



# **COMMONWEALTH GRANTS COMMISSION**

**DISCUSSION PAPER CGC 2002/11**

## **CAPITAL GRANTS**

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## ***Introduction***

1. This paper discusses the Commission's current treatment of capital grants in relation to the equalisation of the capacity of States to provide services. This issue was originally raised in *Discussion Paper GCG 2002/12 Scope and Structure of the Standard Budget* (November 2001) in which the Commission proposed to include relevant State receipts from Commonwealth capital grants in the scope of the equalisation budget. It was also raised by members of the capital working party in the context of the Depreciation assessment. The question was: is it fair to include in standardised depreciation needs for assets that were purchased with a capital grant?

2. The Commission believes that the treatment of capital grants in the assessment framework should reflect the fact that grants relieve recipient States of some of their expenditure needs. This paper discusses the relevant arguments and considers alternative approaches.

## ***The Current Treatment of Capital Grants***

3. In the 1999 Review, the Commission decided that it should equalise only the operating expenses of providing services (including expenses arising from the use of capital in their provision) and operating revenues. Ongoing depreciation expenses resulting from the use of capital in service provision and debt charges associated primarily with the acquisition of capital were within the scope of equalisation. Capital grants, which were regarded as capital revenue, were outside the scope.

4. In the Debt Charges assessment, the Commission recognised that States did not need to borrow and incur debt charges on assets purchased with capital grants.

5. The Depreciation assessment did not recognise that depreciation needs were reduced by capital grants. Depreciation needs were assessed in relation to all in-scope non-financial assets held by States on the assumption that assets are 'used up' in the provision of services and need to be replaced. This was assumed to be the case, regardless of the source of funds available to fund or replace the asset.

6. Thus the Commission recognised that capital grants reduced debt charges needs but not needs relating to the replacement of an asset (the principal).

## ***State Views***

7. The States' views relate to how capital grants should be treated — either as available to meet States needs in a similar way to recurrent SPPs or as reducing States' depreciation needs within the depreciation assessment.

8. ***New South Wales.*** New South Wales stated that assets purchased with capital grants should not be excluded from the depreciation base.

9. **Queensland.** Queensland said capital grants should be assessed on a case by case basis to determine if they should be treated by inclusion or exclusion. It noted that the various capital related assessments under consideration (especially for debt charges) have widely differing theoretical underpinnings. It expressed the view that the appropriate treatment for grants would depend in part on consistency with the theoretical rationale of the chosen assessment approach.

10. **Western Australia.** Western Australia argued that capital grants should receive similar treatment to recurrent grants (SPPs). It argued that treating all capital grants by exclusion would be inconsistent with fiscal equalisation unless the grants were distributed on fiscal equalisation grounds. Western Australia supported the inclusion of capital grants in the standard budget, seeing no conceptual reason for distinguishing between capital and recurrent grant revenues for equalisation purposes. It also considered this approach would be simpler.

11. **South Australia.** South Australia criticised the current approach for failing to recognise that capital grants relieve the State government of the principal cost of capital expenditure as well as interest costs. It proposed that the Commission deduct each State's actual per capita capital grants (treated by inclusion) from the depreciation standard, before applying each State's disability factor. South Australia argued that the Commission needed to consider carefully the proper treatment of various capital grants, including those received in the past, to ensure symmetry of treatment with depreciation. It wanted the Commission to be sure that, where exclusion was the appropriate treatment of a grant, the depreciation on assets funded by the grant subject to exclusion was also excluded from the standard Depreciation expense. It also wanted amortised expenditure of grants made before 1991-92 excluded from the depreciation standard because the general treatment in the past has been to treat capital grants by exclusion.

12. **Tasmania.** Tasmania argued that a capital grant should not affect a State's standardised depreciation. It was concerned about the proposed inclusion of all State receipts from capital grants in the scope of the equalisation budget. It argued that the Commonwealth often provided capital grants to a State to undertake a project that would not normally be considered a State function. Thus an assessment of whether or not a capital grant was included within the scope of equalisation should be made on the same basis as that used for recurrent SPPs.

13. **Northern Territory.** The Northern Territory discussed this issue in the context of holding costs. It opposed the netting off of capital grants on the grounds that:

- (i) the Commission assessed needs by reference to gross, rather than net, costs;
- (ii) each asset's funding source would need to be classified within the GFS; and
- (iii) deducting capital grant flows from the stock of non-financial assets would be misleading due to factors such as asset sales, natural disasters and depreciation.

### *Commission Views*

14. There are two issues to solve regarding the treatment of capital grants.

- (i) Should capital grants be within the scope of the equalisation budget?
- (ii) If included, should they be treated as SPP revenue available to meet needs, or as an offset to depreciation needs?

15. ***Should capital grants be within the scope of the equalisation budget?*** The Commission believes that capital grants should be within the scope of equalisation because:

- (i) since the introduction of accrual accounting, capital grants have been included as operating revenue in State government accounts and in ABS Government Finance Statistics and it would be desirable for the standard budget to reflect this practice; and
- (ii) capital grants are spent on functions for which needs are assessed.

16. Capital grants are available to meet needs assessed for depreciation. There is a timing difference between the receipt of the grant and the depreciation of the asset which has been purchased through the grant but a capital grant can be seen as reducing a State's depreciation needs. States do not exclude from their asset registers, or show as zero, the value of an asset purchased with a capital grant. Thus, the depreciation expense for the asset is included in the depreciation standard and it is against this standard that each State's needs for the depreciation of a standardised level of capital assets are assessed. However, as the State has received a grant for the asset, its depreciation needs have already been met by the grant. This should be recognised.

17. The current approach does not do this. Instead, those States that receive a higher per capita share of capital grants enjoy a benefit that is not presently recognised by the Commission.

18. A change is required which:

- (i) recognises that capital grants are operating revenues;
- (ii) recognises that capital grants relieve the State of the principal cost of capital expenditure as well as interest costs;
- (iii) treats capital grants consistently with recurrent SPPs;
- (iv) avoids, if possible, the use of a different assessment framework in the depreciation assessment; and
- (v) ensures that there is no double-counting of needs or needs met in the approach taken (for SPPs and in the Depreciation and Debt Charges assessments).

19. *How should capital grants be treated?* Because capital grants are no different from recurrent SPPs, the obvious way to treat them is the same way that other SPPs are treated. The Commission would decide those capital SPPs which should be within scope and which should be treated by inclusion or exclusion, using its usual methods. Under this approach, there would be no changes to the proposed Depreciation and Debt Charges assessments (see Discussion Papers 2002/25 and 2002/26).

20. South Australia proposed an alternative in the depreciation assessment. It argued that each State's capital grants treated by inclusion would be deducted from the depreciation standard before disability factors were applied to the adjusted standard for each State.

21. This is not the Commission's usual approach to inclusion. Under the traditional inclusion approach, needs are calculated for the expenditure resulting from the SPP, and the actual distribution of the SPP is subtracted from the State's total standardised needs. Under South Australia's proposal, needs would not be calculated for the expenditure resulting from the SPP. The approach would only achieve equalisation if the actual distribution of capital grants was similar to the Commission's assessment of needs for depreciation. This is unlikely to be the case in the future.

22. In comparing the merits of the different approaches, the Commission notes that South Australia's approach:

- (i) assumes that capital grants are distributed in a way that meets the needs of States;
- (ii) is not consistent with the Commission's treatment of SPPs or with the treatment of capital grants as operating revenue; and
- (i) adds complexity because it adds another layer to the depreciation assessment.

23. Of the two possibilities, the traditional approach to the treatment of SPPs is likely to be more appropriate. It meets the conceptual concerns about taking account of the source of funding when assessing depreciation needs, while minimising the practical difficulties and achieving symmetry with the Commission's approach to recurrent SPPs.

24. There are two implementation issues that would need to be pursued. They are:

- (i) whether it is appropriate to include the unadjusted value of the capital grants received in a particular year or whether an amortised historical series would be required to overcome any problems of volatility; and
- (ii) whether any adjustments will be required to the proposed Debt Charges assessment to avoid any double counting of needs already assumed to be met.

25. Table 1 shows that there is indeed some volatility in capital grants received by the States. However, the use of five year averaging in the relativities may provide sufficient smoothing. Deducting the full amount in the year it is paid would be the simplest approach. The Commission acknowledges that the amounts being deducted would not relate to the depreciation needs assessed because of the timing mis-match. But with capital grants averaging about \$2.5 billion and annual depreciation being about \$6 billion, this should not be a problem.

**Table 1** ACTUAL CAPITAL GRANTS DISTRIBUTION

|           | NSW     | Vic   | Qld   | WA    | SA    | Tas  | ACT  | NT    | Aust    |
|-----------|---------|-------|-------|-------|-------|------|------|-------|---------|
|           | \$m     | \$m   | \$m   | \$m   | \$m   | \$m  | \$m  | \$m   | \$m     |
| 1990-91   | 1 211.7 | 908.1 | 598.3 | 333.4 | 297.7 | 95.7 | 58.3 | 33.9  | 3 537.0 |
| 1991-92   | 903.3   | 725.5 | 589.5 | 360.8 | 229.2 | 80.5 | 34.6 | 84.3  | 3 007.6 |
| 1992-93   | 984.8   | 809.0 | 640.2 | 363.8 | 265.9 | 90.2 | 35.9 | 89.6  | 3 279.4 |
| 1993-94   | 889.8   | 584.6 | 389.9 | 272.1 | 201.1 | 67.3 | 37.7 | 78.1  | 2 520.6 |
| 1994-95   | 695.0   | 420.3 | 335.8 | 198.1 | 136.0 | 42.7 | 33.9 | 62.0  | 1 923.9 |
| 1995-96   | 984.7   | 547.2 | 523.0 | 262.7 | 201.3 | 91.1 | 35.8 | 89.7  | 2 735.6 |
| 1996-97   | 588.3   | 370.3 | 378.8 | 189.8 | 133.5 | 55.2 | 34.5 | 69.0  | 1 819.4 |
| 1997-98   | 871.6   | 473.7 | 583.6 | 253.0 | 240.2 | 84.0 | 33.5 | 150.2 | 2 689.7 |
| 1998-99   | 735.8   | 423.5 | 411.9 | 208.6 | 194.8 | 71.3 | 33.1 | 47.0  | 2 126.1 |
| 1999-2000 | 719.3   | 428.0 | 463.7 | 180.7 | 179.5 | 75.1 | 50.9 | 51.3  | 2 148.4 |
| 2000-2001 | 792.2   | 419.6 | 590.1 | 230.2 | 158.5 | 92.2 | 34.1 | 67.4  | 2 384.1 |

Source: Commonwealth Budget Papers.

26. It appears that there would not be any double counting of needs or needs meet if the Commission:

- (i) treated capital SPPs by inclusion;
- (ii) ignored them in the Depreciation assessment; but
- (iii) continued to deduct them from capital expenditure in the calculation of the 'quantity of debt required' factor in the Debt Charges assessment.

27. This approach is relevant to our assessments in two ways:

- (i) by recognising that above (or below) average per capita receipts are available to fund (or add to) other needs; and
- (ii) by reducing the amount of borrowing (and thus debt charges) that is required.

### ***Conclusion***

28. At this stage, the Commission would prefer to treat capital SPPs in the same way as it treats recurrent SPPs because:

- (i) it is consistent with fiscal equalisation; and
- (ii) it does not complicate the depreciation assessment further.

29. States are invited to comment further on this proposal.