

COMMONWEALTH GRANTS COMMISSION

2010 REVIEW

APPROACH TO DISAGGREGATION – NEW SOUTH WALES SUBMISSION

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Executive Summary

Australia has the most complex system among federations for allocating transfers between the central government and the state governments. The 2010 Review's terms of reference require this system to be simplified.

Aggregation is an important element of simplifying the assessment structure, and maintaining a simpler structure over time.

New South Wales supports a top down approach to disaggregation, reflecting the application of materiality thresholds and reliability guidelines.

This more aggregated approach lends itself to the use of broader indicators than the current highly disaggregated approach, in both expenditure and revenue assessments.

A more aggregated approach, using broader indicators, should reduce data intensiveness and ensure greater reliance on higher quality data.

The approach to disaggregation is strongly influenced by the definition of equalisation. Clearly, any change to the principle of equalisation and its implementation will need to be reflected in the assessment structure.

Background

The Grants Commission's assessment framework provides the structure for the calculation of relativities. The current structure is highly complex, non-transparent and data intensive.

New South Wales commissioned an independent review by Associate Professor Neil Warren of the University of New South Wales comparing and benchmarking Australian and international arrangements for the allocation of taxation powers and expenditure responsibilities between central and subnational governments, and mechanisms for fiscal transfers between governments.¹

¹ Warren, N, "Benchmarking Australia's Intergovernmental Fiscal Arrangements", Interim Report, 23 March 2006.

This report highlighted the need for reform of the current system of transfers between the central government and the states.

Warren found that, “In relation to domestic and international arrangements for transfers from national to subnational governments, Australia’s transfer system, characterised by horizontal fiscal equalisation, is arguably the most complex of any federation. Equalisation in Australia is applied to both expenditures and revenues whereas most other federations equalise only revenues. It would appear that other federations acknowledge more fully than does Australia a likely trade-off between the inter-jurisdictional equity benchmark and achievement of other benchmarks such as efficiency, transparency and simplicity. Australia appears to practice a much more extensive equalisation system than other federations, pursuing a goal of absolute equality for States. Furthermore, there is no objective benchmark to assess whether Australia achieves interstate equity.”²

Warren also stated, “Simple transfer mechanisms and allocation formulae lead to transparency of outcomes and ease of administration. This is not simplicity for simplicity’s sake. Complexity in the grants allocation methodology can be justified if it leads to efficient outcomes. However, there is no evidence that the great complexity and the data-intensive requirement of the CGC methodology are justified by the reliability of its outcomes.

Equalisation in Australia is applied to both expenditures and revenues. This involves around 40 categories of State expenditure with many factors applied to each, resulting in Australia having some 359 expense factor assessments. In the case of tax capacity, 37 revenue component assessments form the basis of the revenue capacity calculations in the assessment. Australia has arguably the most complex transfer mechanism of any federation.”³

The Grants Commission’s terms of reference for the 2010 review recognise the need to simplify the current assessment structure, including by:

- Aggregating existing assessment categories;
- Eliminating unreliable category assessments;
- Applying a materiality threshold to assessments; and
- Reviewing the scope for the use of broader indicators.

Materiality Thresholds and Reliability Guidelines

The Grants Commission has adopted a series of materiality thresholds and reliability guidelines as a result of its considerations in 2005. New South Wales broadly supports these principles.⁴

² *Ibid*, page 5.

³ *Ibid*, page 17.

⁴ Commonwealth Grants Commission, 2010 Review of State Revenue Sharing Relativities, Progress Report to Ministerial Council for Commonwealth-State Financial Relations, March 2006, Chapter 5.

The interim assessment guidelines state that for an expense or revenue item, a separate assessment category will be considered only if:

- the function is clearly a major one and is distinct from other functions;
- the function is affected by disabilities that are markedly different from the disabilities that affect functions in other categories;
- data to estimate the size of the function are satisfactory;
- satisfactory assessments of disabilities can be made; and
- the category satisfies the materiality thresholds (\$50 per capita category size or \$30 per capita category redistribution).

Concerning assessment of disabilities within categories, the guidelines state that a disability will be included only if:

- a sound conceptual basis for the disability exists;
- there is sufficient empirical evidence of differential impacts on States;
- the assessment method is reliable and conceptually rigorous;
- the disability can be measured satisfactorily;
- suitable quality data are available; and
- the disability satisfies the materiality threshold (\$10 per capita disability redistribution).

The Commission proposes to define a reliable method as one which is:

- conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral);
- implementable (the disability can be measured satisfactorily); and
- where used, consistent with external review outcomes.

The requirements in the interim assessment guidelines appear to provide strong tests. It is important to ensure they are not watered down in the process of applying the guidelines in practice.

Data Issues

The interim assessment guidelines identify the data quality issues that need to be addressed if a separate assessment category is to be established or if a disability is to be included in a category.

However, while the Grants Commission proposes to document its evaluation of the data, the guidelines also permit the use of some data that are of less than high quality.

New South Wales remains concerned at the prospect of poorer quality data being used in any assessment. Consistent with the terms of reference, assessments which are unreliable because of unsatisfactory data should be eliminated.

Approach to Disaggregation

New South Wales supports the proposed top-down approach to the structure of assessments. This approach should apply to categories, disabilities and the use of broader indicators.

Of these, the Grants Commission's issues paper (2006/02) deals mostly with the top-down approach proposed for assessment categories, though it also begins to canvass the issue of using broader indicators.

The progress report to the Treasurers' Conference and Issues Paper CGC 2006/02 tend to skip over an analysis of the nature of disabilities and the relevance of disability factors, straight to the issue of deciding when a disability might be included in an assessment.

The initial presumption should be that only disability factors that reflect differences in the use of services should be assessed, because (net) unit costs and location may reflect State policies on user charges and service delivery modes.

For example, population location can be influenced by how and where government services are delivered, by the number of local government bodies established and how their boundaries are drawn and by the legal framework applied to the divisibility and transferability of capital assets.

Constructing Categories

New South Wales supports the category approach to structuring assessments, rather than the disability approach. The category approach is easier to understand conceptually and good quality data are more readily available.

This approach is also in line with New South Wales' view that the assessment of expenses should be limited to State governments' core economic and social functions, such as health, education and public safety.

New South Wales supports basing expense categories on functions as defined by the government purpose classifications used in government finance statistics.

New South Wales supports basing revenue categories on tax types. However, the top-down approach should be applied with a view to minimising disaggregation and using broader indicators.

Use of Broader Indicators

Determining an appropriate category structure is a critical step in achieving simplification, given the close links between the category structure adopted, the disability factors that drive interstate differences and the broad indicators used.

For the assessment of expenses, the broad indicators would generally be the population cohorts which most intensively use the relevant government services.

For services to industries, the relevant population cohort might be the working age population (18 – 64 years).

Disaggregation in Practice

New South Wales agrees that materiality thresholds should be strictly applied and that the onus of proof should rest with those making the case for more disaggregated categories, more disability factors and narrower indicators.

There is an issue of how frequently the category structure might vary.

In the Grants Commission's progress report to the Ministerial Council, the materiality thresholds are expressed to apply "in the reference period". This could indicate that the materiality thresholds may need to be re-tested in the course of annual data updates, giving rise to the possibility of annual changes to the category structure.

Frequent changes to the category structure should be avoided. This possibility is a further reason for minimising disaggregation and being cautious of establishing categories which only just meet the materiality thresholds.

The suggested process makes it likely that at least the conceptual case would be considered for assessments to be more disaggregated than the final category structure.

This could engender support for a more disaggregated structure and make it more difficult to revert to the more aggregated level.

New South Wales supports the general approach outlined. However, the Grants Commission will need to resist pressure to retain a more disaggregated category structure after analysis of the effect of further disaggregation has been undertaken.

Paragraph 32 of the issues paper proposes an additional materiality threshold. A category would not be disaggregated unless the redistribution using disaggregated assessments was different from the redistribution using the aggregated assessment by more than \$30 per capita for any one State. New South Wales supports this proposal.

Expense Assessments

New South Wales believes that expense assessments should be based on functional classifications, rather than type of expenses or service populations. This is more in line with data availability.

New South Wales agrees that education, health and public order and safety are appropriate aggregates.

A fourth aggregate comprised of welfare, social security and housing may also be appropriate. Housing services have welfare objectives. The people who use all these services are those with lower incomes. The average per capita expense is larger than for public order and safety.

A fifth aggregate comprised of transport and communications services, and services to specific industries, could also be considered.

Government finance statistics do not classify depreciation expense as a separate government purpose. Depreciation for schools is reported in education expense; depreciation for hospitals is reported in health expense, and so on. In most cases, the Grants Commission splits depreciation out from its expenditure category and constructs a separate depreciation category. It may be simpler to leave depreciation in the individual expense categories, as per the GFS approach.

If welfare and housing services expenses are dealt with as a separate block, economic affairs (including transport and communications services) are dealt with as a separate block, and the GFS approach to depreciation expenses is followed, then the five major blocks would account for more than 85 per cent of State expenses.

Remaining expenses would then fairly be described as residual, being mostly general public services and recreation and culture expenses.

Some residual expenses might be allocated to one or other of the five major blocks of services, if there is a good fit. For instance, it may be more appropriate to allocate government superannuation benefits expense to the relevant functional area of the employees concerned rather than to general public services. Otherwise, the residual expenses should be assessed as a group, without further disaggregation.

Case Study – Education

New South Wales agrees that the choice of category structure should minimise the differences between services within a category and maximise the differences between categories.

Conceptually, there may be a case to separate vocational education and training from school education.

If the education expense block was disaggregated, then the best fit would need to be found for the smaller expenses. It would not be appropriate to end up with an assessment category structure for expenses with several “miscellaneous” categories.

Pre-schools and transport of school students more closely resemble school education than vocational education and training. On the other hand, higher education more closely resembles vocational education and training than school education.

If vocational education and training was separated from school education, then the appropriate categories would be:

- pre-schools, schools and transport of all school students; and
- vocational education and training, and higher education.

Ultimately, the appropriate degree of disaggregation will be at least in part an empirical issue, reflecting the application of the materiality thresholds and reliability guidelines.

Other Categories

If the health expense block was disaggregated, then appropriate categories might be:

- acute care institutions (excluding outpatient services) and mental health institutions; and
- outpatient services, community health, aged and disabled services, and public health.

The distinction between these categories is that the former involves health services delivered in institutions and the latter involves distributed health services to some extent.

The public order and safety block could include:

- police, administration of justice, corrective services and public safety.

This may not need to be further disaggregated.

The welfare, social security and housing services block might include:

- housing, homeless and general welfare, family and child services, sanitation and protection of the environment, first home owners' scheme, water supply, electricity and gas, and services to indigenous communities.

This may not need to be further disaggregated.

If the economic affairs block was disaggregated, then appropriate categories might be:

- roads, urban transit, non-urban transport and subsidies for petroleum products; and
- primary industry, subsidies for alcohol products, mining, fuel and energy, tourism, manufacturing and other industry.

The distinction between these categories is that the former involves transport and the latter involves support for specific industries.

The residual block might then include:

- general public services, culture and recreation, national parks and wildlife services, GST administration costs and debt charges.

Depreciation and government superannuation benefits expenses would be allocated to their relevant functional expense area.

The residual block should not be disaggregated.

Revenue Assessments

Appropriate categories might be:

- land revenue, stamp duty on conveyances and stamp duty on mortgages;
- gambling taxation, insurance taxation and motor vehicle revenue;
- payroll tax;
- contributions by trading enterprises;

- mining revenue; and
- (residual) other financial transaction taxes, stamp duties on marketable securities and other revenue.

For land revenues, the broad indicator might be total factor income for the property and business services industries.

For mining revenue, the broad indicator might be total factor income for the mining industry.

For gambling, insurance and motor vehicle revenue, the broad indicator might be private household consumption expenditure.

For payroll tax, the broad indicator might be compensation of employees.

Conclusion

The terms of reference for the 2010 review require the Grants Commission to simplify its assessment structure by, *inter alia*, aggregating existing assessment categories.

The proposed top-down approach, combined with the application of the materiality thresholds and reliability guidelines, is in line with the terms of reference.

Five major blocks of services (health, education, public order and safety, welfare and housing, and economic affairs) would account for over 85 per cent of State expenses. The residual block would include general public services, and culture and recreation.

As acknowledged by the Grants Commission, the proposed approach is influenced by the equalisation principle and its interpretation. Any change to that principle will have implications for the assessment structure.

New South Wales notes that the Grants Commission intends to release discussion papers and then a final category structure proposal in May 2007. New South Wales reserves its right to respond to the specific category structure finally proposed.