The intention here of instituting these as

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<sup>1</sup> Refer to the section on Indigeneity in the Socio-Demographic Composition chapter of Volume 7 of the 2004 Review Working Papers, page 187.

<sup>2</sup> Refer to page 249 of *Relative Fiscal Capacities of the States 2006*.

<sup>3</sup> It is difficult to believe that such a large discrepancy is on account of the NT having much higher than standard efficiency in the delivery of such services (and all other jurisdictions having much lower than standard efficiency in the delivery of such services).

pillars is to formally recognise these issues in the principles guiding the CGC's approach, and to assist in maintaining simplification and robustness once achieved.

The issue of simplicity – as evidenced by the focus of the work being done in the 2010 Review – is a fairly non-controversial one. Thus there should be no problems with having this issue recognised in a formal sense within the principles of the implementation of HFE – that is, as another pillar. The notion of simplicity is not inconsistent with the existing pillars. Put simply, because the existing pillars do not explicitly address simplicity, there is a real risk they will not be sufficient to *maintain* simplicity – witness the large growth in complexity over the past three CGC reviews.

Simplicity is an important principle to recognise in the implementation of HFE. The increased understanding of the CGC's methodology and ensuing results that comes with a simplified system increases the credibility of the system via increasing the level of accountability that can be brought to bear on what the CGC does. The cost of implementing HFE also falls with increased simplicity, as there would be fewer employee hours (both on the side of the CGC as well as the States) required to maintain the system

Robustness is another principle that is important to HFE, and thus could be formally recognised as another pillar. An assessment can be said to be robust if it passes the 'reasonable man test' – would it pass a verification test conducted by an independent party? Another test of robustness is via the notion of replication. For example, if the task of formulating an assessment was given to separate, independent groups of employees within the CGC, would they deliver assessment results that were similar?

The characteristics of a robust assessment, which would need to be reflected in the description of the pillar, would typically involve all of the following. The assessment uses sound data – and the Data Working Party has dealt with this issue last year. The methodology applied to the data is simple and well constructed, with minimal use of judgement and 'data massaging.' Finally, the results arrived at are consistent with a reality check, and independent verification.

The more robust is the CGC's methodology, the more credible and accepted the results delivered would be. There would also be less scope for the need for time-consuming processes of constant review of the methodology.

### ***The Scope of HFE***

*Some issues of scope that have arisen in the past and which States may wish to address in their submissions include:*

- *whether equalisation should be confined to 'merit goods' or some concept of core State functions and taxes, such as education, health, and law and order. If so, how might 'merit goods' or another concept of core functions be defined and applied;*

The application of materiality thresholds, and the processes of aggregation and elimination, should (ideally) result in the CGC's methodology focusing on the core State functions. For example, using ABS GPC data as a guide (and which should be used as a guide in determining the category structure), categories may be defined as

Education, Health, Public Order and Safety, and Other. The use of 2 digit level GPC data, with the application of materiality thresholds, should arrive at such a result.

- *whether equalisation should cover all activities of State governments in providing services and raising taxes and charges — that is, should equalisation cover expenses incurred and revenues raised by State trading enterprises as well as those recorded in the general government sector operating statements;*

If anything - consistent with the simplification directive of the terms of reference - the scope of capacity equalisation should be narrowed, not broadened.

- *whether the range of disabilities assessed should be confined to disabilities that reflect interstate differences in the use of services — that is, disabilities that reflect differences in the unit cost of providing services should be omitted; and*
- *whether disabilities that reflect the effects of the location where services are delivered should be omitted.*

Cost weights should be omitted from disabilities. This is on the basis of both reliability concerns as well issues to do with simplification. Work done during the 2004 HFE review by Dr McHugh found that the system for determining cost weights is inherently complex, and likely to remain so. Data is also limited in terms of coverage of the States, limiting the confidence which can be attached to the results.

Judgement is used widely in the determination of cost weights (for example, it is used in nearly all indigenous cost weights, and indigeneity is the largest disability factor applied by the CGC), which reduces their reliability and acceptability and judgement is inherently a subjective notion. For example, in the *2004 Review Report on State Revenue Sharing Relativities*, the minority view of Professor Wiltshire was mentioned. It was his judgement that the cost weights on account of cultural and linguistic diversity were insufficient.

Similarly, the notion of locational disabilities poses a problem. This is not because there may or may not be cost differentials associated with remote areas, or with highly urbanised areas, but because of the influence of policy on the location in which people decide to live. It is clear that government policy is a strong determinant of where people live, and thus it is hard to see how location can be viewed as being a disability, 'beyond the control of individual States.'

Governments are responsible for zoning the type of use that land can be put to (whether it be residential, industrial and so on). It is standard for State governments to have departments that look at where land should be released for residential use, to accommodate growing populations. Governments also determine the intensity of use of residential land: for example, whether, on a residential block of land, a multi-storey apartment block may be built. People, by in large, only live where the government has provided services required for living: such as roads to reach the residential dwelling, water, electricity and so on. Governments also have the power of removing people from where they live: via the compulsory acquisition of land, such as for the purpose of constructing roads and so on.

There are also other State government policy influences on where people live. The location of schools and public transport facilities, for example, have a strong influence in determining where people with families (or those intending to have families) will choose to live.

There are also many other policies that are implemented by State governments that are specifically designed to provide incentives for people to live in certain areas, and typically these are areas located provincially or remotely from the capital city or large urban areas. For example, within the *Moving Forward* programme of the 2006-07 Victorian Budget, funding was specifically allocated “to help small towns create new investment and employment opportunities”. The Queensland Government also released a *Blueprint for the Bush* in their 2006-07 Budget, and this too committed funding designed to improve the liveability and attractiveness of living in remote areas.

### ***Averaging Relativities and their Application***

*The Commission seeks views on whether the current approach of applying historically derived relativities to the future remains the most appropriate way of implementing equalisation or whether other approaches should be considered. Comments should consider conceptual and practical implications of the alternatives.*

### ***Stability and Contemporaneity***

*The Commission seeks views on the trade-off between contemporaneity and stability of relativities — that is, if historical assessments are retained should they be averaged over 5, 3 or 1 years?*

A large part of the volatility in the CGC’s current assessments is driven by the fact that its methodology uses narrowly defined, unreliable and unstable data. This is evidenced by the fact that volatility of the relativity outcome for a *particular* assessment year over successive Update reports is close to the variability of the relativity outcome *between* assessment years within a particular Update report.

For example, in the 2005 Update, the NT relativities for assessment years 2002-03 and 2003-04 were 4.22722 and 4.27410: a significant increase between these two assessment years. Yet, in the 2006 Update, the NT relativities for assessment years 2002-03 and 2003-04 were now 4.26884 and 4.26517: a decline between these two assessment years. In the 2007 Update, these figures will no doubt change again.

The use of an averaging process by the CGC to increase stability is a second best solution: it should be seeking to improve the reliability of its assessment methodology, and the data which it uses, to remove the volatility which presently exists on account of the methodology itself.

Consequently, there need not be a trade off between contemporaneity and stability, as claimed by the CGC. Eliminating unreliable assessments and aggregating categories and factors (thus eliminating the usage of detailed, unreliable and volatile data) can achieve a significant improvement in stability, independently of any changes to

contemporaneity. Assuming simplification leads to a significant improvement in stability, Victoria would advocate a more contemporaneous assessment based on averaging over a period shorter than five years – say three years.

The notion of moving from a relative to an absolute assessment of fiscal capacities<sup>4</sup> has conceptual merit regardless of the number of assessment years that are averaged to produce the application year result. The CGC's methodology computes needs (or equalisation amounts) per capita on an absolute basis – that is, without regard to the size of the pool. It is only at the time that needs are converted to relativities is reference made to the (assessment year) distribution pool. Instead of averaging the relativities over the assessment years and applying this to the pool in the application year, it is conceptually more sound to average the needs over the assessment years (however many there may be) and apply this amount to the pool in the application year (with the possibility of indexing the amount to account for inflation).

This is conceptually more sound because, as the CGC points out, 'the current approach is equivalent to indexing them [the equalisation amounts or needs adjustments] by the growth in the pool.' Given that the GST pool grows (or possibly declines) on account of changes in macroeconomic spending decisions, there is certainly no rationale to believe that such changes are correlated with changes in the influences beyond the control of individual States that require a State to spend more (or allow it to spend less) per capita than other States to provide the average level of service: they are simply completely different things.

### ***The Treatment of SPPs***

*States may wish to comment on the approach to dealing with SPPs.*

SPPs constitute around 20 per cent of total State government revenues. Under the CGC's current implementation process of the equalisation principle, it seeks to equalise the financial capacities of the State Governments by examining all (significant) revenue sources and expenditure requirements of the States. Clearly SPPs are both a significant revenue source and (being tied) expenditure requirement of the States, and thus under the current implementation process of the equalisation principle, they should remain part of the assessment methodology.<sup>5</sup>

The argument that this approach overrides other national objectives and agreements established between Australian and State government ministers is incorrect. SPPs are tied grants and the funds distributed by the Australian Government under SPP agreements *must* be spent on that particular purpose. The expenditure or use of these funds is therefore not affected or overridden by equalisation. GST grants can be spent (or indeed, not spent) by the States as they see fit, with no restriction.

### ***Is Equalisation Being Asked to Do Too Much?***

*States may wish to comment on whether a set of relativities that was based on needs defined in terms of what is required to allow the underlying causes of certain*

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<sup>4</sup> As mentioned in Issues Paper CGC 2006/04 *Contemporaneity*.

<sup>5</sup> With the obvious exception of quarantining as required by the Terms of Reference given to the CGC by the Commonwealth.

*disabilities (Indigenous disadvantage, urbanisation etc) to be overcome would be 'appropriate'. If so, how might it be achieved and how could the Commission decide which disabilities should be addressed?*

Equalisation is not being asked to do too much – it is the CGC's own methodology, which it uses in the implementation of equalisation – that is asking too much (“It is not obvious that increasing detail is producing a better equalisation outcome. Our processes are stretching the available data to the limit.”<sup>6</sup>)

This can be seen by contrasting the definition of equalisation in Australia, and its associated methodology for implementation, with the definition of equalisation in Canada, and the associated methodology that guides the federal transfer programme in that country.

The Australian definition states:

*... if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.*

The Canadian definition states:

*... that allows all provinces, regardless of their ability to raise revenue, to provide roughly comparable levels of services at roughly comparable levels of taxation.*

These definitions are virtually identical, yet the associated methodologies for their implementation in Australia and Canada are extremely different.

The absence of a reference to levels of efficiency in government operation certainly does not account for the vast difference in methodology between Australia and Canada in the application of these principles. Similarly, the reference to “same” as opposed to “roughly comparable” also does not account for the vast difference in methodology between Australia and Canada in the application of these principles.

Indeed, it was only recently, during the 1999 Review, that the definition was amended from “not appreciably different from” to “same standard”. By this time, the CGC's complex methodology had been in place for some time, and the change in definition was not made so as to reflect a *change* in methodology, but to “more accurately reflect the comparisons that were made.”<sup>7</sup> This is something of a curiosity – the methodology guiding the definition – when one would expect the definition to guide the methodology. In this sense, the definition itself is less important than the methodology, given that the latter has guided the former.

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<sup>6</sup> CGC Report on State Revenue Sharing Relativities 2004 Review page 86.

<sup>7</sup> Issues Paper CGC 2006/03 *Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation*, page 3.

There is plenty of scope, within the current (CGC self-defined) definition of HFE for significant, and much needed, reform of the CGC's methodology. These can, and should, be addressed before looking at whether equalisation is being asked to do too much. Such improvements that the CGC should implement as a first step include: elimination of unreliable assessments; aggregation of categories and factors; elimination of usage of unreliable, detailed data; and the elimination of policy influences within the measurement of disability factors.