



**Australian Government**

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**Commonwealth Grants Commission**

**ASSESSING LOCATION DISABILITIES  
FOR THE 2010 REVIEW**

**STAFF DISCUSSION PAPER  
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## **INTRODUCTION**

- 1 This paper considers the conceptual case for assessing differences in the cost of providing services related to location. On the basis there is a case for considering locational influences, it explores possible approaches that could be adopted to measuring them. While not attempting to replicate the assessments made in the 2004 Review, the location assessment will capture influences measured in that review by:
  - Isolation;
  - Dispersion;
  - Service Delivery Scale;
  - Urban complexity; and
  - Input costs.
- 2 In the 2004 Review, the Commission took a cost driver approach to location. It identified specific influences that might explain how location impacted on States' costs of providing services and assessed disabilities for each (for example, dispersion, isolation, urban influences etc). This approach involved detailed calculations often accompanied by requests for detailed State data and requiring the extensive use of Commission judgment.
- 3 In this review, the Commission has expressed its intention to take a top down approach and to undertake assessments in a simpler way. This paper;
  - sets out the conceptual case for assessing locational disabilities;
  - provides evidence that supports the conceptual case;
  - considers a broad measure of the disability; and
  - considers splitting location costs into two groups, with a broad measure for each.

## **THE CONCEPTUAL CASE**

- 4 Australia is not homogenous. The locations in which people live and receive State government services are very diverse, including:
  - half the population live in cities with more than 1 million people;
  - 8 per cent of people live in urban centres or localities of less than 5,000 people;
  - 10 per cent of people live in the 99.7 per cent of the country that isn't an urban centre or locality; and
  - three quarters of the country is very remote, containing just 1 per cent of the population;
- 5 Despite this heterogeneity, State governments make services available to all their residents. For example, all 5-14 year olds notionally have free access to education. The mode of service delivery may vary between locations, but State services are provided across the country.

- 6 There are a range of different influences that act upon costs of service delivery. They include:
- service delivery scale;
  - service delivery threshold; and
  - urban complexity.
- 7 Service delivery scale reflects the experience that a small community's school, for instance, may require almost as many resources to build and operate as a school in a somewhat larger community. There may be fewer children in each class but there may be a similar number of teachers. Each may have a principal and a library, and the school building and grounds may require similar levels of repairs and maintenance.
- 8 While service delivery scale may be more easily identified for very small communities, it operates across all urban centres. It is not just very small communities that have service delivery related costs. Medium sized cities may not have the same capacity as larger cities for specialisation of tasks. For example, specialist medical services may be provided in medium sized cities intermittently at higher unit cost.
- 9 It is not clear whether very large cities such as Sydney have greater scale economies than smaller cities such as Canberra or whether there are diseconomies of large scale in very large cities, which outweigh any scale economies.
- 10 Service delivery threshold reflects that State governments do not provide all services in all urban centres. Some centres are too small to support some services. The service delivery threshold may vary for different services. For example, a small urban centre may have a primary school but not a high school. A medium sized urban centre may have a primary and secondary school, but not a hospital. A large sized urban centre may have all three services.
- 11 For some of these services, the recipients travel to larger centres to access the service, while for other services, they simply receive the service intermittently or not at all. People living long distances from health facilities travel to those facilities to access services. Consequently, they may use less of the service or they may use other providers (for example, the private sector or the Australian Government).
- 12 Urban complexity incorporates the range of services that are only required, or are required at significantly higher levels in large cities. Police are likely to spend more resources directing traffic in larger centres. Some States contend some types of crime (for example, drug related crimes) are more frequent in large cities. Greater congestion in large cities may add to the cost of providing services in some instances.

### *Conclusion*

- 13 States provide different levels of service or different types of service in different areas across a State. This may be due to the size of the centre and/or its distance from centres of supply.
- 14 Some pressures mean that unit costs are higher in remote areas, while other pressures mean that costs are higher in large urban areas. While there is likely to be some offsetting of these

countervailing pressures, it appears likely that location has a material impact on the cost of providing services, and should be considered further.

## **EVIDENCE SUPPORTING THE CONCEPTUAL CASE**

- 15 There is a large body of evidence supporting the case that location influences costs. Given the wide range of ways in which location can potentially influence costs, these do not necessarily indicate the extent or even the direction in which costs vary, but rather highlight that the impacts could, potentially, be relatively large and warrant detailed examination. Examples include:
- States provide different services in different areas. For example, 84 per cent of separations from teaching hospitals with over 10,000 separations per year are in highly accessible areas. Conversely, only 45 per cent of separations from other hospitals are in highly accessible areas. Further, a wide range of specialty services are available only, or predominantly, in hospitals in major cities. The mode of service delivery of hospital services varies considerably with location.
  - There is also evidence that costs and mode of delivery vary with location within the private sector. The range and structure of retailing varies considerably between different locations. Large urban centres often have a wide range of specialist stores targeting niche markets. They also have large concentrated shopping malls with relatively high rents and high turnover. Small towns tend to have lower rents, lower turnover, and less targeting of niche or specialist markets. Home delivery systems, such as Woolworths homeshop, or Pizza delivery chains, are more widely available in large cities than in other parts of a State.
  - Wages are a large component of the cost of service delivery, and there is evidence of a location component to labour costs. Western Australian teachers are offered up to \$11,500 per annum, plus free housing, plus additional leave to work in remote areas. Other States also provide incentives for teachers and other public servants to work in more remote areas.
  - States allocate resources internally based partly on their experience of the impact location has on costs. The New South Wales Health Department has analysed the relationship between costs facing hospitals across New South Wales and found a strong location influence which it reflected in its resource distribution formula for allocating health resources throughout the State.
- 16 These observations present a strong, albeit partial, case that remoteness increases costs. At the other extreme, are pressures that increase costs in large cities, these revolve around congestion, complexity of service delivery and large scale infrastructure involving land.
- 17 It is possible that with some pressures increasing costs in remote areas and others increasing costs in urban areas, these pressures could coincidentally cancel each other out, and that the

overall cost of service is similar in urban, regional and remote areas. In that case, the net effect of all locational pressures may not be material. Given that some of the individual pressures are quite large, and given the history of the Commission in assessing locational disabilities, it is necessary to explore the impact of locational disabilities to assess whether they are, in aggregate, material.

## **IS POPULATION DISTRIBUTION POLICY NEUTRAL?**

18 Victoria argued in their response to *Staff Discussion Paper 2006/02 Location Based Disabilities* that the distribution of the population across a state is not ‘truly free from State policy influence’, but that State policies have numerous impacts upon where people decide to live including that:

- Governments are responsible for zoning land, to determine the location and density of residential land use;
- people, by and large, live where governments have provided essential services;
- Governments, through their power of compulsory acquisition of land, can remove people from where they live;
- Governments run programs to enhance investment, employment and attractiveness of certain areas within the State; and
- Governments shift head office functions to more remote locations to encourage population growth in those areas.

19 Staff accept that States can influence where people live — population distribution is not policy free. However, we do not consider that differences in policies have had a material impact on States’ population distributions. So we propose to use their population distributions as we find them.

20 For the Commission to consider adjusting the observed State population distributions, a State would need to establish a case — supported by empirical information — demonstrating that it or another States has adopted policies different from the average of all States and those policies have materially affected its population distribution.

### **Questions for States**

- Is there reliable empirical evidence that demonstrate that differences in State policies have materially influenced State population settlement patterns?
- If so, how should the Commission remove those differences?

## **2004 APPROACH**

- 21 The 2004 Review approach set out to identify several sources of locational disabilities. Those identified and measured were isolation, dispersion, input costs, service delivery scale and urban influences. In the 2007 Update, all five factors had distributional impacts exceeding \$50 per capita for at least one State. In aggregate, input costs redistributed \$49 per capita, dispersion \$30 per capita, isolation and urban influences each \$7 per capita and service delivery scale \$6 per capita.
- 22 The approach to measuring each of these influences was detailed, data intensive and heavily dependent on both State provided data and Commission judgment. The extent of reliance on State provided data and judgment highlights the difficulty the Commission had in finding a reliable approach to measuring location influences in the 2004 Review. These difficulties remain in the 2010 Review, and the Commission is likely to use judgement again in this review.

### **Isolation**

- 23 The isolation factor measured the additional costs of providing services due to the distance of a State's capital city from other capitals, and from the main centres of supply (Sydney, Melbourne and Brisbane) of many of the inputs used to provide State government services.
- 24 Separate assessments were made for labour related costs; freight; airfares; travel allowances; and medical related travel expenses.

### **Dispersion**

- 25 The dispersion factor measured the difference in the cost of providing services due to the geographic distribution of a State's population.
- 26 Separate assessments were made for voice and non-voice telecommunications, general freight, air travel, inter-regional travel, local travel, remote staff turnover, locality allowances, repairs and maintenance, and training.
- 27 Dispersion was made significantly more complex because the method of assessment was to collect population data at the Census collection district (CD) level and to apply weights. In all, 5 different weighting models were use.

### **Input costs**

- 28 The input costs factor measured the additional cost of providing services because a State faced higher labour, accommodation or electricity costs.
- 29 Separate assessments were made for each of these three inputs. The largest of these components was wages. Economic conditions in different States meant that some States need to pay higher wages to attract and retain staff. This was measured using private sector wage differentials from the ABS Survey of Education and Training (SET). Differences in accommodation and electricity prices were assessed using commercial accommodation cost and electricity cost data.

### **Service delivery scale**

- 30 The service delivery scale factor measured the additional cost of providing a service where it needed to be delivered but where the delivery had a higher unit cost because the population served was small and remote from other points of service delivery.
- 31 The assessment methods for service delivery scale factors were function specific. Service delivery scale adjustments were made for education, health and police.

### **Urban influences**

- 32 The urban influences factor measured the additional cost of providing services in urban areas due to differences in some or all of the characteristics of urban areas such as population density, centre size, urban form, population growth and congestion. Large cities may have higher costs because:
- they have a greater need for freeway networks and tunnels;
  - they may have additional problems because of high concentrations of people with low socio-economic characteristics;
  - they may be centres for organised crime; and
  - national parks near urban centres are likely to have greater levels of use, and may be more subject to invasion by domestic pets and weeds.
- 33 The urban influences assessments are function specific. For many functions there is little substantive data on which to base an assessment. So many of the assessments required the Commission to exercise its judgment.

### **A SINGLE PROXY MEASURE**

- 34 The Commission has accepted the conceptual case for assessing location disabilities. Under its top down approach the first step is to would seek to measure locational disabilities using a single broad measure.
- 35 A number of potential indicators have been investigated, including cost indexes compiled by other organisations and regional cost data for national organisations.
- 36 For an indicator to be a suitable broad measure of locational disabilities it must:
- be nationally comparable, that is it must reflect that comparable services are provided to comparable communities across the country;
  - reflect the full range of location influences impacting on State governments;
  - reflect changes over time in their impacts and in State government responses to them; and
  - be compiled by an organisation willing to provide sufficient data to the Commission to it to undertake analysis to validate these impacts.

37 Staff do not consider any of the investigated indicators to be ideal. Table 1 lists some of them and the concerns staff have with them. Attachment A provides more detail on these indicators and the potential for them to be used as the broad measure of locational disabilities.

**Table 1 Assessment of broad indicators of locational disabilities**

<b>Indicator</b>	<b>Potential problems with indicator</b>
ABS Spatial price index	<ul style="list-style-type: none"> <li>• Not available outside capital cities.</li> <li>• Includes costs affected by State government policies such as health, education and transport costs.</li> </ul>
Building cost index	<ul style="list-style-type: none"> <li>• Components of index are volatile.</li> <li>• The scope of the index is very different from the work of State governments.</li> <li>• The index may not capture the full range of locational influences' impact on State governments.</li> </ul>
Australia post cost structures	<ul style="list-style-type: none"> <li>• Australia Post labour and infrastructure appears to differ significantly in different state for reasons other than locational differences.</li> <li>• Delivery costs appear to be lowest in remote areas, but this may reflect a different mode of delivery in these areas (a higher use of post office boxes)</li> </ul>
Centrelink cost structures	<ul style="list-style-type: none"> <li>• Wage levels are set nationally, and do not vary sufficiently between States to measure the interstate differences in wage levels.</li> <li>• Evolving cost structures, with greater reliance on call centres, means that the relationship between Centrelink and State costs will not be consistent over time.</li> </ul>
Medicare office network cost structures	<ul style="list-style-type: none"> <li>• The Medicare network is under-represented in remote areas. This is probably because health services are commonly delivered using non-Medicare model in these areas.</li> </ul>
Systemic catholic school system cost structures	<ul style="list-style-type: none"> <li>• Different policies are implemented in different archdioceses.</li> <li>• Costs are somewhat responsive to State government policies: driven by competition with the State system for teachers and students, and also driven by the level of State funding.</li> </ul>
Cost structures of bank network	<ul style="list-style-type: none"> <li>• Very rapidly evolving cost drivers, with ATM and EFTPOS networks expanding at much faster rate than Branch network.</li> <li>• The type of work done in major capital city CBDs is very different from work in regional areas</li> </ul>
Cost structures of a Fast food network	<ul style="list-style-type: none"> <li>• No McDonalds, Hungry Jacks or KFC outside large urban areas (3 outlets in NT). Therefore their network is not reflective of the network of State government services.</li> </ul>
Cost structures of supermarket chains	<ul style="list-style-type: none"> <li>• Costs are heavily influenced by State policy (trading hours, liquor licensing)</li> <li>• Level of competition and business growth strategies of supermarket chains vary between States.</li> </ul>

38 While not ideal, staff consider the Australia Post and Centrelink data have the greatest potential to be used as the broad indicator. Staff expect that the problems identified with these indicators could be overcome with further work or the exercise of Commission judgment. At this time, Staff consider it would be difficult to turn these single indicators into a robust and reliable broad indicator. Under the top down approach, the next step would be to disaggregate location costs into two blocks and investigate broad indicators for each. However, if the disaggregated

approach involves a similar level of complexity, staff may reconsider using one of these broad indicators as its preferred approach.

**Questions for States:**

- Do any of the identified indicators have the potential to be a broad measure of location disabilities?
- Can their shortcomings be overcome and should they be investigated further?
- Are there other indicators which should be considered as potential broad measures of location disabilities?

**DISAGGREGATED MEASURES**

- 39 Location costs could be disaggregated by functional area or cost driver.
- 40 It would be possible to measure the impact of location by category. Depending on the extent of disaggregation this could lead to separate location factors for health, education, police, and other expense categories. Such assessments would require States to provide comparable data on total costs in each functional area by fine level geography. Staff would require States to provide their data according to comparable definitions and standards. The discussions at the Data Working Party meeting in March 2007 indicate most States would not be able to provide the data required to support this type of approach.
- 41 Staff consider the best available disaggregation would be to divide costs into labour related and non-labour related.

**Questions for States:**

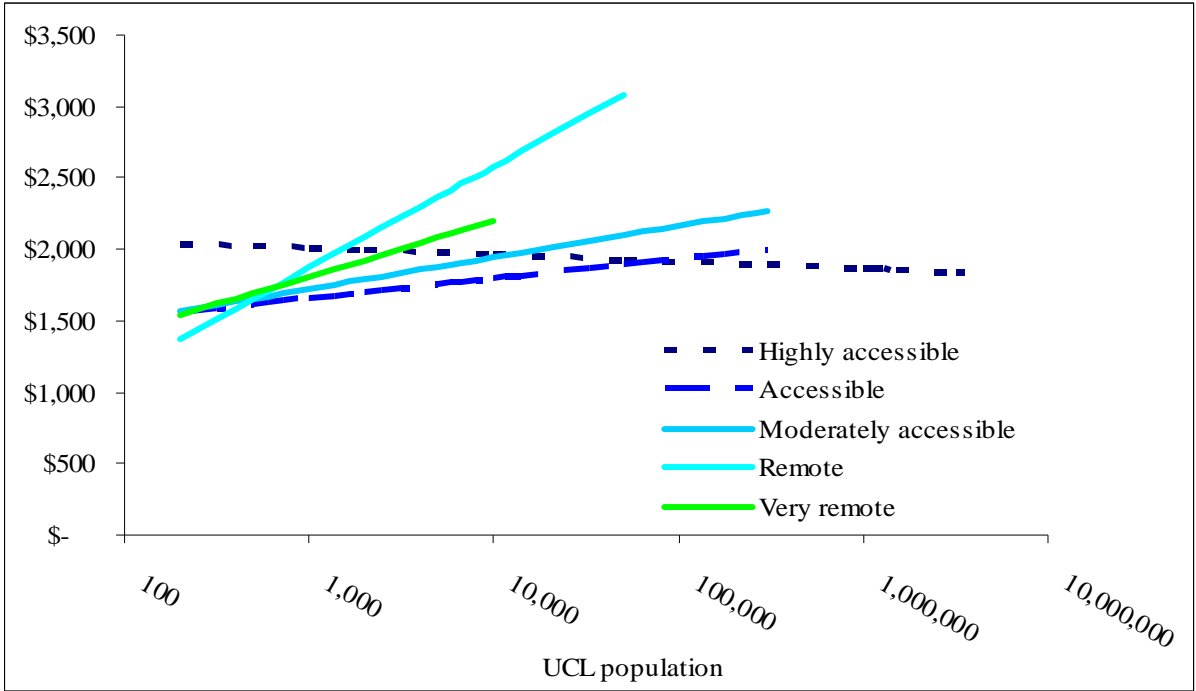
- Would States be able to provide locational costs by function to support a functional disaggregation of location costs?
- Is there a better disaggregation of cost drivers than labour and non-labour costs?

**Labour costs**

- 42 Labour costs represent around 70 per cent of total State government costs, and there is significant evidence that labour costs vary between regions.
- 43 While labour costs can, ideally, be measured using a single indicator, it is worthwhile identifying the elements of labour cost that are to be measured by a single indicator. In different locations, State governments may vary:
- the number of staff;
  - the skill level, or occupational mix of their staff; and
  - the salaries and allowances paid to staff.

- 44 While the impact of location on wages may vary between categories, we are looking for a measure of locational impact on labour costs that can be applied across all categories.
- 45 Census data could be used to measure the impact of location on the total wages bill. The Census can provide data on the number of State government employees in different regions, and their average income. The total wage bill per capita in different regions of the State can be measured by combining the number of employees and their average income (price). The price component reflects both differences in the quality of staff (occupation or experience levels) and the cost for a given quality of staff.
- 46 Figure 1 shows the total State public sector wage bill per capita in different regions. It shows:
- larger centres tend to have higher public service labour costs than smaller centres. This is probably because the range of services, and the expertise required for those services tend to be higher in larger centres; and
  - highly accessible, remote and very remote areas tend to have higher costs than accessible and moderately accessible areas.
- 47 Although costs are slightly higher in highly accessible areas, they apply to a much bigger population. The higher costs in remote and very remote areas apply to a much smaller population. It is not clear which has the bigger impact on total costs.
- 48 Staff have not established whether the higher wages per capita in remote and very remote areas are due to higher staffing levels (perhaps in response to higher levels of use per capita by Indigenous people and people of low socio-economic status) or higher average salaries associated with providing services in these areas.

**Figure 1 State public sector wages per capita**



- 49 Individual functions may exhibit a different relationship between location and cost to that found in aggregate. For example, labour costs in education are higher in small towns and lower in large towns, presumably reflecting service delivery scale drivers. For health, larger towns have higher costs, presumably reflecting a greater range and complexity of health facilities in larger centres. The analysis presented above is in aggregate and it relates to all State services. Staff consider that applying an average location impact across all services is a legitimate approach, which could lead to a simple, reliable measure of the locational labour disabilities.

*Interstate differences in wage levels*

- 50 The previous analysis of labour costs focused on the intrastate differences in labour costs. However interstate differences in economic conditions may mean that wage levels are generally higher in one State than another.
- 51 Staff propose to measure interstate differences in wages using a regression model based on data from the Survey of Employee Earnings, Benefits and Trade Union Membership (EEBTUM). Staff intend to assess private sector wage differentials in a similar way to the current input costs approach, which uses the Survey of Education and Training (SET). This approach assumes private sector wage differentials also apply to public sector wages.

**Questions for States:**

- Is the analysis of labour cost differentials using Census data appropriate?
- Will a regression model using EEBTUM data capture non-policy differences in public sector wages by State?

**Non-labour Costs**

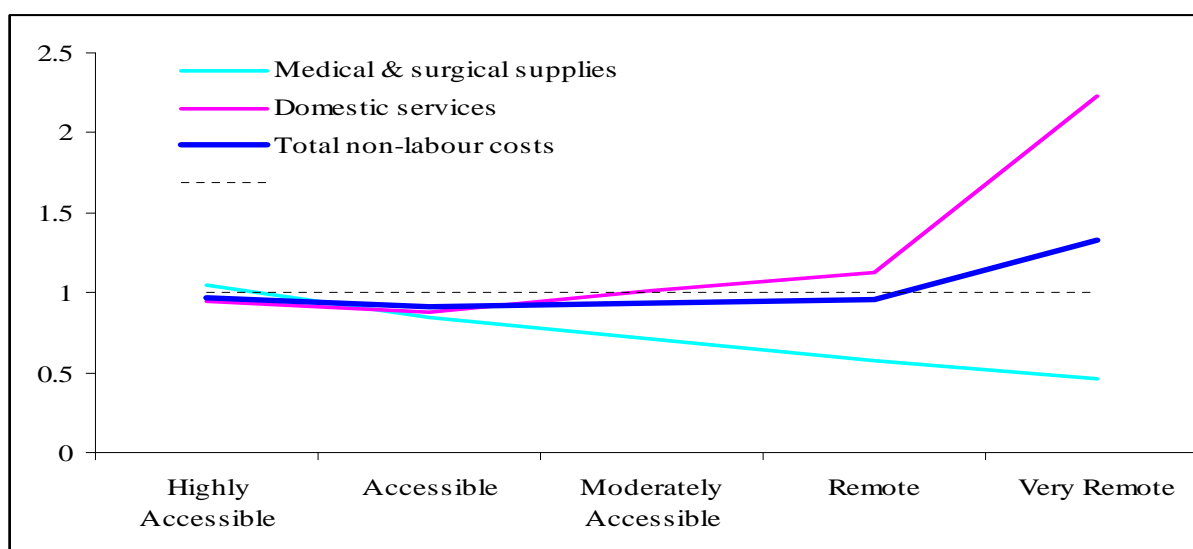
- 52 The conceptual case for non-labour costs is based on the additional cost of transporting goods and people from centres of supply — which tend to be located in larger cities — to remote locations.
- 53 There are empirical data that suggest location has an influence on non-labour costs. Non-labour costs per separation for very remote hospitals are 40 per cent higher than average. The price of petrol is generally higher in smaller centres and in more remote areas. This may indicate that economies of scale, the extent of competition, and the costs of freight influence the private sector cost structures in different locations. To the extent that State governments source goods and services from local private sector businesses, they are also likely to face higher non-labour costs in small centres and remote areas.
- 54 Much of the data which provides evidence of the impact of location on non-labour costs also provides a potential indication of the size of that impact in different areas.
- 55 A number of possible measures of the impact of location on non-labour costs have been identified but have not yet been fully investigated. If some of these measures are found to be fit

for purpose, the broad indicator of non-labour costs would be based on the measure that most closely reflects the pressures faced by State governments.

### *Hospital costs*

56 Some non-labour hospital costs (such as domestic services) are higher in very remote areas. Other costs (such as medical and surgical supplies) are higher in highly accessible areas. If we are to use hospital data as the basis of a non-labour cost assessment, we would need to identify which specific hospital costs broadly capture the general impact of location on non-labour costs.

**Figure 2 Hospital sector: relative labour and non-labour costs per DRG<sup>(a)</sup> weighted separation, 2003-04**



Source: AIHW Health Establishments Collection.

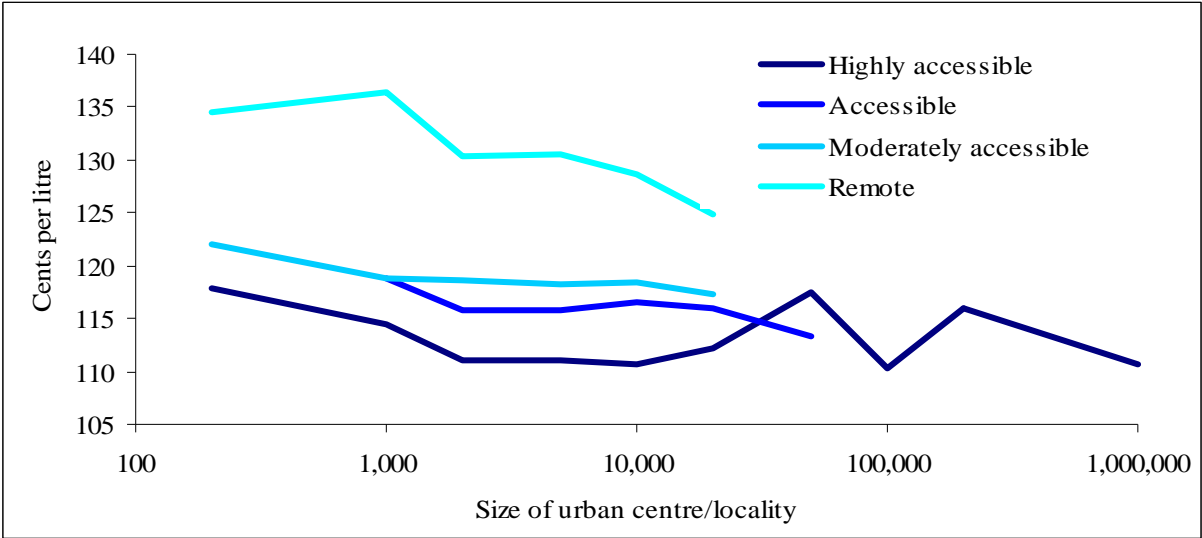
(a) Diagnostic Related Group weighted separations standardises for complexity of a treatment as measured by its total cost.

### *Petrol prices*

57 The cost of a litre of petrol varies considerably across the country. More remote areas and smaller towns tend to have higher petrol prices. Higher prices may reflect:

- the cost of freight.
- lower turnover in country areas leads to higher margins; and
- lower competition in country areas.

**Figure 3** Average Shell petrol prices, 6-8 February 2007 by SARIA by size of urban centre

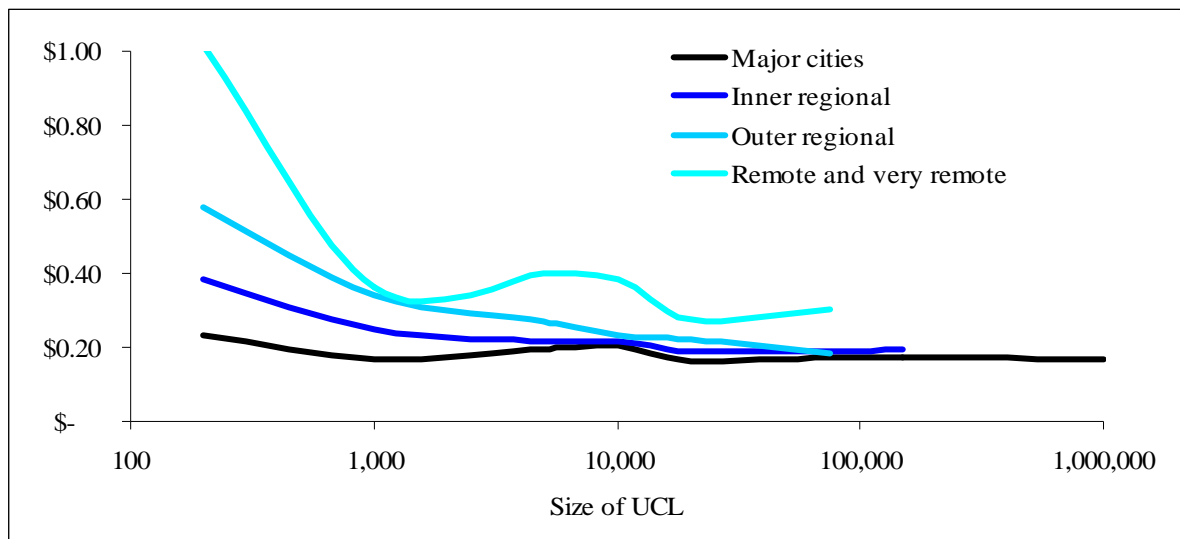


58 The drivers of differences in petrol price are also likely to be the drivers of differences in the non-labour cost of public sector services. Further investigation is required to reveal whether the importance of these drivers differs between petrol prices and public sector costs, and whether there are drivers that affect public sector costs that do not affect petrol prices. However it is possible that differences in petrol prices broadly capture the general impact of location on non-labour costs.

*Census collection costs*

- 59 The Commission has obtained data on the cost of undertaking the field operations of the 2006 Census. These data show labour and non-labour costs varied between collection districts. The non-labour costs could be used as a measure of non-labour locational disabilities.
- 60 These data appear to be comparable across the country, as the timing, size of the task and other aspects of the collection are comparable across regions, and between States. Staff are investigating whether the influences impacting on the cost of undertaking census field operations are comparable to those impacting on the delivery of State type services.
- 61 These data warrant further investigation.

**Figure 4 Non-labour costs of census field operations per person enumerated**



*An alternative approach*

62 If none of the above measures of non-labour cost prove to be practical, an alternative would be to use the measures of labour cost explored earlier in this paper. That is, we would apply them to total costs – both labour and non-labour.

*Conclusions*

63 All of these indicators show a broadly comparable pattern: one of higher non-labour costs in remote areas and in smaller centres. There is little evidence of higher non-labour costs in large cities.

64 Staff do not yet have a firm view on which measure of non-labour costs is preferable, and intend to further explore those that have been presented above. Staff consider hospital costs and petrol prices show the most promise.

65 In comparing the disaggregated approach with the alternatives, it is important to note that while it is largely data driven, some judgment will be required, not only in the selection of indicators, but also in the classification of urban centres and other areas.

**Questions for States**

- Do any of the identified indicators have the potential to be a broad measure of non-labour costs?
- Do States have any comments on the options?
- Are there other indicators which should be considered as potential broad measures non-labour costs?
- If a broad measure of non-labour costs cannot be found, how should the Commission proceed?

## **APPLYING THE LOCATION ASSESSMENT TO CATEGORIES**

### **Which categories will have a location assessment?**

- 66 Location affects costs in a variety of ways. Some influences such as locality allowances and freight costs are likely to apply to a wide range of expense categories. The location assessment is designed to reflect the generic impact of location on cost across relevant expense categories. As such it will be applied in expense categories, unless there is a conceptual case for excluding it.
- 67 Admitted patients has an explicit location assessment incorporated into it. This is necessary because many people do not receive services in the area in which they live. The relationship between where people live, where services are delivered and the cost structure of service delivery in different regions are key parts of the assessment. The generic location disability will not be applied in full in this category, because to do so would double count. However, some elements of the generic assessment may be required.
- 68 The two transport categories are fundamentally derived by measuring location. Location differences in the need for and costs of Roads and Public Transport services are to be incorporated within those assessments. So the generic location disability factors would not be applied in those categories.
- 69 Investigations of Justice Services cost drivers have found no evidence of either service delivery scale or urban influences. However, staff have yet to conclude that location has no influence on this category. It is not yet clear whether a location assessment will be incorporated into the Justice Services category.

### **How will the generic assessment be applied?**

- 70 The generic location assessment is expected to include a number of elements, including:
- differences in total wages across regions (incorporating differences in staffing level; occupation mix; and wage levels);
  - differences in wage levels between States; and
  - differences in non-labour costs
- 71 Each element will be identifiable within the location disability. Some categories, may incorporate some elements but not others. Different weights could be applied to the labour and non-labour elements in different categories depending on the extent to which the service is labour intensive.
- 72 Differences in total wages per capita by region can be used to construct a cost weight for different regions of the country (for example, remote). A regional (labour) State factor would be constructed by applying these weights to State populations within those regions. Differences in wage levels between States can be used to construct a State specific (labour) factor, which would be combined with its regional factor. The combined labour factor would be weighted to reflect the proportion of labour costs within a category.

- 73 Differences in non-labour costs per capita can be used to construct a non-labour factor in the same way as the regional labour factor above. The non-labour cost factor would be weighted to reflect the proportion of relevant non-labour costs within a category.
- 74 As noted earlier, the Admitted patients assessment will incorporate regional labour and non-labour differences. So, to avoid double counting the wages of State government employees working in hospitals should not be included in the construction of the regional State factors. A similar concern may arise in relation to other categories.

### **ISSUES YET TO RESOLVE**

- 75 This assessment is not yet finalised. There are a range of issues that still need to be resolved, including:
- 76 State public services are overwhelmingly provided in urban centres and localities (UCLs). The approaches described in this paper are based on assessing cost differences for different sized UCLs. Staff have not yet considered how to treat populations who live in the rural balance outside of UCLs.
- 77 The higher costs per capita in remote areas may be driven by higher use rates rather than locational impacts. These higher use rates may be due to a greater proportion of people who use State services at higher than average rates (for example, Indigenous people, people from low socio-economic backgrounds). As the individual category assessments would ordinarily take higher use into account, it will be important to ensure that it is not double counted in the location assessment. We have not yet determined how this will be achieved.