



# **COMMONWEALTH GRANTS COMMISSION**

## **INFORMATION PAPER CGC 2002/1**

### **GUIDELINES FOR IMPLEMENTING HORIZONTAL FISCAL EQUALISATION**

This Paper has been prepared by Commission staff as a guide for new staff.  
It does not necessarily express the views of the Commission.

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## INTRODUCTION

1. The Commission's role is to recommend to the Commonwealth how its untied fiscal transfers (the GST revenue and some of the Health Care Grants, but often referred to simply as the GST revenue payments) should be allocated among the States and Territories<sup>1</sup>. Clause B2 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* requires that the untied grants be distributed among the States according to Horizontal Fiscal Equalisation (HFE) principles.

2. The purpose of this paper is to give an overview of how HFE principles are interpreted and implemented in Australia, and guidance on how Commission decisions are reached.

3. During the Priority Issues Conference, held in September 2001 as part of the 2004 Review of Revenue Sharing Relativities, most of the States agreed that the principle of HFE should be interpreted in terms consistent with the definition in use when the Intergovernmental Agreement on Commonwealth-State Financial Arrangements (the IGA) was signed in June 1999 — that is, consistent with the interpretation espoused in the Commission's February 1999 Review Report. Others accepted that the Commission had been asked to undertake a Review based on fiscal equalisation but saw the term having a wider meaning and did not think the Commission should be constrained in its interpretation.

4. This paper outlines how the Commission interpreted HFE, and how and why it took decisions relating to the implementation of HFE during the 1999 Review<sup>2</sup>. It also identifies some of the issues being discussed in the 2004 Review that could lead to changes in how HFE is implemented.

5. The paper provides guidelines only on the types of decisions that must be taken and on the decision making processes. It is not possible, or even desirable, to eliminate the use of judgement from the Commission's processes.

### ***Federal Fiscal Arrangements in Australia***

6. In Australia, the amount of own source revenue raised by the Commonwealth is much larger than its own purpose outlays. By contrast, the States' own purpose outlays exceed the revenues they raise from their own sources. This imbalance between the expenditure responsibilities and revenue capacity of the Commonwealth and the States is referred to as vertical fiscal imbalance (VFI). All Federations have some VFI, although it is not always in favour of the central government.

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<sup>1</sup> In this Paper, the word State(s) should be read to include the ACT and the Northern Territory, unless the context indicates otherwise.

<sup>2</sup> In many ways, this paper is a summary and should be read in conjunction with other Commission documents (especially the Working Papers that accompany its reports) which provide details of decisions in specific areas.

7. In the absence of a reassignment of expenditure responsibilities and revenue capacities between the levels of government, the VFI in the Australian federation will continue. Fiscal transfers from the Commonwealth to the States are used to redress VFI. Currently, a little more than half the transfers are in the form of untied grants (grants the States can spend as they choose) and a little less than half are specific purpose payments (grants that must be spent on the purposes for which they are given).

8. The GST revenue payments, which are distributed among the States on the basis of Commission advice, are the largest single intergovernmental transfer. The IGA makes it clear that the GST revenue allocated to each State may be spent according to each State's own priorities — that is, the Commonwealth has no control over how States choose to spend the funds. The untied nature of the GST funds has important implications for how the Commission has interpreted and implemented HFE.

## THE THEORY OF HORIZONTAL FISCAL EQUALISATION

### *The Objective of Horizontal Fiscal Equalisation*

9. HFE has no agreed and internationally applied definition<sup>3</sup>. In Australia, HFE stems from the Commission's work in the 1930s when it decided that the distribution of untied funding between the States should:

make it possible for [a] State by reasonable effort to function at a standard not appreciably below that of other States.<sup>4</sup>

10. The implementation of this principle required a great deal of judgement as it included the phrases 'reasonable effort' and 'not appreciably below', but it remained largely unchanged until the 1970s. In the mid 1970s, the six States agreed that there should be an overall review of how untied funds were distributed among them. In April 1977, they agreed that untied funds should be distributed so that:

each State should be able to provide State Government services of a recurrent kind of the same standard as other States without imposing higher rates of taxes or charges.<sup>5</sup>

11. Later in 1977, after considering several alternatives, the Commonwealth and State governments agreed that the Commonwealth Grants Commission would do the review. The terms of reference given to it were based on the *States (Personal Income Tax Sharing) Act 1976* which said the HFE objective was:

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<sup>3</sup> Even in Australia, the HFE practiced by Local Government Grants Commissions is different from that applied by the CGC.

<sup>4</sup> Commonwealth Grants Commission, Third Report, 1936, p 75.

<sup>5</sup> Commonwealth Budget Paper No. 7. Payments to or for the States and Local Government Authorities 1977-78, p 17.

to enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States.<sup>6</sup>

12. The Commission and the States soon realised that, in practice, the clearest and simplest implementation of the principle required these flexible terms ‘appreciably different’ and ‘not appreciably different’ to be replaced by ‘the same’, as had been agreed in April 1977. The Commission’s first Review Report therefore defined HFE in terms of a mathematical model that gave all States equal (rather than ‘not appreciably different’) fiscal capacity.

13. With the general agreement of the States, the Commission continued on that basis and, in its 1999 Review Report, 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.<sup>7</sup>

14. The 1999 IGA is the most recent indication that the Commonwealth and the States accepted the Commission’s approach to HFE. However, some States now express dissatisfaction with that approach. The most recent statement by the Commonwealth in support of the current approach to HFE is held in Commonwealth Budget Paper No. 3, *Federal Financial Relations 2002-03*.

### ***The Three Pillars***

15. This definition is supported by what the Commission currently describes as ‘three pillars’:

- (i) **Capacity equalisation.** HFE is about equalising the fiscal capacity of State governments. It is not about equalising the States’ performance or the outcomes they achieve. Capacity equalisation means that there is no requirement for States to follow any particular policies on either side of their budgets — a feature that follows from the untied nature of the GST funds.
- (ii) **Internal standards (What States do).** The standards the Commission applies are an average of the ones actually applied by the States — what States do. The Commission does not try to guess what level of service might be appropriate, even where it can be demonstrated that a level of service is below public expectations, professional guidelines or United Nations standards. The Commission

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<sup>6</sup> *States (Personal Income Tax Sharing) Act 1976*, section 13(3)(a).

<sup>7</sup> Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1999*, p 4.

is guided solely by what States on average do. Thus, the fiscal capacity calculated for each State would enable it to provide the average level of services being provided by the States, if they so chose.

- (iii) **Policy neutrality.** A State's own policies or choices in relation to the services it provides or the revenues it raises should not directly influence the level of grants it receives. The Commission has implemented policy neutrality by undertaking its assessments on the assumption that each State follows the same (or standard) policies in delivering services and raising revenue. As a result, its calculations are not affected by (or are neutral to) the specific policies each State follows. Since each State's share of the GST funds is based on the assumption that it applies the standard policies, it has minimal incentive to change its policies in the hope of gaining a greater share of assistance (engage in grant seeking behaviour)<sup>8</sup>.

If policy neutrality is not present in the assessments, and there is an incentive for States to act in a certain way to increase their grant share, we have what is termed a *Grant Design Inefficiency* in the process.

16. In summary, HFE is about:

- (i) GST revenue distribution being the method through which the Commonwealth equalises States' fiscal capacities, taking account of their individual expenditure requirements and revenue capacities; and
- (ii) each State government having the capacity to provide the same standard of services, assuming each:
  - makes the same effort to raise revenue from its own sources; and
  - operates at the same level of efficiency.

17. HFE is not about interpersonal equity. It is therefore not about:

- (i) the States providing all their residents with an equal level of services; or
- (ii) apparently 'equal' residents in different States being provided with equal levels of services.

18. To implement HFE, the Commission must identify and measure differences in per capita costs of providing services and per capita capacities to raise revenue. The

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<sup>8</sup> As discussed later in the paper, because the standard policies the Commission applies are an average of the policies applied by all States, the policies of each State can affect the standard and can have some indirect effect on its GST share. This creates a theoretical possibility that States may take the potential effects on their grant shares into account in determining their policies. However, there has been no indication in recent years that States behave in that way.

theory of HFE does not tell us which expenditures or revenues to equalise, how to measure disadvantage or advantage or how to transform the assessed positions into shares of GST revenue. Decisions on these matters inevitably involve judgement.

*Main Points:*

- *Ultimately, HFE is intended to give all States the same financial capacity to provide services.*
- *Implementing HFE involves identifying and measuring differences in States' expenditure requirements and revenue capacities.*
- *Implementing HFE cannot be done without judgement.*

## **THE PRACTICE OF HORIZONTAL FISCAL EQUALISATION**

19. Since 1981, the Commission has operated under a formula based process which has evolved to cope with the inclusion of the two Territories and the change from cash to accrual accounting in the public sector. The features of the process are that it is:

- dynamic — it recalculates States' relative disadvantages (and advantages) annually and adjusts the shares of GST revenue accordingly;
- continuous — it is based on five yearly reviews of the calculation methods with annual updates of the calculations between reviews;
- historical rather than forward looking — in general, the conditions of a past period are used as the guide to the conditions that are likely to exist in a future 'application' period, with the result that equalisation should be achieved over time, provided the experiences of each year are given equal weight over time<sup>9</sup>; and
- values stability — a moving average of the assessments for the most recent five years is used to give greater stability to State shares of GST revenue. The events of any year work their way through the assessments as the data for the year move through each of five successive inquiries. Averaging over five years produces shares that are more stable than averaging over three years, or using just the most recently completed year, but it does so at the expense of contemporaneity<sup>10</sup>.

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<sup>9</sup> Recent research indicates that some States are subject to very long term trends in their relative financial capacity.  
<sup>10</sup> The Commission has considered the length of the review period several times, including its 1989, *Report on Updates of Relativities* (p 21) which recommended that a three year period be used and its 1999 Review Report

## *The Equalisation Model*

20. The Commission's Equalisation Model is a mathematical representation of the equalisation principle. The approach can be explained in two different, but equivalent ways<sup>11</sup>.

- (i) States' shares of GST revenue should be equal to their per capita share of GST revenue, *plus* needs assessed by the Commission (and needs can be either positive or negative). This model is:

A State's per capita grant = its per capita share *plus* its assessed needs per capita (both revenue and expenditure).

This highlights the main features of the equalisation model:

- the starting point<sup>12</sup> is an equal per capita share of GST revenue, which represents a simple perception of equity that is used in some other countries and avoids the need to make judgements about the merits of other benchmarks;
  - a State's share of GST revenue will differ from its equal per capita share only if the Commission assesses non-zero needs for some services or revenues; and
  - if the Commission assesses zero needs for a particular service or revenue, the impact of that function on States' shares of GST revenue will remain an equal per capita (EPC) amount.
- (ii) A State's share of the GST revenue reflects the amount it would spend to provide the standard level of services after taking account of the revenue it would raise from its own sources by making a standard revenue raising effort, its receipts of specific purpose payments (SPPs) and allowing for a standard per capita budget deficit (or surplus). This presentation recognises that the States can, and do, operate with a surplus or a deficit each year and provides for an average outcome to be reflected in the 'equalisation budget'. Mathematically, this presentation reflects a budget identity of:

$$G = E - R - O - B \quad (1)$$

Taking the States as a whole, these terms can be seen as:

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which concluded that equalisation would be harmed by frequent changes in the length of the assessment period and thus would not be improved by changing from the five year period governments adopted in 1990.

<sup>11</sup> For a more complete discussion of this issue, see the Commission's *Report on State Revenue Sharing Relativities, 2002 Update. Supporting Information, Attachment C.*

<sup>12</sup> The starting point is the distribution that would result if no assessments of disadvantage (or advantage) were made.

- G the total of all untied grants received from the Commonwealth;
- E the total of all expenses incurred in providing State services;
- R the total of all State revenue collections;
- O the total of all receipts of SPPs from the Commonwealth, the expenditure of which is in (E); and
- B the average budget result of the States, either surplus or deficit.

The G term is the equalising element in a formula where each of the other terms is known. The task of determining HFE can be seen as taking the total of each of E and R and redistributing it between the States according to the relative need to spend to provide the average level of service, or their capacity to raise revenue if the average policy is applied.

*Main Points:*

- *A State's assessed requirement for untied funding is equal to its per capita share of the total amount of revenue available, plus its per capita expenditure and revenue needs (either of which may be positive or negative).*

## **THE SCOPE OF THE COMMISSION'S INTEREST**

21. The first questions the Commission asks itself when applying the model are:

- (i) what services provided by State governments are of interest; and
- (ii) what sources of State revenue are of interest.

22. These questions are asked irrespective of any differences in States' per capita expenditure needs or revenue capacities in the functions under consideration. We will return to that issue later.

23. The Commission first produced guidelines on how the scope of the equalisation budget was to be approached in its *Report on Issues in Fiscal Equalisation, 1990*<sup>13</sup>. The scoping aspects of those guidelines were:

Test 1: Is the function one which is not constitutionally or administratively the responsibility or preserve of the Commonwealth or local government; and

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<sup>13</sup> Report on Issues in Fiscal Equalisation, 1990, p 64-65.

Test 2: Can revenues and expenditures related to the function be identified with reasonable confidence for each State.

24. 'Yes' answers to both tests meant the function would be included in the scope of the equalisation budget. 'No' answers to either question meant the function would be excluded.

25. The second of these tests has remained unchanged, but the first was amended during the 1999 Review to read:

Test 1 (1999 Review version): Is the function wholly or partly the responsibility of the States?

26. Both the 1990 and 1999 versions of the test used legal or administrative responsibility as the basis for decisions. That is, functions which were the responsibility of the Commonwealth or local governments were excluded from the equalisation budget. Or, in positive terms, functions which were the responsibility of State governments were included in the equalisation budget.

27. The use of 'responsibility' as the decision criteria covered most but not all circumstances. For example, it did not cover circumstances such as higher education where the Commonwealth has accepted the financial responsibility, but most States provide small amounts of supplementary funding. Consequently, the Commission interpreted responsibility against the background of what States do and how they actually operate — considerations which are reflected in the three pillars underlying HFE.

28. More recently, in Discussion Paper CGC 2001/12, *Scope and Structure of the Standard Budget*, the Commission amended the first scoping test to explicitly base it on 'what States do'. It now reads:

Test 1 (2001 version): Does the function have an impact on State budgets?

29. The practical outcome of the Commission's current approach (and that in the 1999 Review) is that all functions funded through State budgets are included in the equalisation budget, so long as reliable data are available to measure the expenses and revenues. Thus, subject to data availability, the equalisation budget has a comprehensive coverage of what States do. This is consistent with the HFE principle which is based on the equalisation of States' capacities to 'provide services' —the principle is not limited and does not differentiate between services.

30. Similar logic applies to the revenue side of the budget. All funds that States receive and which are available to finance State activities are included in the equalisation budget. This is regardless of whether the funds come from State taxes and charges, general revenue transfers from the Commonwealth or SPPs from the Commonwealth.

31. There are however some points to note about these scoping practices and the equalisation budget.

- (i) In the 1999 Review, the Commission decided that only operating revenues and the recurring operating expenses incurred in providing services should be included in the equalisation budget. Capital outlays (on the purchase of land, and the purchase or construction of buildings and major equipment) and capital revenues (from the sale of assets and capital grants) were outside the scope of equalisation, but depreciation expenses resulting from the use of capital, and debt charges associated with capital acquisition, were within scope.

The Commission adopted that approach because it considered that the untied grants were intended to supplement States' recurrent revenue, thereby helping to finance the operating costs of providing services. They were not meant to fully acquit State capital needs in any year<sup>14</sup>.

The Commission examined the nature and purpose of transactions and made its own decisions on whether they were capital or recurrent, regardless of how the States or the Commonwealth classified them. For example, it treated as recurrent part of the Commonwealth SPPs for housing, which the Commonwealth classified as capital, because the States generally used the funds for recurrent purposes. Road rehabilitation expenses and one-off casino licence premiums were also treated as operating activities to achieve consistency across the States, thereby ensuring that the assessments were not affected by differences between the States in accounting policies or the form in which they received revenues.

However, in Discussion Paper CGC 2001/12, *Scope and Structure of the Standard Budget*, the Commission proposed expanding the scope of the equalisation budget for the 2004 Review to include all transactions that the ABS includes in deriving State operating results under its Government Finance Statistics (GFS) processes. The major impact of this proposal would be to include capital grants in the scope of the equalisation budget. By moving to GFS, the change incorporated the policies of most States to adopt accrual accounting to better reflect the full operating costs of their activities. The proposal also reflects the reality that the ABS GFS collection, the only source of data to prepare the equalisation budget<sup>15</sup>, has been prepared on an accrual basis since 1998-99.

- (ii) In the 1999 Review, the Commission decided that the equalisation budget should be largely confined to the general government sector. That is, with some exceptions, it excluded the detailed expenses and

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<sup>14</sup> There were also conceptual and practical problems associated with assessing capital requirements.

<sup>15</sup> Previously, the Commission prepared the equalisation budget by examining State public accounts and collecting additional data from the States. That process is no longer practical because the State documents no longer contain the detail required and collecting the data direct from the States would be a resource intensive task which would largely duplicate the ABS GFS processes.

revenues of State trading enterprises. It did, however, include the impact of State trading enterprises on the general government sector. (Thus, it included government payments to the trading enterprises for subsidies and community service obligations, payments by government on behalf of the trading enterprises and government receipts of dividend and tax equivalent payments from the enterprises).

This approach was adopted because under the National Competition and Micro-economic Reform policies, States are, in effect, no longer providing the services of enterprises, rather they are providing a new service (subsidies or contributions to the users of the services) and are receiving contributions from the service providers.

The major exceptions to that approach were urban transit and housing. In these cases there was a variety of administrative arrangements across the States. The Commission included all the internal transactions of all State housing and urban transit authorities because it improved the interstate comparability of the data.

- (iii) One of the aims of the equalisation budget is to provide data on State revenues and expenses that are comparable across all States in terms of coverage and classification of transactions. The Commission examines individual transactions at the margin and treats them in a manner that achieves the greatest possible level of comparability. Past decisions to include the transactions of housing authorities, one-off casino licence revenues and road rehabilitation expenses were based largely on the need to ensure comparability.

### ***Explicit Assessment Decisions***

32. A decision to include a service or a revenue in the equalisation budget does not automatically mean that it will affect the States' per capita relativities (the basis of their shares of the GST revenue). As noted in paragraph 20(i), a function only affects State shares if the Commission assesses non-zero (or differential) needs for it — where assessments are made on an equal per capita (EPC) basis, needs are zero for all States and there is no effect on State shares.

33. Including a service (or revenue source) in the equalisation budget and assessing it on an EPC basis has the same (zero) effect on State shares of GST revenue as excluding it from the equalisation budget. The approach of having a comprehensive equalisation budget and making separate explicit decisions about the needs assessment is preferable to excluding the function from the equalisation budget because it improves transparency by:

- (i) recognising the full range of State revenues and expenses; and
- (ii) requiring explicit decisions on whether there are non-zero needs associated with each function.

34. The circumstances in which an EPC assessment is appropriate are discussed later in this paper.

*Main Points:*

- *The scope of the equalisation budget should be comprehensive. It should cover all the operating transactions of the State general government sector, as defined by the only practical source of data, the ABS GFS collection.*
- *Including services and revenues in the equalisation budget does not automatically imply States have different per capita needs for them.*
- *To leave a service or a revenue source out of the equalisation budget implies that the States have equal per capita needs or capacities for them.*
- *The tendency should be to include State activities rather than to leave them out and so imply EPC needs before the question has even been asked.*

***Specific Purpose Payments***

35. HFE is about equalising ‘States’ capacities to provide services’, taking account of their capacity to raise revenue from their own sources. The previous discussion has made it clear that it is desirable that ‘States’ capacities to provide services’ should be defined comprehensively and cover all services. The question of how those services are funded should be irrelevant<sup>16</sup>. Services funded from State own-source revenues, untied revenue grants and most SPPs are included in the equalisation budget. Consequently, all recurrent sources of funding available to a State, including its revenue from related SPPs, should be taken into account in calculating its relative need for GST revenue. SPPs are available to meet the States’ assessed needs.

36. Because of this comprehensive nature of HFE and because few SPPs are distributed on the currently applied equalisation criterion, the Commission examines all Commonwealth SPPs and makes explicit decisions about how it will treat them<sup>17</sup>. It treats all SPPs in one of the following three alternative ways.

- (i) By **inclusion**, where expenditure financed from the SPP and State sources<sup>18</sup> is included in the expenditure standards. The payment is treated as part of other Commonwealth revenue payments (O) which are available to finance part of each State’s total financial assistance

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<sup>16</sup> There is nothing in the definition of the HFE principle that restricts it to States’ capacities to provide services funded from own-source revenues and untied grant funding’.

<sup>17</sup> For a more complete discussion of this issue, see the Commission’s *Report on State Revenue Sharing Relativities, 2002 Update. Supporting Information, Attachment C.*

<sup>18</sup> State sources include State own-source revenues and untied grants.

requirements.

- (ii) By **exclusion**, where the SPP and the expenditure funded from it are excluded from both the expenditure standards and O. Neither the receipt of the SPP nor its expenditure appears in the financial standards.
- (iii) By **absorption**, where expenditure financed from the SPP and State sources is included in the expenditure standards. The SPP, however, is treated as though it were part of the untied revenue pool distributed among the States.

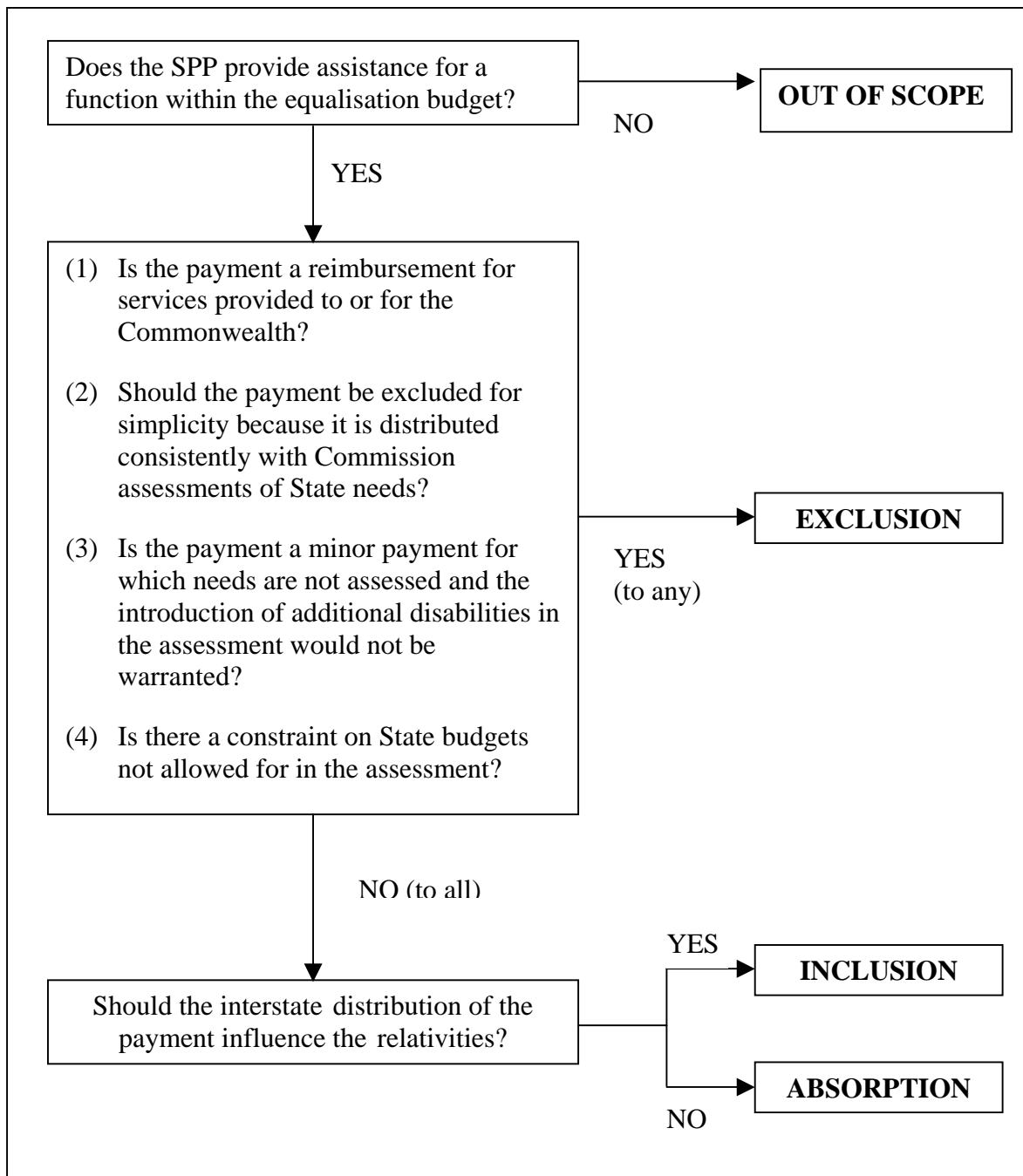
37. Figure 1 illustrates the process used to decide the treatment of each SPP. Further details, including the treatment accorded to each SPP, are in the *Supporting Information* volume to the Commission's annual Revenue Sharing Report.

38. The SPPs brought into the equalisation budget are not limited to those which the Commonwealth budget documents classify as being for recurrent purposes. Every SPP is examined and the Commission decides whether it (or part of it) funds services that are included in the equalisation budget and for which non-zero needs are assessed. Consequently, the equalisation budget includes some 'capital' SPPs and excludes some 'recurrent' SPPs.

39. All receipts of SPPs treated by inclusion are assessed by the actual per capita method (implying that there are no policy or capacity differences causing differences in the States' receipts of this source of revenue) because:

- (i) they are seen as being able to fund States' fiscal needs; and
- (ii) the States' needs in relation to the services being funded by the SPP are assessed on the expenditure side of the equalisation budget.

**Figure 1** TREATMENT OF SPECIFIC PURPOSE PAYMENTS



40. The use of the inclusion approach is now a generally accepted feature of the Australian form of equalisation. However, it was a contentious issue in earlier reviews. The debate centred on:

- (i) whether the distribution of the SPPs takes account of States' advantages/disadvantages and allows each of them to provide the average level of services funded from SPPs; and

- (ii) where the objective of HFE sits in relation to the objectives of the SPPs — that is whether HFE should put at risk the agreed outcomes of programs financed by SPPs.

41. The first issue was concerned with whether the distribution of an SPP gave States the capacity to provide the average level of services financed by that SPP (as assessed by the Commission). If it did, treating the SPP by inclusion had no effect on States' shares of GST revenue. If it did not, there was a question of whether States that were not given the capacity to provide the average level of services financed by the SPP should receive additional assistance by way of an increased share of GST revenue. (Conversely, should those that have been given extra capacity through the SPP receive a lesser share of the GST revenue.) If inclusion is used, the States that received a lower share of the SPP than that indicated by the Commission's assessment of needs receive a higher share of GST revenue. If exclusion is used, States that receive more of the SPP than they were assessed as needing to provide the standard level of service financed by the SPP retain that advantage.

42. The second issue concerns the relative priority given to equalisation and the other objectives of the Commonwealth. That is, should equalisation have a higher (or lower) priority than the policy objectives agreed by Commonwealth and State Ministers and reflected in the SPP Agreements. There was a concern that use of inclusion overrides these other objectives and gives primacy to equalisation.

43. In the 1999 Review, the Commission said that any trade-offs between equalisation and other policy objectives should be open and transparent. This is best done by the terms of reference explicitly quarantining (or excluding) the SPP from the equalisation process. The Commission noted that quarantining SPPs lessened equalisation and advised the States that it thought its responsibilities would be best met by only quarantining SPPs if the terms of reference directed it to do so.

*Main Points:*

- *In general, the equalisation budget should include all revenues that are available to fund services included in the equalisation budget. This covers most SPPs.*
- *Where an SPP funds a service included in the equalisation budget, the expenditure of that SPP should be included in expenditure standards and the receipt of the SPP should be treated as a State revenue (that is the inclusion approach should be applied).*
- *A State's actual receipts of SPPs are assumed to reflect its capacity to raise revenue from SPPs.*

***Commonwealth Own Purpose Outlays***

44. In some cases, the Commonwealth may use what are called Commonwealth own purpose outlays (COPOs) to fund services that are substitutes for, or which

supplement, services normally provided by the States. Commonwealth agencies may make those payments to State agencies (for example, the Aboriginal and Torres Strait Islanders Commission [ATSIC] may pay State public works agencies for housing or other services provided to Aboriginal communities), to joint Commonwealth-State agencies (for example, the Australian National Training Authority [ANTA]) or to community or non-government bodies (such as Aboriginal community councils or Aboriginal Community Controlled Health Organisations [ACCHOs]).

45. The Commission examines COPOs on a case by case basis and makes decisions on whether they should be included in the equalisation budget, depending on its judgement about:

- (i) whether the services being funded are predominantly ones that are provided by the States and the COPO relieves the States of some expenditure they might otherwise make; and
- (ii) whether the disabilities assessed for the relevant function reflect the States' needs for those services funded by the COPO.

46. The Commission would also include a COPO in the equalisation budget if it considered the payment was similar to other payments that were previously (or still are) made as SPPs. The Commonwealth payment to ANTA as its contribution to the costs of vocational education and training is an example of this type of payment.

47. Where the Commission decides to include a COPO in the equalisation budget, it treats the transaction as a notional SPP. Where the transactions do not pass through the accounts of the States, a notional expense equal to the value of the COPO and an equivalent notional receipt by the States must be included in the equalisation budget<sup>19</sup>. The value of the COPO is thus both included in the expenditure standard and treated as a notional SPP.

48. By way of example, in the 1999 Review, Commonwealth contributions to the costs of ACCHOs were treated as State expenses and the COPOs were treated as if they were SPPs to the State governments concerned because:

- (i) the COPOs were considered to be funding community health services (services that are predominantly a State responsibility and which would otherwise have been provided by State governments) and thereby relieving the States of the need to directly incur expenses;
- (ii) the interstate distribution of the COPOs was different from the Commission's perception of the relative needs; and
- (iii) the disabilities assessed in the relevant health expenditure category were considered capable of reflecting the full impact of Indigenous

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<sup>19</sup> One exception to the usual procedure relates to the Commonwealth's payments for vocational education and training which are COPOs when paid to the ANTA, but also pass through the State accounts after that Authority passes the funds to the States.

people on the interstate differences in the demand for and cost of community health services.

49. By contrast, COPOs relating to Medicare payments by the Commonwealth to individuals were excluded from the equalisation budget because the Commission considered that payments to, or on behalf of, individuals for services provided by private medical practitioners were a Commonwealth responsibility. The Commission acknowledged arguments made by Western Australia that State health systems incurred higher per capita expenses in remote areas because there are fewer private practitioners (and consequently lower per capita Medicare payments) in those areas. It did so by ensuring that the health assessments allowed for the additional demand on State services (and thus the additional costs incurred) arising from the relatively fewer doctors in remote areas.

*Main Points:*

- *Services funded by COPOs may be included in the equalisation budget, if it is concluded that the service is one that is normally provided by the States and the COPO relieves the States of expenditure.*
- *COPOs that are included in the equalisation budget are treated as notional SPPs, (that is, as if they were SPPs).*

50. In the context of the 2004 Review, there are several issues to be considered, partly because it seems that Commonwealth agencies are incurring increased levels of expenditure on services where the distinction between Commonwealth and State responsibility is not clear. For example, COPOs in the area of Indigenous health services are increasing as a result of a Commonwealth policy explicitly aimed at improving the health status of Indigenous people. This may have implications for HFE because the Commonwealth's policy:

- (i) could be interpreted as the Commonwealth accepting responsibility for the function and thus it changing from 'what States do' to 'what the Commonwealth does';
- (ii) could be aimed at doing more than the States are doing (acting in a wider field — for example, a more proactive health policy rather than relying on reactive health services); and
- (iii) might be implemented through non-State organisations — in this case, the COPOs allocated to organisations within a State might not be perfect substitutes for State expenditures. For example, if the share of the COPOs allocated to organisations in a State exceeded the Commission's assessment of needs for that State (implying the State's share of GST revenue would be reduced) the State might not have the ability to provide the standard level of other services.

It could also be interpreted as being cost shifting by the States.

51. In these circumstances, it might be desirable to consider:
- (i) whether HFE is better served by the existing approach to COPOs or by an alternative which focussed more on the services State governments are actually providing and ensuring that the assessment processes allow for any differential impact on State budgets of Commonwealth policies that are implemented through non-State organisations;
  - (ii) whether the range of COPOs included under the existing approach should be varied, if that approach is retained.

### **HFE IS BASED ON AN HISTORICAL MODEL**

52. The Commission's task is to recommend a distribution of funds for a future year (the application year). Over the years, many approaches have been examined to try to overcome the obvious problem that the recommended relativities cannot be based on data for the year in which they will be used because such data are not available. The alternatives that have been considered include:

- (i) a Victorian suggestion that the Commission use published financial estimates for the application year — this was not adopted because the Commission had insufficient confidence in the accuracy of the financial estimates, there was a risk that the policies and estimating processes adopted by individual States could affect the assessments and none of the non-financial data (such as school enrolments, age distributions and property values) used in the assessments would be available; and
- (ii) a two part process under which shares for the application year would be initially based on estimates and adjusted retrospectively when actual data for the application year are available — this was not adopted because it was considered to be too complex.

53. As the only practical method, the Commission uses calculations of States' relative needs for funding over a past period for which data are available (the assessment period) as the best estimate of their relative needs in the application year.

54. Calculations based on historical data can only ever be estimates of State requirements in the application year. There is a minimum lag of a year between the end of the assessment period and the beginning of the application year, and a maximum of six years between the start of the assessment period and the beginning of the application year. This is plenty of time for the States' relative economic and to a lesser extent demographic circumstances (and thus their relative needs for funding) to change. Consequently, there has been much debate about processes that could be adopted to ensure the historically based estimates of relative funding requirements are the best possible estimates of the requirements in the application year.

55. These debates generally involved striking a balance between the advantages of contemporaneity (up-to-dateness) and stability in grant shares. Basing the assessments on the most recent year alone might produce the best indicator of States' relative fiscal circumstances in the application year. However, because of possible short term influences (particularly on revenue capacities) shares based on data for only one year could be quite volatile. States like to avoid volatility in their grant funding, even though it might be balanced by movements in actual revenue collections from sources such as stamp duty on conveyances which move rapidly with economic cycles. States they like to be able to prepare budget estimates for grant receipts on a longer term and find it easier to see trends in grant distributions if annual volatility is minimised.

56. To minimise year to year volatility in grant shares, calculations are done for a number of past years and averaged. This raises issues of:

- (i) how many years should be included in the averaging process — a longer period would better smooth out temporary changes in State circumstances and data deficiencies but a shorter period would, on average, be more up-to-date;
- (ii) should all years be given the same weight in the averaging process — applying heavier weights to the more recent years might produce shares that better reflect State circumstances in the application year, but there is no obvious way of deciding what the weights should be; and
- (iii) can the data for the assessment years be adjusted to better reflect the effects of the policies or other circumstances that will apply in the application year?

57. Prior to 1989-90, the assessed State shares were based on an assessment period of three years. In 1989, the Commission was specifically asked to examine the options for the assessment period. In its *Report on Updates of Relativities 1989*, it recommended the retention of the three year period (with each year receiving an equal weight), largely because it considered that a longer period would be less responsive to changes in State circumstances. However, the States chose to adopt a five year assessment period (with each year receiving an equal weight), because it was thought that the longer period would remove more of the volatility in State shares.

58. The Commission was asked to re-examine the issue in the 1999 Review. At that time, it concluded that experience provided little or no evidence that a three or a five year assessment period produced State shares that better predicted the circumstances of the application year or produced less volatile grants<sup>20</sup>. It concluded that in the long term both three and five year assessment periods could be consistent with HFE, but frequent changes in the length of the assessment period would not be consistent with HFE. This was because over the long term the experience of each year would not receive an equal weight in the

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<sup>20</sup> It also noted that volatility of grants was not the real issue. It said that stability of total resources was more important to maintaining services than stability of grants.

assessments. For example, a change from five years to three in 1999 would have meant that two years of the early 1990s recession, which affected some States more than others, would have permanently had a lesser weighting in the HFE achieved over time. That would have benefited those States more deeply affected by the recession, forever.

59. When considering the Commission's 1999 Report, Governments decided to retain the five year assessment period.

60. To date, it has been generally accepted that if the circumstances of each year are given the same weight in the assessments over the long term, we will go closer to achieving HFE over time, even if it is not fully achieved in any one year. This logic was applied by the Commission in the 2001 Update to justify the inclusion of transitional arrangements in the superannuation assessments. (Those arrangements were intended to ensure that the change from cash to accrual accounting did not implicitly result in the experiences of some years receiving a different weight from those of other years.<sup>21</sup>)

61. In the 2004 Review, some States have argued that HFE may not be achieved if the rate of change in the circumstances of some States is constantly below or above the average. For example, it was noted that the rate of growth in Tasmania's financial capacity has been below the average and that of Western Australia above the average, for a long time. In this case, basing the assessed grant share of Tasmania (Western Australia) on historical data implies its share will be less (greater) than it requires to have the capacity to provide the standard level of services. South Australia has proposed a process by which this effect will be partially compensated for in each application year. Tasmania has proposed a return to a three year assessment period. The issue will be considered during the Review.

### ***Backcasting***

62. It is often suggested that the Commission should adjust the data to make the historical period more representative of the application period by 'backcasting' known changes. This would entail estimating what the impact of a change would have been if it had applied in the assessment period, and adjusting the historical data accordingly. It is often tempting to do this. However, while backcasting may improve the accuracy of HFE in the short term, it may reduce it in the long run because the circumstances of the assessment years would not receive their full weight over the run of years.

63. The Commission has only used backcasting where there have been major changes to Commonwealth-State financial relations that can be assumed to have a long term impact into the future. It has done this because it considered that the distribution of untied assistance is an integral part of Commonwealth-State financial relations, and the distribution in a year should be consistent with the other main arrangements operating in that year.

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<sup>21</sup> Without the transitional arrangements, the experience of years when cash accounting was applied would have received a different weight in the assessments over the long period. This is because with the change to accrual accounting the large amounts of unfunded liabilities incurred under cash accounting were reflected in changes to State balance sheets but were not explicitly reflected in the operating expenses of States for the cash accounting years. Nor were they recognised in State operating statements for the accrual accounting years, although both funded and unfunded liabilities incurred in the accrual years were recognised.

64. Materiality tests are used in deciding which changes in Commonwealth-State financial arrangements to backcast. Decisions on this are taken on a case-by-case basis but, in the past, the Commission has not backcast new SPPs which totalled over \$40 million per year — which would have changed the financial standard in the relevant expenditure category by just over \$2 per capita. The limit might be somewhere below \$100 million, but cannot be specified.

65. Changes in State policies or economic circumstances are not backcast. To do so would mean the circumstances of each year would not receive equal weight and it may influence State decisions on the timing of policy changes. In the 1999 Review, the only backcasting was that undertaken catered for:

- (i) the changes to health funding resulting from the 1999 Australian Health Care Agreements the Commonwealth reached with the States; and
- (ii) the changes to the Commonwealth policies on what Legal Aid is would fund, introduced in 1996-97.

*Main Points:*

- *The Commission uses historical data to estimate what the HFE positions of the States might be in a future year.*
- *Achieving equalisation over the long term requires the circumstances of each year to receive equal weight in the assessments over time.*
- *The length of the historical period used in the assessment of State shares (for example three or five years) has little effect on the achievement of HFE. However, changes in the length of that period can reduce the extent to which HFE is achieved over time because the circumstances of each year would receive unequal weights.*
- *Backcasting results in the circumstances of individual years receiving unequal weights in HFE processes over time, but it is appropriate when there are major changes in Commonwealth-State financial relations.*

## **THE CONCEPT OF THE STANDARD**

### ***The Average Level of Services or Revenue Collection***

66. The average level of services is usually referred to as ‘the standard’. In a natural sense, it would usually be discussed in terms of outcomes achieved by States. For example, the average level of education services might result in students in each State having the same average literacy or numeracy levels, or the same university acceptance rate.

Health outcomes might result in each State's population having the same health status or the same life expectancy. But these are difficult concepts to build into a mathematical model.

67. Variations from the average outcome can often be measured, but there is no automatic association between those variations and the inputs required to achieve the average outcome. We do not know what expenditure per capita might be required to improve the health status of a State's population by, say, 2.5 per cent. Does it need 2.5 per cent extra funding per capita, or are the problems so difficult that 22.5 per cent extra is required? For its purposes, the Commission needs to have a measurable identity of financial need to include in its model.

68. The Commission works with inputs for service delivery and interprets standards in terms of average per capita expenses or average per capita revenue because:

- (i) its work is about funding requirements (inputs) for a future year;
- (ii) State governments are free to make their own decisions on how they use those inputs; and
- (iii) the alternative approach — examining outcomes — is very difficult and would include even more judgement than is currently required.

69. The use of per capita expenses and revenue says nothing about equality of physical inputs, outcomes or revenue collection effort, but is based on assumptions that:

- States would be able to provide the same services from the same level of per capita inputs if they all:
  - faced the same per capita level of demand for each service;
  - had the same unit cost of providing each service; and
  - operated at the same level of efficiency in providing services; and
- States would raise the same level of revenue per capita from each revenue source if they each:
  - had the same per capita revenue base for each source of revenue;
  - imposed the same tax regime; and
  - collected revenue with the same level of efficiency.

70. The concept of standard the Commission uses, therefore, is a numerical one based on the financial activities of the States. It is measured by the Australian average per capita expenses incurred (or revenues collected) — that is, by summing the expenses (revenues) of all States and dividing by the Australian population. Thus, a standard of say \$1 000 per capita for police services implies that \$1 000 is the average per capita expense incurred on this function, across Australia. On the revenue side, a standard of \$1 000 per

capita in Land Tax implies that, on average, this is the per capita revenue raised from this source, across Australia.

71. This approach to calculating the standards stems from detailed discussion in the early 1980s when it was agreed that the aim of government activity was the provision of services to people. Thus, the average way States impact on people was considered important. It gives the policies of the more populous States' more weight in the overall equation<sup>22</sup>, but that is simply representative of their population share.

72. The financial standards are the result of the many decisions taken by each State on what it will spend to provide a service (and how it will spend it) or what revenue it will raise from each source (and how it will raise it). If States provide different standards of service in remote areas from those provided in their capital cities, this is reflected in the standard policy and the standard levels of expenses. The financial standards therefore implicitly reflect the average of the policies and procedures operating in the States (the policy standards). The Commission's acceptance of 'what the States do' in deriving the standards says nothing about their acceptability to the Commission. It does not comment on the appropriateness of State policies.

73. Nor does the Commission consider whether the implied standard policies are the most efficient in the circumstances of each State — it assumes each State considers its operational efficiency as a normal part of doing business. In any case, since the actual policies of individual States do not directly influence their grant shares, if they adopt service delivery processes that are more (less) efficient than the standard they retain the benefit (bear the extra cost).

74. The Commission simply accepts the average of what the States do as the standard and uses it as the benchmark for the assessments.

75. However, as noted in paragraph 32, the inclusion of a function in the equalisation budget, with the resulting derivation of a standard expense (or standard revenue) does not automatically mean that the Commission will assess the States as having different needs per capita for that service (or tax). That financial standard might reflect the provision of the service (or the imposition of a tax) by only one State. The decision on whether or not to assess non-zero needs is based on criteria of:

- (i) materiality — expenditure by only one State, by the two least populous States or even small amounts by all States is unlikely to result in sufficiently large standards to have a material effect on the State shares of GST revenue;

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<sup>22</sup> This compares with the alternative that was considered at the time of summing the per capita expenditures of each State and dividing by eight — a process which would give the policies of each State the same weight. There was strong agreement that it would be inappropriate to give the same weight to the policies of say New South Wales and Tasmania when the number of people affected by the Tasmanian policies was about 7.5 per cent of those affected by the New South Wales policies.

- (ii) policy neutrality — to assess non-zero needs when only one or two States provide the service may introduce a risk of the States varying their policies to try to influence their shares of GST revenue; and
- (iii) the special circumstances of the States — a judgement might be required as to whether the provision of a service or some extra resources for a particular group of people is necessitated by circumstances that do not exist in other States.

76. In the past, to ensure policy neutrality and materiality, the Commission has assessed different per capita needs only where most of the States follow the policy in question and most of the eligible Australian population are potentially affected by it. For example, the Commission assessed zero needs in relation to the accommodation taxes previously imposed by New South Wales and the Northern Territory because it considered these to be above standard tax efforts by those States, rather than standard policy against which all States should be assessed. However, even if a service was largely provided in only one State, and the Commission was convinced that the extra expenditure reflected circumstances of people in the State that those in other States did not face (or faced to a much lower order of magnitude), it may recognise the expenses or part of them as a special need of the State<sup>23</sup>. This was the case in the Aboriginal Community Services category.

*Main Points:*

- *Ultimately, government activity and HFE is about providing services to people —therefore each person (not each State) has equal impact on the standards. As a result, the policies of the more populous States usually have a larger impact on the calculations than those of the less populous States.*
- *The standards the Commission uses are financial standards, either expenditure per capita or revenue collections per capita — the inputs into the equalisation budget.*
- *The Commission’s standards embody an average of the policies operating in the States.*
- *The Commission’s standards embody a population weighted average of the levels of efficiency with which States operate.*
- *Non-zero needs are not usually assessed for a function (or a revenue source) unless most States provide it and it is available to most of the eligible population in Australia.*

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<sup>23</sup> Similar considerations arise when expenses related to a particular service are increased because one State provides extra resources for a particular sub-group of potential users. Again, the Commission would not allow such policies to affect its recommended State shares of GST revenue, unless most States followed it.

## GIVING STRUCTURE TO THE COMMISSION'S ASSESSMENTS

77. The first issue considered in attempting to calculate what each State would need to spend to provide the standard level of services, or what each State's capacity is to raise revenue, is how total State expenditure and total State revenue should be broken into manageable categories or groups of functions.

78. Guidelines for how this might be done (called the structuring tests) were first developed by the Commission in 1990<sup>24</sup>, but they have been refined over time and the latest expression of them was in the November 2001 Discussion Paper CGC 2001/12, *Scope and Structure of the Standard Budget*. They were:

*Do the proposed categories within a function:*

- (i) reflect the predominant way in which State governments provide services or raise revenues;*
- (ii) ensure that expenditures or revenues within a category are affected by similar disabilities, or no disabilities;*
- (iii) facilitate the accurate measurement of policy-neutral disabilities or policy variables;*
- (iv) allow for accurate and consistent budgetary data to be obtained with reasonable confidence from the ABS GFS series and other supporting sources;*
- (v) avoid the possibility that a State could, by changing its policies, directly influence its grant share; and*
- (vi) make a worthwhile contribution to fiscal equalisation through its impact on relativities — is it material (although this is often difficult to judge before any attempt has been made to assess disabilities that might be applied to the category)?*

If the answer is **yes** to all of the above, the proposed category structure would be accepted. If the answer is **no** to any of the above, then a different structure should be considered.

79. Implementing these guidelines requires judgement, and there are several terms within them that require discussion.

- (i) The concept of disability is central to the tests. The Commission defines a disability as:

an influence, beyond a State's control, that results in it having to spend a different per capita amount than the standard, or raising

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<sup>24</sup> Report on Issues in Fiscal Equalisation, 1990, p 66-67.

a different level of per capita revenue than the standard, if it applies standard policies (including efficiencies) to the provision of a service or the collection of the revenue.

In summary, disabilities are what lead to the States having different per capita needs for funding if they are all to have the same capacity to provide services. Disabilities may be positive or negative because they are measured relative to the average Australian position (which is set at 1.0000).

- (ii) The concept of policy neutrality was introduced in paragraph 15(iii) where it was noted that the Commission interprets the term as ensuring its calculations are neutral to the actual policy choices of individual States by basing them on an assumption that all States follow the same policies. It is discussed in more detail later.

80. The first two tests are about getting commonality in the category. They result in, say, education services being grouped together. They also allow us to look at how the States provide education services and, since all States apply a different approach to funding non-government schools from the one adopted for government schools, the Commission also differentiates between government and non-government education. Differentiating also produces categories that are affected by similar disabilities, or by the same disabilities but in different ways. For example, the different services involved in Child Welfare are sufficiently similar as to give rise to similar disabilities and are treated as a single function of government.

81. The fact that the ABS GFS collection is now the only practical source of financial data has also influenced the structure of the equalisation budget. The category structure the Commission can use must be supported by the level of detail available in the GFS collection. Since the detail in the GFS classification is not currently reliable, there are constraints on the Commission's ability to use it to identify individual services. There are also constraints on the ability to create special categories (such as Aboriginal Community Services) to cope with special circumstances (such as those stemming from the relatively large proportion of the Indigenous population of the Northern Territory, which lives in remote areas)<sup>25</sup>. In future, such instances will need to be catered for in other ways or within other assessments<sup>26</sup>.

82. The expenditure assessment framework that was adopted in the 1999 Review gives the Commission the ability to further disaggregate expenses in each category. That framework uses data from a variety of sources to make estimated sub-divisions of expenses

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<sup>25</sup> The ABS definitions of functions are consistent with international conventions which generally reflect types of services provided. However, for some purposes, the Commission's assessment categories might more appropriately reflect the people (Aboriginal Community Services) or the region served (Urban Transit Services).

<sup>26</sup> The need for different approaches to these sorts of issues will be increased by the recent decision of Heads of Treasury to prepare and publish financial data at the level of detail the Commission adopted in the structure of its equalisation budget for the 1999 Review. Since, in practice, there are long lead times involved in the implementation of State based systems to collect the necessary data, this decision will severely limit the Commission's flexibility to vary the contents of individual categories.

within a category, so that disabilities can be better matched with the expenses to which they relate, and to avoid double-counting arising from unintended interactions between disabilities.

83. In the 1999 Review, the Commission simplified the structure of its equalisation budget by reducing the number of expenditure categories. It then used the assessment framework to allow for differences within those categories that should and could be allowed for.

84. There is also a materiality test applied in determining the category structure, with the aim of minimising the number of categories that contain a very small proportion of the expenses in the equalisation budget. Over the years, the number of expenditure categories has been reduced from about 60 to about 40 — many of the discontinued categories contained one per cent or less of total per capita expenditure. However, decisions on which categories would be abolished were also influenced by the size of the associated disabilities. At the extreme, a category with a small standard expenditure but a wide range of assessed disabilities could have a larger impact on States' grant shares than one with a large standard expenditure but category disability factors that are very close to 1.0000.

85. To a lesser degree, materiality considerations are also applied in deciding the extent and nature of the further disaggregation of expenditure categories within the expenditure assessment framework.

86. The structuring issues on the revenue side of the budget are easier. There is a tendency to have a separate category for each source of revenue because of their different revenue bases, the ease of assessment and the ready availability of data on revenue collections. The number of revenue categories has not been reduced to the same extent as the expenditure categories and many of the current 20 or so categories hold small percentages of total State revenue. However, many State taxes and duties raise revenue from quite different tax bases which can vary markedly between States, and there are no obvious reasons why they should not be assessed individually.

*Main Points:*

- *A category should:*
  - *reflect the predominant way States provide services or collect revenues;*
  - *group expenses or revenues that are affected by similar disabilities;*
  - *assist the measurement of policy-neutral disabilities;*
  - *be based on accurate and consistent budgetary data; and*
  - *make a material difference to States' shares of the untied grants.*

- *If a proposed category would contain only a very small percentage of total expenses or revenues, it is unlikely to be a separate category.*
- *It can be a separate expenditure category if the assessment process indicates this is a better approach and it cannot easily be handled within another category through the expenditure assessment framework.*
- *It can be a separate and small revenue category if the data on collections are readily available and the tax accesses a base that is different from other bases.*

87. During the 2004 Review Priority Issues Conference with the State Heads of Treasury in September 2001, the Commission proposed that the level of detail in the structure of the equalisation budget would be similar to that for the 1999 Review (that is about 40 expenditure and about 20 revenue categories). The consensus of the conference supported that proposal and it has been reflected in the decision by Heads of Treasury to prepare and publish data on State revenues and expenses to support that level of detail on an annual basis using a uniform presentation framework.

88. However, in its main submission to the Review, Western Australia argued that the continued use of a highly disaggregated structure increased the level of complexity and false precision in the assessments. This was said to obscure the State's broader policy objectives of delivering reasonable outcomes to their community and to improve outcomes where these were deficient. In particular, it argued that the approach ignores the interconnectedness of services and the fact that State decision making processes focus on achieving broad policy outcomes through a variable basket of services rather than some standard mix of services with implied formulae to allocate resources to particular areas or groups of people. This issue might have most impact in the health area where States may adopt different ways of achieving essentially similar objectives depending on the particular circumstances they face.

89. This issue will be considered further during the 2004 Review. However, it is not obvious that aggregated assessments would lead to a better consideration of the different circumstances States face in delivering services. As noted earlier, there is no simple proportional relationship between differences in outcomes and the additional resources needed to improve outcomes. Hence measuring the impact of circumstances on State financial capacity inevitably requires some assumptions about what services will be provided and how they will be provided. Such assumptions provide a basis for deciding what influences might affect the costs of providing services in each State, and the size of those effects.

### *Assessing States' Circumstances in a Category*

90. Once the structure of the equalisation budget has been determined (for both expenses and revenues), the task becomes one of deciding, for each category:

- (i) what expenditure is necessary for each State to be able to provide the standard level of service if it operated at the standard level of efficiency; and
- (ii) what revenue each State would raise if it applied the standard rates of tax to its revenue bases (defined in terms of an average of the bases States use) and collected revenue at the standard level of efficiency.

## **EXPENDITURE ASSESSMENTS**

91. Differences between the standard per capita level of expenditure and a State's actual per capita expenditure on a function might be due:

- (i) totally to differences between the standard policies and those of the State — either in the range of services, the level of services or the efficiency of their provision;
- (ii) totally to circumstances beyond the State's control that result in it having different per capita levels of demand for the service, or different unit costs of providing the service; or
- (iii) a mix of both these circumstances — the most common situation.

92. It is only the circumstances beyond the State's control that we want to take into account as disabilities.

- Where the circumstances in (i) are found, the States are assessed as having an equal per capita (EPC) requirements for funding.
- Where the circumstances in (ii) are found, the States' actual levels of expenditure can be used as a measure of the expenses they would incur if they were to provide the same level of services. Thus, when all States follow the same policies, the difference between the standard per capita expenditure and their actual per capita (APC) expenditure can be used as a measure of their relative needs for funding.

93. Where differences in per capita expenditure are caused by a mixture of policy differences and disabilities, the task is to differentiate between the two and allow only for the disabilities. This is done using what the Commission calls the Factor Assessment Method (FAM). Under this method, we identify and quantify the factors that cause disabilities, and apply them to the standard to estimate the expenses each State would incur if it were to provide the standard level of service.

### *Main Points:*

- *Where all the differences in expenditure per capita are due to policy differences, an EPC assessment is made.*

- Where none of the differences in expenditure per capita are due to policy differences, an APC assessment is made.
- Where differences in expenditure per capita are due to a mixture of needs and differences in policies, the FAM is applied.

94. At an expenditure category level, the FAM task starts with the Australia-wide expenditure on a function and, allowing only for things beyond the control of the States, allocates that Australia-wide expenditure so that all States could provide the level of service inherent in the Australia-wide average policy and expenditure standards — the average level of service.

### ***What is a Disability?***

95. In broad terms, disabilities arise because of differences between States in the physical, economic, social and demographic characteristics that are not under the control of State governments. Disabilities reflect the differential impact of those conditions on the demand for services, costs of each unit of service and revenue capacities. They are relative rather than absolute measures and can be positive (the disability factor is above 1.0000) or negative (below 1.0000).

96. For discussion purposes, we find it useful in considering disabilities, to distinguish between demand influences and cost influences. In practise, this distinction is not always clear but some examples might assist the explanation.

97. The most frequently used disability factor that relates to demand is based on differences in the *socio-demographic composition* of the States' populations. This takes into account differences in the characteristics of State populations (such as age-sex, Aboriginality and income levels) on demand for and unit costs of services. For example, differences in the age distributions of population affect the demand for a number of services. Persons of school-age require education services; many elderly persons require nursing home services; and males in the late teens or early twenties are more likely than others to generate police services.

98. Similarly, differences between States in the proportion of persons of Indigenous background affects the relative demand for and cost of providing health services. The numbers of migrants from different language groups affects the demand for services because they tend to seek services later (health services in particular) which leads to more complex problems.

99. Another demand influence is the *cross-border factor*. This measures the net effects on a State's costs of:

- use by its inhabitants of services provided by other States; and
- use of its services by the inhabitants of other States.

100. The major instance of cross-border use of services is the flow of people into the ACT from the surrounding State of New South Wales. The ACT services most used by

the residents of New South Wales are hospitals, education, police, court facilities and social welfare provision. Without an adjustment to the assessment for this movement, the ACT would receive insufficient funds to provide the standard level of services, and New South Wales would receive too much.

101. Looking at influences on the unit cost of services, the *location of the population* is an obvious cause of cost differences. Other things being equal, a more dispersed population costs more to service than a more concentrated one. The costs of telephone communication are greater over longer distances; travel in connection with the provision of services is more expensive; the average cost of freighting goods or transferring staff is greater; and the cost of compensating staff for working in remote and harsh locations may be greater. Population dispersion factors aim to measure and allow for differences in the influence of these types of costs.

102. Beyond a certain point of population concentration, however, urbanisation adds to costs. A large enough urban area will require the provision of a public transport service (nearly always at a net cost), and the larger the city the greater need for railways (always more demanding on the budget than road transport).

103. Another cost differential arises from differences in economies of **scale**. The Commission measures these at two levels.

- *Administrative scale* relates to the additional expenditure of those States not able to take advantage of the economies of scale available to the more populous States. It concerns mainly policy development and administrative tasks carried out in central and regional offices, or specialised services (such as the legislature) provided centrally for the whole of a State's population.
- *Service delivery scale* refers to the differential costs of providing services at the point of service delivery (a school or a police station) arising from lower efficiency in the use of staff and other resources at service outlets. It usually arises where settlement patterns result in small and widely separated communities.

104. The last example to be discussed is *input costs*. The Commission has taken the view that the costs of some basic inputs into State government service provision are not within, or fully within, the States' control. A very important example is wages.

105. Salaries and related costs are a high proportion of total expenditure on State functions. The wage levels which a State pays its employees are determined more by the general economic climate in the State, or by the centralised wage-setting system than by any action or inaction of the State Government.

106. The statistics show, for example, that the level of private-sector wages in New South Wales are higher than elsewhere in Australia. It would be surprising if there were no flow-on effects into the State public sector. Obviously, however, States have some influence on the level of wages they pay, and the Commission has therefore approached the estimation of wage cost disability factors cautiously.

107. There is a question about whether, over the long term, State governments can influence their economic, social and demographic situation — for example, Queensland’s decision to abolish death duties ahead of other Governments may have influenced the location choices of retirees in Australia for several years in the late 1970s, and hence States’ relative demographic profiles for many years. Often, judgement is required on where to draw the line.

108. Some argue that many things accepted by the Commission as the basis of a disability could be avoided by a State adopting policies that were more appropriate to its circumstances. They propose, for example, that a State should not make it so easy for people to live in remote areas, which might reduce the costs that are reflected in the disabilities assessed for population dispersion. The Commission decides on such matters by asking ‘what States do’. If all States incur higher costs per unit in providing services to people in rural or remote areas, this is interpreted as the standard policy and the higher average costs per person served form the basis of a disability. We could not build-in any assumption about the use of more appropriate policies without changing the basis of equalisation from ‘what States do’ (the basis on which the financial standards are determined) to ‘what States should do’.

109. In this Review, Victoria has again argued that States that receive additional funding because of disabilities should be using that funding to overcome the disabilities. It may be possible, in the long term, for States to use technology and other means to influence the things that cause differences in unit cost, such as dispersion. On the other hand, it will be very difficult, if not impossible, for States to influence demand type disabilities such as the proportion of Indigenous people in their communities.

110. In deciding whether a disability exists, the Commission must be convinced that States exhibit expenditure patterns that they would not have if the disability did not exist. The recognition of a disability must be based on what affects costs, given the average of the policies States actually apply. For example, the area of a State is sometimes said to be a relevant basis for the quantification of disabilities. It may be, but what costs incurred by States are influenced by area, and does area influence those costs differently between States? At present, we use area as a relevant indicator of States’ different per capita need for funding in only one of the assessments — national parks.

111. The use of the term ‘disability’ is something unfortunate as the basis of a disability factor is not necessarily something that might generally be termed a ‘disability’. If, for example, all States spent 25 per cent more per student on those with an IQ over 145, the number of such students would be a basis for a disability factor. This is an extreme and fictional example, but it illustrates the point that a disability is based on influences that affect costs, given the average of what States do. Children with high IQs would generally not be seen as a group with a disability, or a disadvantage to their State, but they could be the basis of a disability factor.

*Main points on when a disability should be assessed:*

- *There must be a conceptual basis for the existence of a disability — implementing the standard policy results in different per capita levels of expenditure for each State.*

- *Either:*
  - *there is empirical evidence that the differences being examined affect the costs of provision of State services (through different levels of use of the service or different unit costs in providing the services); or*
  - *there is incomplete evidence that additional use and/or costs are incurred, but:*
    - ❖ *the case is strong in logic;*
    - ❖ *the Commission judges that sufficient evidence exists; and*
    - ❖ *the Commission judges that including the factor will increase the likelihood that HFE will be achieved.*
- *The disability factor is material, either because it is large or has a large impact on HFE based funding.*
- *The margin of error associated with the disability's application is acceptably small.*

### ***Policy Neutrality***

112. Because disabilities lead to a State's share of untied assistance being different from its population share, the assessment of disabilities must be done in a policy neutral way. That is, the disabilities we identify and the way we measure them must not be influenced by the policies of individual States.

113. The aim of the assessments is to estimate what each State would spend if it were to provide a standard level of service. We therefore need some basis for costing that standard service. We could do so in many ways. Those most frequently debated are:

- (i) the best practice approach (often discussed in terms of minimum cost, which may not always be the most appropriate measure of 'best');
- (ii) based on what one or more States actually do; and
- (iii) something that reflects the average of what all States do.

114. The Commission uses the last approach because it believes it is the least value-laden — that is, it accepts what all States do and strikes the average per capita cost (which, in turn, implies that the assessments reflect an average of the policies States actually use on service provision and delivery processes). To do otherwise would require the Commission to make decisions about what is best practice (which the Commission may not be qualified to make), which State is achieving that (there is no obvious basis for such a choice) and whether it would need to be the same State for all functions.

115. The Commission then works out the expenses each State would incur if it applied this average policy. This is done independently of what the State actually spends. Obviously, the process is not free of the influences of State policies (quite the opposite: it is firmly based on an average of the policies of all States). It is, however, policy neutral in the sense that all States are assumed to apply the same policy. As a result, disabilities reflect the influences that would cause a State to spend an above or below average per capita amount were it to apply the standard policy. In other words, the disability should be measured so that a State cannot, by its own policy decision, influence the calculation — except through its impact on the standard policy.

116. For example, all States have a policy of spending more per student on Indigenous students compared to non-Indigenous students. This is a standard policy. Resulting from that standard policy there might be, on average across the States, 20 per cent more per student spent on Indigenous students (some States might spend only 5 per cent more, others might spend 40 per cent more). The 20 per cent would be used as the standard cost weight.

117. A disability would then be based on the standard cost weight per student that results from the standard policy (1.2000), and the proportion of students in each State that are Indigenous. This process is said to be policy neutral because the standard weight is derived from the policy actions of all States and the number of Indigenous students is outside the control of the States.

118. If we now assume that one State increases its expenditure per Indigenous student from 20 per cent more than non-Indigenous students to 50 per cent more, the effects on the calculations would be as follows.

- (i) The standard policy of spending more on Indigenous students would remain unchanged, as would the number of Indigenous students in each State.
- (ii) The standard cost weight given to Indigenous students would increase a little, but not by the full increase in the State that changed its policy. It might increase from 1.2000 to, say, 1.2200.
- (iii) All States, including the one that increased its expenditure to fifty per cent more, would be funded to meet the standard policy at the standard cost, but that standard cost weight has changed from 1.2000 to 1.2200.

119. In measuring the cost impact of standard policies, the Commission looks as far as practical at what ‘actually happens on the ground’ and not at just the written policies of the States. For example, under the written policy the impact of Indigenous students on schools funding might be, say, 15 per cent higher expenses per student. But if what actually happens at the schools indicates that more resources are applied to Indigenous students so that the real cost impact is, say, 20 per cent higher, then the standard cost impact would be 20 per cent higher. In this sense, ‘policy’ is interpreted as any action that causes differences in levels of input for identifiable groups of users.

120. The same relationships between policies and cost implications can be found in disabilities based on unit cost differences. All States provide in-service training to their teachers, and teachers in remote areas cost more to service (say, 20 per cent more per teacher on average). As a result, the cost impact of the standard policy would be 20 per cent more, even though training might be done in different ways in different States, and involve different costs. A policy neutral disability might be based on applying the standard extra cost per teacher to the number of teachers each State would have in remote areas if it had the average student/teacher ratio in remote areas.

*Main points:*

- *There is an inevitable interaction between policies and disabilities. Policy neutrality does not mean that disability factors are not influenced by the policies of individual States. It means that the average of all States policies are taken as the standard policy.*
- *There is no basis for a State to be assessed as having a disability unless its policies are influenced by the circumstance being examined — either there are different levels of cost incurred in reacting to a sector of the client base, or there are different levels of cost incurred in providing the same level of service to all elements of the client base.*
- *Policy neutrality is about a State's inability to influence the size of its grant — it must not be able to manipulate the application of the HFE model so as to fund its policy decisions from an increased grant.*

121. Some States argue that policy neutrality should be interpreted to mean 'policy free'. They argue that the assessment methods should not assume any particular approach to service delivery or revenue raising if States have choices about the services to be provided (revenues raised) or how they will be provided (raised)<sup>27</sup>. We do not think this is possible under the current approach to equalisation which is based on the average policies of the States — 'what States do'.

### ***Evidence and the Application of Judgement***

122. Determining any disability factor requires the application of evidence and judgement. In assessing the impact of socio-demographic differences on costs, for example, it would clearly be best to have data showing differences in total cost between two groups of users. This is very rarely available, however, and the types of information that we rely on as evidence of disability are:

- (i) States' administrative data, for example hospital admission data;
- (ii) States' budget documents and Departmental Annual Reports;

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<sup>27</sup> For example, New South Wales has said that a global assessment of revenue is required to remove the effects of State revenue policy choices. NSW Treasury, Main Submission to 2004 Review, p 14.

- (iii) national surveys;
- (iv) local surveys;
- (v) anecdotal information in a series of similar circumstances across States;
- (vi) service provision funded by Commonwealth SPPs;
- (vii) State arguments; and
- (viii) general acceptance by the parties.

123. Judgement is an essential ingredient and the recognition of a disability is based on the actions of States and their agencies, not just written policies or resource allocation formulas.

124. It is the quality and quantity of information relating to a possible disability that will make the case more or less convincing — that will guide the judgement that is inevitably required to come to a conclusion. The level of confidence required to justify the inclusion of a disability will depend on the likely size of the disability, the importance of its underlying cause in the policy standard and the strength of the logic used to support it.

125. Even where very good data are available to show that different age groups use services differently, such as in hospitals, judgement may be required to derive the cost weights that link the use patterns to the input or cost. The following questions can be asked to assist the appropriate use of judgement:

*Guidelines for the use of judgement are:*

- *What hypothesis are we testing — for example, that more Indigenous students result in greater cost, or that costs increase due to distance from the source of supply?*
- *Does it appear that this group of users or this element of service provision cost structures (eg dispersion-related costs) results in States spending different amounts per capita?*
- *Does the different expenditure stem from a circumstance unique to the individual State (or something it experiences to a much larger or lesser degree than other States)?*
- *What information do we have with which to calculate or estimate a disability factor?*
- *Can logic, together with some basic data, be used to predict the direction of the effect on costs (for example, more of something results in higher costs)?*

- *Does the calculated or estimated disability indicate that States' costs vary in an expected manner?*

126. These questions can only assist us — conclusions based on judgement will differ between individuals. The level of evidence needed by one person to support a decision will differ from that of another. It is tempting in these circumstances to go to the 'least common denominator' and include only those assessment elements that everyone will accept, but that may result in many potential disability factors being omitted.

*Ultimately, the test of judgement is:*

- *Is this conclusion likely to match that of an informed and impartial observer?*

### ***The Relevance of SPPs***

127. Where SPPs are paid to the States to assist in the provision of services, and we treat those SPPs by the 'inclusion' approach, the expenses flowing from the SPP may be seen as a floor for measuring a disability factor. For example, SPPs for students for whom English is a second language (ESL) can be assumed to be spent on those students. If ESL students numbers are seen as the basis of a disability factor, and if the total SPP per ESL student is \$50 which is, say, 5 per cent of the average expenditure for all students, the 'floor' weighting for a disability factor for ESL students in our school age population is 1.0500. To that floor must be added the average impact of any extra State funded expenses.

*Main Point:*

- *The expenditure funded by SPPs may be seen as a floor for the cost weight that should be applied to the service recipients for whom the SPP is given to the States.*

### ***The Margin of Error***

128. There is always a chance that we have measured a disability factor incorrectly — either it is redistributing funds between the States in an illogical way, or it is redistributing too much or too little. We cannot approach this issue of margin of error in the usual statistical sense as we rarely deal with data of a quality that such a concept requires. It is more like a level of confidence that we need to think about. In doing so, the direction of the redistribution is easier to examine than the quantity of the redistribution.

129. The direction of the disability factor can be logically determined from a range of basic evidence, including the expenditure funded from SPPs. If the direction of the quantified disability factor does not match the expectations of the hypothesis that has been set, or the results are unexpected and have to be examined very closely before we can accept them as being plausible, they would not generally be applied — they do not meet a common sense test of acceptability. If the direction is in accordance with the hypothesis and is thought to be of the right magnitude, the method of assessment might be proceeded with.

130. But what is ‘of the right magnitude’? Here again, judgement and materiality play essential roles, but it seems that:

- *When judgement is being heavily relied on in the assessment of a disability factor, it should be set conservatively (closer to EPC).*

131. In the final analysis, however, the test is that if the level of uncertainty attaching to the method and data used in the assessment of the disability would result in a margin of error greater than the amount redistributed, the assessment should not be proceeded with.

132. These issues of judgement and materiality are frequently more of a problem in theory than in reality. The States generally have some evidence to support their arguments. Since the agenda papers presented at Commission meetings are potentially open to public scrutiny, Commission staff are ever mindful of the need to be objective. We do not recommend the Commission apply disability factors that have not been supported by the research, which in most cases is quantitative. More judgement was used in the early Reviews than now because States’ management information has improved. There are still gaps in our knowledge of what drives differences in unit cost, but patterns of use are now more often known and quantified. For example, hospitals, schools and prisons now know the age groups and socio demographic profiles of their ‘clients’. We are now also able to relate State service use and Census data with more accuracy, and to apply average State policies of service provision to the uniform and comparable data emanating from the Census.

### ***Materiality in Disability Assessments***

133. Materiality is most frequently discussed in terms of financial impact on States and it is tempting to try to lay down rules about what is and is not material. For example, any assessment decision that redistributes less than \$X, or \$Y per capita, to or from any State could be said to be immaterial. Individual functional assessments are not always relevant when thinking about materiality because a widely applied factor, such as administrative scale or dispersion, might have an immaterial impact when looked at from an individual category perspective, but might be very material when looked at overall.

134. The value-based approach (\$X per capita) to testing for materiality is often a more attractive proposal where there is no need to think about the interaction of the different disabilities that make up an assessment. But disabilities do interact with one another and we must think about this interaction when thinking about materiality.

135. Interaction between disabilities is handled in two ways — either within the assessment of joint factors or within the expenditure assessment framework.

### ***Joint Factors***

136. Joint factors simultaneously assess disabilities arising from several influences. They generally require comprehensive data and their use is limited to areas

where Census data are available to cross-classify the population using several attributes that have different impacts on each State's total demand for the service. They were developed to better associate each group with their individual propensity to use the service being assessed or their effect on unit costs, and to avoid unplanned interactions. Effectively, using the joint factor approach does separate assessments for each population sub group,

137. As an example, a Child Welfare assessment could be approached by looking independently at the impact on service use of age (say 4 groups), sex (2), Indigeneity (2), ability to speak English (3) and socio-economic background (say 4), and then combining the five assessments. This would be somewhat imprecise as there are obvious interactions between the groups and we would be letting the means of combining them cope with the interaction. As an alternative, the joint factor approach would divide the possible user group into the 192 sub-groups (4 x 2 x 2 x 3 x 4) and, use actual user data to attribute a relative demand indicator to establish the relative level of demand of each sub-group (eg. Indigenous males aged 15 to 18 with low English fluency and a low socio-economic background).

138. Because of the need to sub-divide the user population by as many attributes as necessary, joint factors can only be applied where there is a great depth of data on the likely user population. There is generally not the same depth of data on how actual demand is structured or cost is affected, and judgement is often required to get the appropriate 'use and cost weights' that should be applied to each sub-group used in the joint factor calculation. However, as with other areas, better management data has helped in this regard since the 1980s. Nevertheless, too much judgement in deciding the use and cost weights to be applied should be avoided, especially since joint factors appear to add complexity to the assessments. On the other hand, joint factors make the judgements about the weights attributed to each sub-group transparent.

#### *Main Points*

- *Joint factors are good ways of avoiding unintended interactions between disabilities and including 'real' interactions between personal characteristics where these impact on demand and cost differently. They make interactions of disabilities associated with personal attributes transparent.*
- *Joint factors require high standards of data availability and have been applied only where Census data allow stratification of the potential user population in each State.*
- *The Australia-wide data needed for the calculation of use and cost weights to support the level of user differentiation that can be derived from the Census may not be available. If too much judgement is required to assess the use and cost weights, the use of joint factors should be considered carefully.*

139. Joint factors are relevant to materiality because they depend on the simultaneous assessment of a number of factors. In these circumstances, any one of the

elements being brought into the assessment may not be considered material, of itself, but will be assessed as part of a larger whole.

### ***The Expenditure Framework***

140. Prior to 1999, the Commission assessed each category as a whole and combined the disability factors by simply compounding all of them or by compounding some and adding others to the compounded result. This meant that factors were often applied to the whole of the standard expenditure (although they were frequently discounted to align with the proportion of the standard expenditure they affected). We were left, however, with some unintended or inappropriate interactions of factors.

141. In the 1999 Review, the Commission developed the Expenditure Assessment Framework. It divided each category into components, based either on the different services or elements of expenditure in the category. This enabled the basis, range and size of disability factors to be varied between the components of each category, thus better reflecting their effects on States' expenditure needs. Within a component, the disability factors were generally compounded to produce a 'component factor' and the total category factor was achieved by weighting and adding the compounded results for each component.

142. In effect, the expenditure framework increased the number of assessment categories and thus negated any gains in simplicity that may have arisen from the reduced number of assessment categories. However, the Commission considered that the disadvantage of greater apparent complexity was outweighed by the advantage of greater accuracy (better matching disabilities with the expenses they affect) and transparency (the disabilities applied to each service or cost element were more readily seen).

143. As an example, Table 2 shows the expenditure assessment framework for the Family and Child Welfare category.

**Table 1** ASSESSMENT STRUCTURE

Expenditure component	Component weight	Factors	Abbreviation
	%		
Scale-affected expenditure (SAE)	2.42	Input costs	IC
		Administrative scale	S
Juvenile detention (JD)	19.48	Dispersion	D
		Input costs	IC
		Socio-demographic composition	SDC
		Cross-border	X
Residential care (RC)	69.92	Dispersion	D
		Input costs	IC
		Socio-demographic composition	SDC
Children's services (CS)	7.99	Dispersion	D
		Input costs	IC
		Socio-demographic composition	SDC
		Cross-border	X
Isolation (ISO)	0.19	Isolation	ISO

144. For each component, the IC, SDC and X disability factors are assessed differently because they relate to different services. The assessments for each component are then combined by:

$$\begin{aligned}
 \text{SAE} &= 0.0242 (ic * s) \\
 \text{JD} &= 0.1948 [(ic + d - 1) * sdc * x] \\
 \text{RC} &= 0.6992 [(ic + d - 1) * sdc] \\
 \text{CS} &= 0.0799 (ic + d - 1) * sdc * x \\
 \text{ISO} &= 0.0019 (iso)
 \end{aligned}$$

$$\text{Category factor} = \text{SAE} + \text{JD} + \text{RC} + \text{CS} + \text{ISO}.$$

145. Previously, there was simply one assessment for each of the IC, D, SDC and X factors, weighted so as to apply to a set percentage of total category expenses, and then multiplied to get the category factor.

### ***Responsibility for Proof***

146. Who should provide the evidence of the existence and size of a disability? Responsibility lies mainly with the States to show there is a conceptual basis for a disability

and that it is material. Once they have presented the case, the Commission is responsible for checking the conceptual basis and the materiality of the argument, and for making any decision to proceed with its insertion into the assessment. The Commission then has responsibility to measure it in a way that would give confidence to an impartial and interested observer that HFE is being progressed by its application.

*Main Points:*

- *The States have responsibility for showing that a disability exists.*
- *The States and the Commission have joint responsibility to show that the disability is material and can be measured with sufficient confidence to use it in the assessment.*
- *The Commission has responsibility for measuring the disability once it has decided the disability is relevant and material.*

## **REVENUE ASSESSMENTS**

147. Many of the questions confronting the Commission and its staff are the same when approaching an assessment of States' revenue capacities as those discussed for the expenditure assessments. The difference is that in expenditure, we try to measure why States' requirements for funding would differ from equal per capita. In revenue, we try to directly measure what the differences are in States' per capita revenue raising capacity – the revenue they would collect if they made the standard revenue raising effort<sup>28</sup>

148. We do this by looking not at what causes each State to have a different capacity, but at what the revenue of each State might be if it applied the same effort to raise revenue. The revenue assessments differ from the expenditure assessments, however, in that there is a major issue to be considered before any assessment is done. It is whether there should be a single global assessment of States' capacities to raise revenue, or a separate assessment done for each type of revenue States raise.

### ***Global or Tax by Tax Approach***

149. This issue has been raised in each review of relativities done by the Commission, and the 2004 Review is the seventh. New South Wales has been at the forefront of the arguments in favour of a global approach. A global revenue approach reflects a view that a single broad measure could provide a good indicator of the relative capacities of States to raise revenue from the multiple and different revenue bases they actually use. It would apply such a single measure irrespective of the relative importance of

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<sup>28</sup> Since these calculations are made by applying the same standard revenue effort to each State's revenue base, differences in revenue raising capacity are equivalent to differences between States in their revenue base per capita.

the different sources of tax actually being accessed in each State and the legal incidence of each tax.

150. A global assessment approach would imply that equalisation is about measuring the capacity of a community to pay taxes and charges, rather than the capacity of the States to raise revenues<sup>29</sup>.

151. In past Inquiries, revenue capacities have been measured tax by tax (or tax group)<sup>30</sup>. Wherever possible, revenue bases have reflected the range of activities, transactions and assets that States actually tax, because the Commission considered that captured the revenue raising advantages and disadvantages faced by the States. In cases where a direct policy neutral measure of the legal revenue base is not possible, the Commission has used a broad measure that encompasses the underlying revenue base<sup>31</sup> of the particular tax (it calls these sub-global measures). For example, in gambling tax, the legal revenue base would be an indicator of gambling turnover, but it is not possible to measure turnover in a way that is free of the influences of the policies of individual States on what forms of gambling are legal and other regulatory (or promotional) policies. In this case, the Commission has used household income as a broad measure of the underlying tax base.

152. This approach implies that equalisation is about measuring the capacity of State governments to raise taxes, through the taxes actually applied by the States and which lie behind the standard policy and the financial revenue standard. It is based firmly on ‘what States do’ and reflects the mixes of economic flows and stocks that characterise each State’s economy.

153. The two approaches are based on different theoretical constructs. The Commission has taken the view that the tax by tax approach better achieves HFE as it is currently understood. A global assessment based on gross State product or household income, may appear simpler and produce less annual volatility in relativities, but it assumes capacities that States do not have (or use) — it assumes there are no constitutional, intergovernmental or other restrictions that limit States’ access to what is being used as the taxable capacity measure. State taxes and charges are generally not imposed on income and do not vary with changes in personal or company income. In addition, the tax by tax approach, with its separate assessment for each activity being taxed, better captures the impact of differences between States in the wealth of their populations, the type of economic activities engaged in and the mix of household and personal income.

### *Main Points*

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<sup>29</sup> See Discussion Paper 2002/4, *Global Revenue Assessments*, for further discussion of this issue.

<sup>30</sup> Most federations use a tax by tax approach (often called a representative tax system) to measure capacity in their equalisation systems. For instance, Canada has about 30 separate revenue categories and measure revenue capacity in each by applying the average tax rate to an activity or asset type tax base.

<sup>31</sup> The Commission uses a broad indicator of taxable capacity, similar to a global measure, where data limitations preclude the use of a tax base, or where it is impossible to measure the tax base in a way that removes the effect of differences between the average tax policy and the actual policies of the States.

- *global revenue assessments assume States have capacity to raise revenue from a wider ranging set of revenue bases than they actually use;*
- *the tax by tax approach to measuring revenue capacity is more closely aligned to what States do, and is a better method of measuring States' capacities in terms of the application of an internal standard.*

### ***The Basic Approach to Revenue Assessments***

154. The task of assessing States' relative capacities to raise revenue involves measuring policy neutral capacities of States to raise revenue, not policy neutral measures of differences in the communities' capacities to pay tax and charges. It is done by making assessments for each of the about twenty of State own source revenue.

155. Differences between the standard per capita level of revenue raised and a State's actual per capita revenue raised from a source might be due:

- (i) totally to differences between the standard policies and those of the State — either in the rate of tax imposed, the activities to which the tax is applied, or the efficiency with which it is collected;
- (ii) totally to circumstances beyond the State's control that result in it having a different per capita level of revenue collection; or
- (iii) a mix of both these circumstances — the most common situation.

156. As in the expenditure assessments, it is only the circumstances beyond the State's control that we want to take into account in the assessments.

- Where the circumstances in (i) are found, the States are assessed as having equal per capita (EPC) capacities to raise revenue (and therefore equal requirements for Commonwealth funding).
- Where the circumstances in (ii) are found, the States' actual levels of revenue can be used as a measure of what they would raise if they were to apply the same policies. Thus, when all States follow the same policies, the difference between the standard per capita revenue and their actual per capita (APC) revenue can be used as a measure of their relative needs for funding.

157. Where differences in per capita revenue collections are caused by a mixture of policy differences and influences beyond their control (disabilities), the task is to only allow for the disabilities. We do this by directly measuring the differences in States' revenue bases (defined according to the standard revenue policy) — generally a quantity or a value. We therefore aim to find policy neutral measures of those quantities or values — the revenue bases.

*Main Points:*

- *Where all the differences in revenue per capita are due to policy differences, an EPC assessment is made.*
- *Where none of the differences in revenue per capita are due to policy differences, an APC assessment is made.*
- *Where differences in revenue per capita are due to a mixture of needs and differences in policies, the assessment is done by measuring the per capita revenue bases of each State.*

### ***Measuring Revenue Bases***

158. Leaving the EPC and APC approaches aside, there are three ways we approach the identification and measurement of State revenue bases. They are:

- (i) the *tax base method*, which uses the incidence of the tax as indicated by legislation to arrive at a policy neutral legal tax base — data on the size of each State’s tax base are obtained from actual tax collections;
- (ii) the *proxy tax base method*, which also reflects the legal incidence of the tax, but uses data from independent sources so that assessments are less influenced by differences in State policies — a revenue base is defined and measured on the basis of how States, on average, impose tax; and
- (iii) the *sub-global method*, which uses broad indicators, such as Gross State Product, or Household Disposable Income, as the revenue base to capture differences in States’ capacities in a general way when more direct measures are not available or cannot be measured in a way that is not affected by the policies of individual States.

159. The Commission prefers not to use the sub-global approach as it is furthest removed from what States do. It has used it only where the more preferred approaches — tax base and proxy tax base — are not available for data or other reasons.

160. An implicit assumption of the tax base approach is that differences in propensity to undertake the taxable activity are sources of disability — they are non-State policy influences. It is used when:

- differences in tax bases per capita are predominantly due to non-policy influences; or
- policy influences exist but their effect can be removed.

161. The proxy tax base is used when it is too difficult to remove the policy contamination from the level of activity (either value or quantity) that is being taxed. We focus on how the tax is levied and then try to replicate how the States impose the tax, using independent data as the measure of relative capacity. For example, a tax base approach to the Payroll Tax assessment would be based on the actual value of payrolls taxed in each

State: a proxy tax base approach would be based on ABS data on gross earnings of employees in medium and large businesses in each State.

162. Only where we are unable to arrive at a tax base, or even a proxy tax base, for the assessment do we look at general indicators of the economic activity in the States that might be used as a measure of the relative size of the tax base. In the case of Payroll Tax, this might be Gross Household Income. Here, we are not trying to measure the actual tax base used, but are using related economic data to arrive at a measure of what the relative tax base might be.

163. It is often necessary to adjust tax bases and proxy tax bases for the effects of observed differences between the standard policy and the policy of individual States, and to adjust sub-global bases for influences that affect the ability of States to raise revenue, but which are not captured by those measures. For example, tax bases may need to be adjusted for differences in tax rates (if the value of transactions is affected by the tax rate applied to them), compliance effort, collection efficiency and other policy differences. Sub-global bases may need adjustment for differences between the States in the propensity of people or businesses to undertake the taxable activity. For example, in the 1999 Review, geographic access to gambling activity was considered to influence the amount of gambling undertaken in each State, and the proximity to major centres of commerce may influence the level of financial activity.

164. Some of these adjustments involve judgement because reliable data are not available. Where sufficient evidence is available we have made estimates of the size and direction of the adjustment required for each State. Where such evidence is not available, the Commission has been reluctant to make adjustments.

165. Whether adjustments are made depends on questions of responsibility, judgement and materiality that parallel the expenditure disability factor assessments. It is up to the States to argue that adjustments are necessary and can be measured, it is then the Commission's responsibility to justify the adjustments being made, show that they are material and are based on a mix of evidence and judgement that would support their application in the mind of an informed and impartial observer.

#### *Main Points*

- *in descending order, the Commission's preferred approaches to assessing differential per capita revenue capacities are the tax base approach, the proxy tax base approach and the sub-global approach;*
- *adjustments are often made to the data being used in the tax base and proxy tax base approaches to allow for policy differences between States; and*
- *judgement will often be an ingredient in arriving at an adjustment to the assessed tax base.*

### *Elasticity Adjustments*

166. As well as adjustments for policy differences, the Commission is often confronted with arguments for the application of elasticity adjustments. States argue that the rate of tax being applied (where it is different from the standard rate implied in the assessment) influences the measure of the base and the base should be adjusted to what it would have been had the standard rate of tax been applied.

167. In the 1999 Review, the Mining Revenue category was the only area in which the Commission judged that differences in tax rates have had a large enough effect to require adjustment and for which sufficient information was available to allow an elasticity adjustment to be estimated. This was done having regard to the Commission's 1996 Research Report on Elasticity. The Commission decided in 1999 that the use of elasticity adjustments was not justified where there was an incentive on States to harmonise tax rates and where tax bases are highly mobile and the application of an elasticity adjustment could lead to a grant design inefficiency<sup>32</sup>. In those circumstances, States could try to manipulate their grant share.

#### *Main Points*

- *elasticity adjustments are not made very frequently, and are difficult to justify. They have, in the past, required convincing empirical evidence.*

## **ASSESSMENT OF USER CHARGES**

168. Revenues raised by service providers are becoming an increasingly important method by which governments fund services, although data relating to them are not always held in the published accounts. Within the GFS collection, and therefore the Commission's equalisation budget, most of the revenue raised by service providers is from user charges, but some is from the sale of minor assets and other sources. We treat all this revenue as User Charges. The possible treatments of them within the HFE processes are to:

- net them off the relevant expenditure standards; or
- treat them as 'another source of State revenue' and assess States' relative capacities to finance services through this source.

169. We need to consider the type of revenue being raised by service providers when deciding whether it should be treated by netting it off the expenditure or as a revenue, and then whether an assessment of differential revenue capacities is appropriate. The approach has generally been that:

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<sup>32</sup> Report on General Revenue Grant Relativities, 1999, Volume II, Methods, Assessments and Analysis, p. 187.

- (i) non user charge revenue, such as from the sale of minor assets, has been offset against expenses;
- (ii) minor user charges (where the user charges are a very small proportion of expense in a category) have been separately identified but assessed by the EPC method; and
- (iii) more significant user charges have been separately identified and assessed differentially using a factor assessment approach similar to that for expenditure assessments, rather than a tax base approach.

170. User charge revenues have not been netted off the expenditure standards because to do so implies that a State with a 10 per cent disadvantage in the cost of providing a service will have a 10 per cent advantage in raising user charge revenues from that service. This is often not the case.

*Main Points*

- *user charges are becoming more important as a means of financing government services;*
- *there are instances where States have differential capacities to fund services from user charges;*
- *to net user charges off expenditure standards produces illogical implied assessments.*