



DEPARTMENT OF TREASURY

Mr John Spasojevic  
Secretary  
Commonwealth Grants Commission  
Cypress Court  
5 Torrens Street  
CANBERRA ACT 2612

Dear Mr Spasojevic

**ACT SUBMISSION ON APPROACH TO DISAGGREGATION**

Thank you for the opportunity to provide a submission to the Commonwealth Grants Commission's Issues Paper CGC 2006/02 *'Approach to Disaggregation'*.

The enclosed submission outlines the ACT's conceptual views on how the Commission might approach the 2010 Review objective of greater simplification and transparency in the calculation of the annual update relativity through aggregating categories and removing unreliable data sets.

At this point the ACT does not support rigid application of thresholds until the category framework is more advanced.

If you or your officers have any questions regarding the attached response, please contact Mr Roger Broughton Executive Director, Investments and Economics Division (telephone 6207 6082) in the first instance.

Yours sincerely

Roger Broughton  
Executive Director, Investment and Economics Division  
May 2006



# **AUSTRALIAN CAPITAL TERRITORY**

## **SUBMISSION TO THE COMMONWEALTH GRANTS COMMISSION'S ISSUES PAPER 2006/02: *APPROACH TO DISAGGREGATION***

**May 2006**



## BACKGROUND

The Commission's issues paper 2006/02 builds on the Progress Report to the 2006 Ministerial Council for Commonwealth-State Relations. In that report the Commission states that its strategy for the 2010 Review is based on a commitment to the interpretation of the equalisation principle which includes, *inter alia*:

- starting with a clean slate approach when it comes to assessment methods;
- adopting a top-down approach, whereby revenue or expenses would be disaggregated only where appropriate;
- establishing new assessment guidelines with stronger reliability and materiality criteria; and
- introducing new assessment methods as a package.

The paper illustrates the Commission's suggested approach to deciding the category structure or framework, based on the adoption of a top-down approach to the disaggregation of State revenues and expenses to derive a new assessment for the 2010 Review.

The paper specifically canvasses comments from States and Territories in the following areas:

- The conceptual approach the Commission envisages to follow in considering the appropriate category structure, including:
  - how major aggregates of revenue and expenses might be disaggregated to best assess fiscal capacities.
- the proposal to continue to adopt a category approach to its assessments;
- the construction of broader expense categories on a functional or purpose basis using the ABS GFS collection as the prime data source;
- The construction of broader revenue categories on a tax type basis using data collected direct from the States; and
- The proposed \$30 per capita materiality threshold for determining when a disaggregated assessment is materially different from the more aggregated one.

The ACT's comments have been structured accordingly.

## DISAGGREGATION AS A CONCEPT

The ACT agrees with endeavours to simplify the annual relativity calculation through aggregating existing assessment categories, components and factors, as well as eliminating unreliable category assessments whilst maintaining a commitment to Horizontal Fiscal Equalisation (HFE) principles as defined in the 2004 Review.

Importantly though, the notion of simplicity needs to include the element of comprehensibility. Fewer categories will not achieve simplicity if in fact those categories embody more complex assessment methods.

The top-down clean-slate approach advocated in the paper has been supported, in principle, to-date by the ACT against a backdrop of conceptual discussion and rudimentary analysis by the Heads of Treasuries review, conducted in 2004. The ACT has always been concerned that a top-down approach might:

- result in unnecessary complex assessments where clearly different disabilities apply to aggregated components of expenditure; and
- reduce the extent of equalisation achieved by ignoring some influences that create differences between jurisdictions.

The ACT has consistently argued that whatever final methodology is adopted, it must maintain or improve the level of transparency and quality of equalisation to be achieved. It must be structured to ensure that a comprehensive level of material differences between States' cost of service provision (COSP) and revenue raising capacity (RRC) is captured by the assessment.

It is increasingly apparent to the ACT, however, that a rigidly applied top-down approach to disaggregation, while simple in theory, might not be overly practicable in all cases. The model of how top-down disaggregation would work in practice, as espoused in the discussion paper, has highlighted some concerns which in turn causes the ACT to reflect on its previous in-principle support for a top down approach. In particular, the ACT is concerned that the top down approach commences with some arbitrary disaggregation, attempts to build a conceptual case for further disaggregation, then undertakes an assessment to measure if the level of disaggregation is material (according to the agreed materiality threshold). The concerns with this approach are:

- the initial disaggregation is arbitrary;
- the requirement to disaggregate until the impact is not material is a hybrid approach of top down and bottom up, which appears to be less than efficient and of questionable simplicity; and
- the materiality test is heavily reliant on the choice of assessment disabilities.

Aggregation should, as a matter of principle, be driven by a strategy that focuses on determining the first-best indicators of differences in COSP and RRC drivers between States. When accomplished, the framework should then be structured around these indicators to determine the optimal level of disaggregation, rather than aggregating to achieve a minimal number of categories.

An approach to disaggregation based on the measures of differences in needs or disabilities provides a much sounder conceptual basis for category splits. Functions

could be grouped on the basis of similar measures of disabilities. For example, it could be that the Transport of School Children function is more closely aligned with public transport than with the education categories. Once functions are allocated to categories according to similar disabilities, a materiality test can be applied. Failure to meet the materiality threshold may warrant further aggregation. However, where such aggregation is likely to result in a more obscure assessment - that is, the disabilities have limited relevance to the functions being assessed, aggregation may not add to the transparency and simplicity of the assessment.

The ACT is willing to work with the Commission in the proposed working parties to develop a strategy which reflects our concerns. The proposed materiality thresholds of \$30 for disaggregation and \$50 for categories are supported in principle only, subject to review, following the proposed working parties initial attempts of redesigning the assessment categories.

## **CONSTRUCTING CATEGORIES**

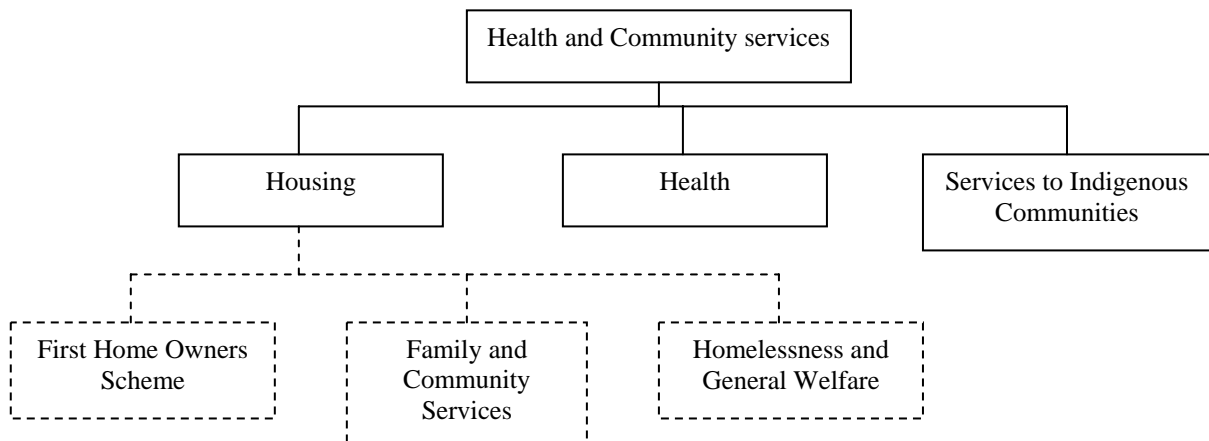
The ACT's interpretation of the proposed approach in the issues paper reflects the application of the \$30 per capita materiality threshold. That is, a category based on a State function will be disaggregated only when a redistribution occurs to at least one jurisdiction of \$30 per capita or more. In reality, it might appear that such an approach would lead to a reduced number of categories but will see a similar level of overall equalisation achieved. This arises because the threshold level of \$30 per capita in principle will capture the bulk of the fiscal differences between States. More simply, it might appear that the \$30 per capita threshold is too high and therefore may result in only one level of disaggregation occurring in most categories.

While conceptually this might appear to achieve the outcomes outlined in the Progress Report to the 2006 Ministerial Council for Commonwealth-State Relations the ACT believes that such an aggregated level of categories will not achieve a comprehensive level of equalisation or the stated aims of simplicity and transparency.

Hence, the ACT has concerns that this threshold approach may be too rigid in implementation and fails to consider the first-best indicators of RRC and COSP drivers between States.

The ACT suggests that an alternative approach should always be available which allows a category to be developed based on best-fit data even though it may not exceed the materiality threshold.

This is best illustrated in the following hypothetical example:



In the case of the process proposed by the issues paper:

- The components under the 'housing' category may have similar drivers (say the proportion of a States population in the age range of 16 - 35 years) and the disaggregated assessment fails the materiality threshold of \$30 per capita, thus the components are aggregated into a 'housing' category.
- Disability adjustments could then be made to incorporate, for example, average weekly earnings in the 'housing' component as it is deemed to be a significant explanatory factor of homelessness, general welfare, family and community services.
- The FHOS and the other two categories fail the materiality threshold test of \$30 per capita, which, in theory, obviate the need for any further disaggregation of the housing category.
- However, the simplicity and transparency of the assessment has been reduced because accurate and readily available data on the 'First Home Owners Scheme' component is a first-best policy neutral measure of COSP to State governments, and therefore, should be retained at the expense of a rigid materiality threshold.

The ACT proposes that a component should be disaggregated in order to:

- utilise the use of first-best policy neutral data, such as 'First Home Owners Scheme'; and
- avoid complex adjustment internal to assessments, such as 'homelessness and general welfare'.

However, the ACT agrees with the Commission that certain categories should be aggregated, where the drivers of RRC or COSP closely correlate, noting that, a rigid application of the discussion paper approach rules would in some cases reduce the degree of equalisation and potentially add to the complexity of the assessment process.

## **DISAGGREGATION IN CONTEXT**

### **Category versus disability approach**

The Commission's view to adopt a category approach for the 2010 Review is strongly supported.

Building assessment methods based on a disability approach would result in States no longer being able to directly associate a disability with a specific category. Importantly, valuable data which provides useful comparisons across jurisdictions on costs and expenses relating to functions would be lost therefore diminishing simplicity and transparency.

Undertaking disability assessments can also be problematic in terms of assessing category standards. Under the current methodology, standardised expenditures are derived by applying disability factors to category standards. Assessing common factors using a disability approach would require the estimation of standard expenditures for each disability. In some cases this would be extremely difficult to achieve in the absence of hard data providing the actual costs faced by States. Such an approach would add an unnecessary layer of complexity due to the need to re-categorise State expenditure data and would remove direct comparisons with other State financial data series.

### **Data sources**

The construction of expense categories on a functional basis using ABS GFS data as the primary source is supported given that it: reflects *what States do*; is comprehensive, comparable and reliable; and is subject to a quality control process readily managed by a number of parties.

Any concerns held with the GFS in terms of not being contemporary enough, could be partially addressed by reducing the five-year average to something less.

However, for revenue categories, the ACT considers the existing method of classifying revenues by tax type, and not via GFS compilation, is the superior approach as it facilitates a more up-to-date compilation and allows the Commission to obtain data directly from the States.

## **BROADER INDICATORS**

### **Expenses**

The ACT questions whether the use of broader expense categories and indicators will necessarily increase transparency or simplification whilst maintaining comprehensive equalisation. Instead the Commission should aim to determine the first-best indicators of cost drivers to the differences in policy neutral COSP between States, then ascertain the level of disaggregation required to accurately assess these indicators. The limiting factor for the degree of disaggregation would be materiality.

An example of an expense category with a policy neutral implementation across States is the First Home Owners Grant (FHOG). The ACT is concerned expense categories, such as FHOG, will fail to be assessed due to the rigid application of materiality rules even though a readily available and comparable policy neutral measure of the effect on State expenditure is available. The ACT believes that aggregating such categories will reduce equalisation and not improve simplicity.

## Revenues

For revenue assessments, differences in RRC between States are captured using policy neutral measures of the revenue bases. To the extent that the actual (policy neutral) revenue bases are used, or a close approximation, assessments are consistent with the achievement of equalisation.

The ACT considers the use of global indicators of RRC does not produce equalisation. Broader revenue indicators fail to accurately reflect *what States do* and consequently a States capacity to raise revenue. In the case of the ACT, broader indicators:

- do not reflect actual ACT activity as a relatively large component of Commonwealth activity is allocated to the ACT;
- fail to recognise data problems which are inherent in measures such as Gross State Product;
- do not reflect actual policies of the States and differences in the propensity of individuals to engage in taxable activities, and hence are incompatible with the equalisation principles; and
- do not take account of the problems associated with highly mobile taxes.

The ACT considers that the use of a broad indicator fails to properly assess relative capacities to raise gambling revenues from gambling taxation. Broad indicators may not account for influences that affect the propensity of a States population to gamble, and thus the capacity of a State to raise gambling revenues. Such influences, as they affect the ACT, are:

- a lower propensity to gamble given above average levels of education and income;
- lower levels of Asian culturally and linguistically diverse persons; and
- the lack of world class racing events and international tourism (negating access to high-roller gambling).

While it is not always possible to assess all differential disabilities, the broader the measure adopted the more approximate is the equalisation outcome. In some cases an approximate result may be appropriate, particularly if it is not materially different to a more comprehensive result. However, where material differences do occur the resulting assessment does not produce equalisation.

## **MATERIALITY THRESHOLDS**

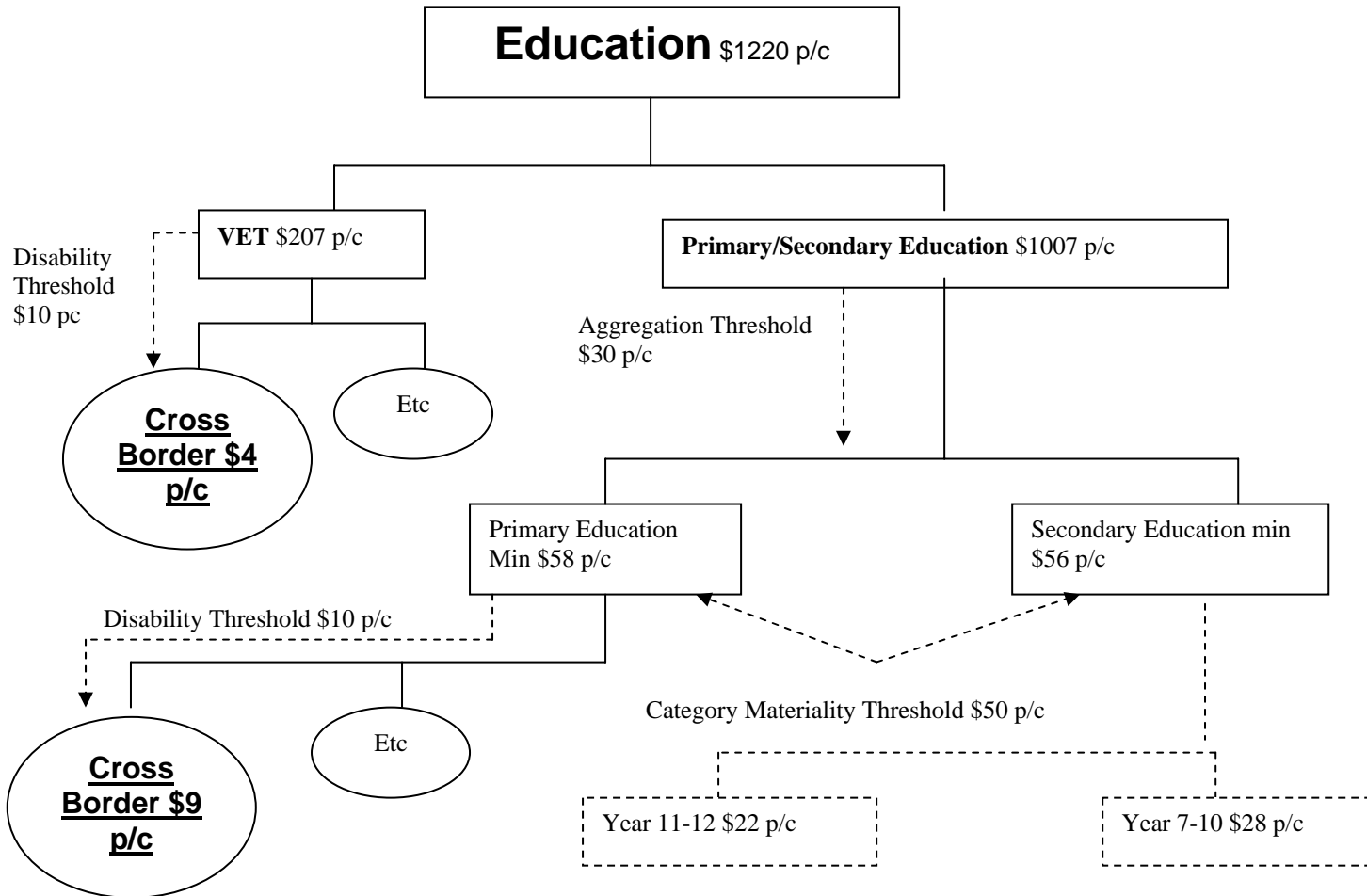
The ACT supports, in principle, the proposed \$30 per capita disaggregation and \$50 per capita category materiality thresholds

However, as previously outlined the ACT is concerned that the rigid implementation of these thresholds could adversely effect the quality of equalisation and reduce transparency.

Furthermore, it is debatable whether much of the assessment will pass the ‘aggregation materiality threshold’ of \$30 within one level of disaggregation. As such the ACT will endeavour to work with the Commission to review the process and achieve a methodology that simplifies the calculation of the annual relativity and increases the transparency of the process, as well as improving the quality of categories assessed.

In order to assist the discussion, the ACT has developed a schematic presentation of the application of the materiality thresholds, which is provided at **Attachment A**. This has helped officers in our internal discussions and could be of benefit to other parties.

# ACT TREASURY'S INTERPRETATION OF MATERIALITY THRESHOLDS FOR THE 2010 REVIEW



**Aggregation Threshold (\$30 per capita):** The Commission is proposing that an aggregated category would be disaggregated only if the effect on the distribution of the GST pool resulting from the use of the disaggregated assessment instead of the aggregated assessment exceeds \$30 per capita for any one State, i.e. disaggregation is appropriate if the redistribution for any State is \$30 per capita.

For Example: The “Primary/Secondary Education” category is disaggregated into “Primary Education” and “Secondary Education” as the disaggregation leads to a redistribution of more than \$30 per capita for a particular State.

**Category Materiality Threshold (\$50 per capita):** All categories in the final category structure will have average revenues or expenses that exceed \$50 per capita.

For Example: The “Primary School” and “Secondary School” categories have an average expense of \$50 per capita and thus are eligible for disaggregation. However, the “Year 11-12” and “Year 7-10” categories are not eligible for disaggregation as they fail the materiality test.

**Disability Threshold (\$10 per capita):** A \$10 per capita threshold applies to aggregated disabilities (i.e. aggregated for all assessments).

For Example: The “Cross Border Influences” disability for “Primary Education” (\$9 per capita) and “VET” (\$4 per capita) combine to be greater than \$10 per capita and thus “Cross Border Influences” are included in the assessment.