

**QUEENSLAND'S RESPONSE TO
COMMONWEALTH GRANTS COMMISSION ISSUES
PAPER 2006/02
“APPROACH TO DISAGGREGATION”**

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QUEENSLAND'S RESPONSE

1. Introduction

This paper presents Queensland's response to the Commission's approach to disaggregation outlined in its Issues Paper 2006/02.

2. Main points

Queensland broadly supports the Commission's proposed top-down approach to determine an appropriate level of disaggregation for categories to be used in the 2010 Review of Methodology.

The Commission has requested feedback about:

- *aspects of the conceptual approach to disaggregation and the processes through which that approach might be implemented;*
- *how major aggregates of revenue and expenses might be disaggregated to best assess fiscal capacities; and*
- *the interactive approach and timetable for developing the structure.*

In response, Queensland:

- broadly supports the Commission's proposed top down approach to determining appropriate levels of disaggregation – subject to concerns outlined below;
- supports the Commission's proposed category based approach to assessments;
- supports the creation of expense categories based on a functional or purpose basis, and the use of Australian Bureau of Statistics Government Finance Statistics (GFS) as the primary data source;
- supports the creation of revenue categories based on a tax type basis, and, subject to data quality and comparability being resolved, the use of data collected directly from States; and
- supports the proposed timetable.

However, Queensland is concerned about some differences between the thresholds presented to the Ministerial Council and the approach proposed in Issues Paper 2006/02.

Specifically, in the report tabled at Ministerial Council in March 2006, the Commission proposes to apply materiality thresholds as follows:

- a category will be considered for inclusion in the assessments if it is expected to:
 - contain average revenue or expenses that are greater than \$50 per capita; or
 - redistribute more than \$30 per capita for any State;
- a disability assessment will be included in the calculation of relativities if it redistributes more than \$10 per capita for any State in the reference period. Where a disability

- influences more than one category the materiality threshold will be applied to the total impact it has on the redistribution of funds;
- an adjustment to data aimed at improving their interstate comparability should redistribute more than \$3 per capita for any State in the reference period; and
 - once assessments have been made, the category level redistribution threshold of \$30 per capita would be reapplied. Any preliminary categories that did not pass it would either remain part of an aggregated category that has similar, often broader, disabilities or be assessed on an equal per capita basis.

To keep the thresholds up-to-date, we will index the values for movements in price levels up to the time when final decisions are made for the 2010 Review.

However, in the discussion about the application of materiality thresholds outlined in Discussion Paper 2006/02, the Commission seeks states' feedback about:

- the proposed \$30 per capita threshold for determining when a disaggregated assessment is materially different from the more aggregated one.

Queensland has significant concerns about the proposal outlined in Discussion Paper 2006/02 to use a \$30 per capita test to determine if there are material differences between different levels of aggregation, rather than the simple application of the \$30 per capita threshold test at a single level of disaggregation, along with the \$50 per capita threshold test, as outlined in the update report to Ministerial Council.

If this is what the Commission is proposing to do, then Queensland believes more discussion is required to explain the reasons for the apparent change from the approach the Commission tabled at Ministerial Council. If the Commission is not taking a different approach, it would be highly desirable to amend the information paper to reiterate that there are two thresholds for categories, namely the \$50 materiality test, and the \$30 redistribution test.

Queensland does however support the following elements of the proposed approach to disaggregation:

- commencing the disaggregation of expenses from three of the Commission's proposed four blocks of education, health, law and order services, with the proposed "other" services category split further because of its size and relative importance;
- the need for a disaggregated category to have:
 - ✓ a strong conceptual basis;
 - ✓ with material differences (as measured using the materiality thresholds); and
 - ✓ reliable data, or if required, the Commission's judgement to make assessments.

3. Disaggregation in Context

The Commission has requested feedback about its intentions to:

- *continue to adopt a category approach to its assessments;*
- *construct expense categories on a functional or purpose basis using the ABS GFS collection as the prime data source; and*
- *construct revenue categories on a tax type basis using data collected direct from the States.*

In response, Queensland:

- supports the Commission's proposal to adopt a category approach yet continue to provide an additional presentation of the results based on the disabilities;
- supports the Commission's proposals to base the expenditure and revenue category structures on the basis of functions and revenue streams identified in the Government Finance Statistics Framework. Queensland also supports the use of GFS data as the main source of revenue and expense data for its assessments. Despite some limitations, this would appear to be the only credible source of comparative and comprehensive state revenue and expense data; and
- recognises that there are timing problems with the availability of latest year data. One option to resolve this issue, subject to agreement amongst the relevant parties, is for the Commission to request the latest year data directly from the States rather than wait to receive them from the ABS. This may result in operational efficiency gains and better quality data than the current processes.

Queensland broadly supports the proposed category structure guidelines, as presented to the Ministerial Council in March 2006 and discussed and agreed to by states, and the Commission's use of them in determining the category structure for the 2010 Methodology Review.

Queensland broadly supports the Commission's view that the outcome of the top down approach should reflect the minimum disaggregation that is consistent with achieving equalisation. However, Queensland considers that equalisation can best be achieved by examining the disaggregation of categories to the next level before deciding the most appropriate level of disaggregation. That is, the Commission should continue disaggregation until doing so would not materially improve the equalisation outcome.

3.1 Category versus disability approach (paras 13-16)

Queensland considers that there are merits to both the category and disability approaches, and recognises that the disability approach has the advantage of focussing attention directly on the fundamental differences between jurisdictions.

However, it is not clear if the disability approach would provide an intuitively satisfactory explanation of the Commission's work for some users, and could reduce the transparency of the Commission's processes.

Regardless of the merits of a disability approach, Queensland considers that the Terms of Reference for the 2010 Review reflect an expectation that the Commission will use a category-based approach.

3.2 Scope of state activities (para 21)

Queensland considers that the scope of the equalisation budget should encompass all activities which have a direct impact on the operating statement of the State general government sector. Queensland's response to Issues Paper CGC 2006/03, *Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation* will address this issue in more detail.

However, an implication for the development of assessment categories is that it may be necessary to have both “Other Revenue” and “Other Expense” categories, which may not meet either of the proposed materiality thresholds. It is not clear if this will be an outcome, but it is possible, and Queensland supports including these categories in the new standard budget – at least until all stakeholders have had the opportunity to carefully consider this issue.

3.3 Broader indicators- (paras 23-27)

Queensland acknowledges that a relationship exists between the level of an assessment category and the data used in undertaking that assessment.

Until the actual assessment categories are determined and agreed it will be difficult to draw any firm conclusions about the appropriate level of indicator data to use. The process may well prove to be iterative, as the Commission seeks to get the ‘best fit’ between category structure and data. A focused discussion of this issue is likely to occur in the process of disaggregating the assessment categories.

4. How Disaggregation might work in Practice

The Commission has requested feedback on:

- *the general approach the Commission envisages to follow in considering the appropriate category structure; and*
- *the proposed \$30 per capita threshold for determining when a disaggregated assessment is materially different from the more aggregated one.*

In response, Queensland:

- supports the broad approach outlined by the Commission, recognising that it is likely to be iterative, involving consideration of a number of factors, including:
 - ✓ ‘best fit’ between categories and indicator data
 - ✓ the ability to assess known disabilities within new categories, and
 - ✓ coherence of categories ie. that they reflect logical groupings of activities.
- has specific concerns with the proposals put forward so far, including:
 - ✓ the use of a \$30 threshold as the basis for determining if there is a material difference between levels of disaggregation, and
 - ✓ lack of clarity about the treatment of material disabilities.

4.1 Use of thresholds for defining categories

Queensland’s understanding of the category structure guidelines, at Attachment A of the Issues Paper, is that assessment categories “will be considered material if ... the average expense or revenue is greater than \$50 per capita; **or** the assessment is likely to redistribute more than \$30 per capita for any State”. These guidelines are consistent with the guidelines presented to the Ministerial Council in March 2006.

However, paragraphs 34 and 36 of the paper only refer to the guideline of \$50 per capita average revenues or expenses when defining the level of disaggregation. With the exception of the Attachment, the whole paper, including these two paragraphs have omitted the use of the category materiality threshold of a redistribution of \$30 per capita for any state.

Queensland requests the Commission confirms that it intends to establish its categories on the basis identified in the category structure guidelines, or identify why the guidelines presented to the Ministerial Council in March 2006, and agreed by states, will not be followed.

4.2 The use of a \$30 per capita threshold for determining if there are material differences between levels of disaggregation (para 32)

The Commission has not previously proposed a criterion to use to determine whether the redistribution differences between different levels of disaggregation would be considered to be material.

In theory, if a broad category is disaggregated into smaller categories the sum of the redistributions at the disaggregated level should be similar to the redistribution at the higher level. Queensland's view is that the proposed threshold difference of up to \$30 per capita would be a sign that significant conceptual, methodological, or data differences existed between the two levels.

In addition, it is not clear how the proposed \$30 difference test would be applied in practice, nor how it would interact with the Category Structure Guidelines in Attachment A.

A more appropriate test for the redistribution difference for any state might be \$10 per capita, on the basis that this is the currently agreed materiality threshold for disabilities.

Queensland could accept that different levels of disaggregation can be regarded as broadly equivalent if the difference between them is less than \$10 per capita for any state. However, in the case of larger differences, a thorough investigation of the reasons for the differences would need to be undertaken before a decision could be made on the most appropriate level of disaggregation.

4.3 Lack of clarity about the treatment of material disabilities.

The disaggregation paper does not make any reference to the previously agreed \$10 disability materiality threshold. The scope of the standard budget and the category structures are the means to assess disabilities. There is a real risk that material disabilities, currently recognised by the Commission, may not be assessed as a result of the top down approach to creating categories.

Queensland would like to see some assurance that the Commission intends to continue to assess disabilities which currently exceed the threshold of \$10 per capita in any state. It is not clear how the \$10 per capita threshold for disabilities is intended to apply in the new aggregated structure.

5. Expense Assessments

The Commission has requested preliminary views from States on:

- *the logic of its proposed approach to disaggregation;*
- *the proposal to commence the disaggregation of expenses with the four blocks of education, health, law and order and other services; and*
- *potential disaggregations of each block, together with a rationale for those suggestions.*

In response, Queensland:

- broadly supports the Commission’s proposed approach to disaggregation;
- supports three of the four “blocks” proposed by the Commission for the commencement of disaggregation of expenses (see discussion below); and
- broadly supports the proposed disaggregation of blocks, but subject to comments made above in relation to how thresholds are applied.

5.1 *The starting point for disaggregation (paras 39-44)*

The Commission suggested four broad category groups as a starting point. Education, health, and law and order are reasonable for three of the broad category groups. In the current category structure these comprise 16 categories and account for 55% of state expenditure. However, the fourth broad category of “other” accounts for 24 categories and 45% of state expenditures. It is also a mixture of social and economic services.

Because of the size and relative importance of the Commission’s proposed “other” category, Queensland proposes that it be split further into three categories as shown in the table below. In this table, the education, health, and law and order groups are the same as those proposed by the CGC. The remaining three are essentially a first level disaggregation of the Commission’s proposed “other” group.

	No. of existing categories	Expense	
		\$pc	%
Education	8	1,294.93	22.63
Health	3	1,329.26	23.23
Law and Order	4	544.62	9.52
Community and Welfare	8	661.07	11.55
COPs and Services to Industry	8	501.95	8.77
Other services	8	1,389.46	24.29

The community and welfare group comprises the remaining social services categories which include three welfare categories, housing, first home owners scheme, services to indigenous communities, culture and recreation, and national parks and wildlife.

The concessions and other payments (COPs), and services to industry group includes the four COPs categories (including urban transit and non-urban transport) and the four services to industry categories.

The remaining eight categories (including roads) could then be grouped into a relatively smaller "Other Services" group.

The Commission could consider creating a category called "Other Expense", which could include those expenditures which are currently treated equal per capita.

Below are some broad ideas on disaggregation the Commission may wish to explore. These are put forward as options for consideration and are not necessarily Queensland's preferred position.

5.2 Options for disaggregation - Education

Queensland suggests the Commission explores the disaggregation of the education group into the following 4 broad categories:

- Pre schools, government primary and secondary;
- Non-government primary and secondary;
- Vocational and educational training; and
- Transport of rural school children.

As higher education expenditure is currently treated equal per capita it could be included in the newly created Other Expenses category.

5.3 Options for disaggregation - Health

Health is currently disaggregated into three categories which should arguably be maintained on the basis of materiality.

5.4 Options for disaggregation - Law and Order

It is very likely the current four categories will be continue to be needed owing to their diversity of services provided and their materiality.

5.5 Options for disaggregation - Community and Welfare

A starting point for separate categories within this broad group could include:

- Welfare;
- Housing;
- Culture and recreation;
- National parks and wildlife; and
- Services to indigenous communities.

5.6 Options for disaggregation - Concessions and Other Payments, and Services to Industry

For this primary category the Commission may wish to explore disaggregation into sub-categories on the following lines:

- Regulation expenditure – includes regulation expenditure from 7 categories (all except urban transit);
- Economic development expenditure – includes economic development expenditure from 7 categories;
- Concessions – from electricity and gas, water etc and non-urban transport;
- General subsidies – from electricity and gas, water etc and non-urban transport; and
- Urban transit – continue to assess separately.

5.7 Options for disaggregation – Other services

This category includes some large, some small and very diverse sub-categories. Suggestions for further exploration include disaggregating this category into the following sub-categories:

- Roads;
- Superannuation;
- General public services;
- Depreciation; and
- Other expenditure (includes debt charges, GST administration costs, two subsidy categories and those noted above) which should be treated equal per capita similar to the “other revenue” category.

5.8 Drivers of expenditure

The main drivers of differences between states in relation to expenditure or costs include:

- socio-demographic composition;
- locational influences;
- scale related costs;
- input costs; and
- economic and physical environments.

Other indicators could be sought to better represent these broad cost drivers or, as the Commission suggests, broader indicators could be used to assess the demand for services. The Commission uses the example of using either a target population or the number of users to assess the demand for school usage. In this example a target population would be more appropriate as a policy neutral indicator because the number of users would largely reflect expressed demand only rather than total demand, and may be a function of state policy. However, while a target population represents a demand for school services it does not recognise many of the cost drivers identified above. As a result, other broader indicators should be included to better reflect the cost of providing the service.

One of the major problems pertaining to cost drivers and of course for the calculation of the disability factors is the quality and availability of appropriate and accurate data. This has

been highlighted not only by the Commission, but by the consultants engaged in the recent HFE review.

Data issues are prevalent for dispersion costs, input costs and many of the socio-demographic composition components. For example, the collation of dispersion related costs is difficult because state financial systems do not adequately identify such costs. A more transparent and simpler method based on population dispersion may better represent the underlying costs. However, population concentrations/densities per se would not be a good measure of so-called urban related costs. While there has been substantial evidence to support dispersion related costs, there has been very little evidence supporting urban related costs.

In summary, Queensland supports the Commission exploring the suitability of using broader measures of cost drivers.

6. Revenue Assessments (paras 58 – 66)

6.1 Revenue Category Structure

The possible disaggregation in the Issues Paper (para 61) identified broad groups based on economic rent or profits, wealth, income or wages, transactions or turnover. Queensland considers that disaggregating to these broad revenue groups would not adequately and reliably capture the main differences in the States' capacity to raise revenue from specific revenue sources. Further, the use of broad revenue groups would reduce the transparency of the Commission's processes, particularly for non-participants in the process, as the link between specific revenue streams and the broad groups are not likely to be intuitive.

Queensland considers that there are significant differences between the majority of the current revenue assessments, and does not see how these could satisfactorily be assessed within the four category structure proposed by the Commission.

Queensland proposes the following categories as being at a suitable level of disaggregation:

- Stamp duty on conveyances;
- Insurance taxation;
- Payroll tax;
- Land revenue;
- Gambling taxation;
- Vehicle registration fees and taxes;
- Stamp duty on motor vehicle registrations and transfers;
- Mining revenue; and
- Other revenue – includes all residual revenues and those currently treated equal per capita including contributions by trading enterprises.

Conclusion

Queensland supports the broad direction that the CGC is proposing for disaggregation but notes some concerns with the detail of the process, including the following key points:

- It is not clear why the Commission is not proposing to use the \$30 per capita distribution threshold for establishing categories, as well as the \$50 per capita revenue/expenditure threshold, as previously agreed,
- The justification for using a \$30 per capita test for evaluating the materiality of differences between different levels of disaggregation is not clear, and it is higher than expected,
- It is not clear that there is a process for ensuring that material disabilities (greater than \$10 per capita for any state) will be assessed,
- More work needs to be done on developing options for expenditure disaggregation, and
- The proposed revenue disaggregation is at too high a level to be practical.