



COMMONWEALTH GRANTS COMMISSION

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INTERPRETATION OF THE TERMS OF REFERENCE FOR THE 2004 REVIEW, AND ISSUES OF CONCEPTS AND METHODS

PRIORITY ISSUES CONFERENCE

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1. Differences among States in the way horizontal fiscal equalisation (HFE) should be implemented are not new. The introduction of the New Tax System and the Intergovernmental Agreement on Commonwealth/State Financial Relations (the IGA), has prompted further discussion of the interpretation and implementation of the Terms of Reference (ToR) for the 2004 Review.

2. This paper:

- (i) sets out the Commission's interpretation of the ToR;
- (ii) considers some issues in the current practice and implementation of equalisation; and
- (iii) discusses the scope for addressing those issues in the context of the ToR for the 2004 Review.

INTERPRETATION OF THE TERMS OF REFERENCE

3. The preamble and Part I of the ToR state:

'I am writing to convey to you Part 1 of the terms of reference for the Commonwealth Grants Commission to review the methods used to determine and report upon the question of the per capita relativities for distribution of GST revenue grants and health care grants which the Commission would regard as appropriate to apply after 2003-04.

The terms of reference are as follows:

'1. Pursuant to sections 16, 16A and 16AA of the Commonwealth Grants Commission Act 1973, I hereby refer to the Commission for inquiry into and report upon, by 25 February 2004 at the latest, the question of per capita relativities which the Commission would regard as appropriate to apply after 2003-04 for the distribution of the combined pool of GST revenue grants and health care grants among the States, the Northern Territory and the Australian Capital Territory.

2. The Commission should review whether the allowances for special circumstances granted to the Australian Capital Territory continue to be necessary and, if so, make appropriate assessments.

3. The Commission should commence a work programme for improving methods of assessment and consult with the States and the Commonwealth in deciding the priorities for the work programme.'

4. The ToR are broad and give little guidance on how terms used in them should be interpreted. **However, given:**

- **the words used;**
- **the history of previous Reviews; and**
- **the context in which the ToR were prepared;**

the Commission interprets them as asking it to review the methods of assessment used in applying the principle of HFE.

5. *Methods of assessment.* The historical contexts of past reviews support the view that methods of assessment, broadly defined, should be reviewed. For example, the 1988 Premiers' Conference, agreed that, in addition to preparing annual updates of relativities, the Commission would review *methodological issues* (our emphasis) at five-yearly intervals. The ToR for the 2004 Review are consistent with that agreement, with the preamble asking the Commission to 'review the methods used to determine ... the per capita relativities ...' and paragraph 3 stating 'The Commission should commence a work programme for improving the *methods of assessment* (our emphasis) ...'.

6. In addition, in the past, when the Commission has been asked to review issues of principle, they were the subject of separate and specific ToR. For example, the Commission's 1990 Report on Issues In Equalisation was a response to ToR issued in 1989. That report was requested to assist governments finalise the ToR for the 1993 Review. That is, in the past, issues of principle have generally been examined and resolved separately from reviews.

7. The key question is therefore '*What does 'methods of assessment' mean?*' History and convention indicate that 'methods of assessment' could be interpreted broadly to cover virtually everything relating to the practice and implementation of HFE, but not the principle of HFE itself.

8. 'Methods of assessment' are much more than just the calculations for particular revenue or expenditure categories. They also include:

- (i) determining the model used to apply equalisation – for example, previous reviews considered whether the model should include a budget result term;
- (ii) determining the coverage (or scope) of the expenditure and revenue to be included in the assessments – this has been considered in each review, with roads and housing being included in the 1993 Review and depreciation in the 1999 Review;
- (iii) deciding how the internal standards against which the assessments are made should be derived – for example, previous reviews considered whether the standards should be based on a population weighted or a simple average of the policies of each State;

- (iv) deciding the range of Specific Purpose Payments to be included in the assessments and how they should be treated; and
- (v) deciding the range of revenue and expenditure disabilities and how they should be measured – for example, input costs disabilities were introduced in the 1993 Review.

9. **HFE.** The ToR for the 2004 Review differ from those for the 1999 Review. Part I of the current ToR does not mention the principle of fiscal equalisation. Instead, it refers to ‘the per capita relativities for distribution of GST revenue grants’. Guidance on the principles on which the relativities are to be based must therefore be obtained from past reviews and the context in which the 1999 IGA was signed.

10. The *Commonwealth Grants Commission Act 1973* defines only the basis on which special revenue assistance can be provided to a State. It is ‘the grant of financial assistance ... for the purpose of making it possible for the State, by reasonable effort, to function at a standard not appreciably below the standards of other States’. The definition and interpretation of HFE in Australia has remained much the same since the very early days of the Commission, though its expression has varied from time to time. In the 1999 Review, the Commission defined HFE as:

State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

11. The *A New Tax System (Commonwealth-State Arrangements) Act 1999*, specifies in Schedule 2 (which is the IGA) that GST revenue is to be distributed among the States on the basis of the principle of HFE. Thus **the Commission has understood that the relativities it is asked to recommend in this review should be based on the HFE principle as articulated in the 1999 Review Report.** Questions of whether HFE is the appropriate basis for distributing funds or whether other concepts of equalisation (such as community or outcome equalisation) could be adopted are deemed outside the scope of the ToR.

SOME ISSUES OF CONCEPT AND PRACTICE OF EQUALISATION

12. The current HFE principle relates to the **distribution of untied funds** in a way that **equalises the fiscal capacity of State governments.** Since the funds subject to distribution are untied funds, which the States can spend as they decide, the basis of distribution can not contain any implications that the States are required to spend them in a particular way. The Commission has accordingly taken the view that the application of the HFE principle can not contain any expectation of performance or outcome equalisation – to do so would constrain the sovereignty of State governments.

13. HFE is intended to ensure each State government has the capacity to provide the same standard of services. Whether the same services are actually provided is a matter for individual State governments to decide. Because a State government's fiscal capacity is affected by its ability to raise revenue from its own sources, its receipts of specific purpose payments from the Commonwealth and its costs of providing services, they are all reflected in the assessments.

14. The implementation of the HFE principle has been guided by notions of:

(i) 'what States do':

- the range of revenues and expenditures included in the assessments is decided by the response to the question 'is this something that States do'¹ (things that are the responsibility of the Commonwealth or local governments are excluded);
- the financial standards used in the assessments are based on the actual experience of all eight States;
- the range of disabilities is mostly² decided by the response to the question 'does this influence the level of expenditure (or revenue) associated with something States do';
- the measurement of standard revenue efforts is based on the average of the extent to which States use the revenue bases available to them; and
- the measurement of expenditure disabilities is based on a policy standard that reflects how the States on average provide services;

(ii) 'policy neutrality' is important in the sense that:

- the implementation process is intended to ensure that a State's own actions do not directly affect its relativity and revenue share; and
- the Commission does not make judgements on the merits of policies or practices adopted by the States.

15. The internal financial and policy standards used in the assessments stem from these notions. They are an average of the policies adopted by all States in relation to the services they provide, the efforts they make to raise revenues and the efficiency with which they operate.

16. HFE as it is currently implemented seeks to identify and measure the factors that influence:

¹ In practice, the criterion has been 'what States in general do', which has required decisions on the threshold for including a function. That is, should a function be assessed if it is performed by one State, a majority of States, States containing a majority of the Australian population or all States?

² Considerations of materiality and reliability of measurement also influence the final decisions on whether a function or a disability will be assessed.

- (i) the cost of providing the standard of services the States actually provide on average across the nation, assuming those services are provided with the average level of efficiency; and
- (ii) the level of revenue that would be collected from the sources (including specific purpose payments from the Commonwealth) that the States actually access, on average across the nation, assuming they are accessed with the average effort.

17. It is these standards, not the actual expenditures or revenues of each State, that are the starting point for the assessments. That is, the States are equalised to what, on average, they actually do. No State is assessed as requiring more (or less) untied revenue per capita simply because their policies on level of services provided, level of revenue raising effort or efficiency of service delivery differ from the average. The process is policy neutral in that each State's share of the untied revenue is based on the application of the same average standards of service, revenue raising and efficiency of service delivery.

State Concerns with HFE

18. Some States have, however, expressed concerns about aspects of how HFE is currently implemented and the outcomes it is producing.

- (i) Victoria has suggested that States which receive above average per capita grants should be accountable to the broader Australian community for the use of the funds. This could extend to some explanation of why the extra funds received have not led to reductions in disabilities over time.

On the face of it, such arguments imply a shift in the concept of HFE towards performance equalisation. They may also be inconsistent with the untied nature of the funds being distributed as they imply some constraints on how States spend the funds they receive. As such, they would be outside the Commission's interpretation of the ToR.

- (ii) Victoria has argued for the use of standards that reflect 'best practice' in service delivery or revenue collection.

These arguments appear to reflect concerns that the existing approach does not encourage improvements in efficiency.

Consideration of alternative standards would be technically possible, and may be within the scope of the ToR. Use of 'best practice' or external standards would be a significant departure from what is presently done and would raise issues such as:

- How would the Commission decide what is 'best practice' and should it reflect the likelihood that 'best practice' in some economic, social and physical environments is not 'best practice' in other environments? This would increase the level of judgement involved in the assessments.

- Would the use of ‘best practice’ standards represent a move towards performance equalisation?
- Would the use of ‘best practice’ standards, imply that the Commission was making judgements about the merits of the policies followed by individual States? The Commission would not welcome this possibility.

- (iii) Several States have argued that the scope of the assessments should be extended to better reflect the role States play in developing their economies and enhancing their revenue bases. They have argued that since the effects of these actions are reflected in State revenue bases, the expenditures required to produce those effects should also be recognised in the assessments.

The scope of both the standard budget and the disabilities assessed can be considered under the current ToR.

However, if it were accepted that economic development is partly a consequence of State industrial promotion, how could policy-neutral assessments be made?

- (iv) Several States have raised issues relating to the concept of disabilities and questioned whether too much of the differences between States in the costs of providing services or the revenue raised has been attributed to the effects of disabilities with a consequent understatement in the effects of policy differences.

Conceptually, it is possible to dissect differences between States in the costs of providing services into the effects of: differences in policies on the standard of service; differences in operating efficiency; and disabilities (influences beyond the control of State governments). However, in practice, the distinctions are not always clear.

There is also a question about whether influences on costs of providing services that may be avoided by adopting different policies should be accepted as disabilities.

Issues relating to the proper identification and measurement of disabilities fall within the scope of the ToR. A separate paper on the identification of disabilities is being prepared by Victoria.

- (v) Several States have suggested that decisions are based too heavily on ‘what States do’, resulting in a high level of detail. They argue that other decision criteria such as materiality and reliability of measurements should be given increased emphasis.

These issues fall within the scope of the ToR and are the subject of a separate paper (CGC 2001/9, Developing Simpler Assessments).

- (vi) Western Australia has suggested that fiscal capacity may be better measured using an economic framework rather than the current

approach which is based on expenditures and revenues derived from State accounts.

It is understood that Western Australia intends to develop the issue further for the conference.

Conclusion

19. The Commission has concluded that:
- (i) Part 1 of the ToR for the 2004 Review ask it to review the methods of assessment used in applying the principle of HFE to the determination of the per capita relativities, but not the principle itself;
 - (ii) the principle of HFE should be interpreted in terms of the definition at the time the IGA was signed (that is, the 1999 Review definition);
 - (iii) methods of assessment should be interpreted broadly to include:
 - the specifications of the equalisation model used to assess relativities;
 - the range of expenditures and revenues included in the assessments;
 - how the internal standard may be derived;
 - what constitutes an expenditure disability or revenue base; and
 - how expenditure disabilities and revenue bases are measured; and
 - (iv) a separate ToR should be provided if governments want the Commission to review the principle of HFE.