



COMMONWEALTH GRANTS COMMISSION

DISCUSSION PAPER CGC 2002/3

SCOPE AND STRUCTURE OF THE EQUALISATION BUDGET

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INTRODUCTION

1. The principle of horizontal fiscal equalisation is that:

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 standard¹.

2. The principle requires the Commission to make assessments of relative need for both revenue and expenditure, but it does not prescribe which revenues or expenditures ought to be assessed. This matter is left to the judgement of the Commission.

3. There are two issues:

- the scope of equalisation — the range of expenditures and revenues the Commission will consider in its processes; and
- the structure of the equalisation budget (previously termed the standard budget) — how the Commission breaks the included expenditures and revenues into manageable chunks. That is, the level of disaggregation and the Commission's category structure.

4. The next section deals with issues relating to the scope of equalisation and the following section deals with issues relating to the structure of the assessments undertaken to achieve equalisation. The objective of equalisation is to give States the capacity to provide 'an average level of services'. The Commission's predisposition is to include all services and revenues in the standard budget. Whether differential disabilities should be assessed for each item in the equalisation budget is a separate issue².

ISSUES RELATING TO THE SCOPE OF EQUALISATION

5. The scope of equalisation deals with the questions of what services States provide, what revenues they raise or receive through grants and, more importantly, which of them should be included for consideration by the Commission.

6. The principles underlying the current scope of the equalisation budget are that it should:

¹ *Report on General Revenue Grant Relativities 1999, Volume 1 Main Report*, Commonwealth Grants Commission, p 4. References to States should be understood to include the ACT and the Northern Territory.

² However, a transaction will have a zero effect on the relativities if it is omitted from the standard budget or included in the standard budget and assessed with zero needs (assessed on an equal per capita basis).

- (i) reflect what States do — that is, it should be based on the State governments' activities (expenditures and revenues);
- (ii) be restricted to the operating activities of State general government sectors — activities of other levels of government, activities of other sectors (especially public enterprises) and State capital activities are excluded, but any budgetary impact they may have on the operating activities of States' general government sectors are included;
- (iii) be comprehensive — all general government operating expenditures and revenues should be included; and
- (iv) be comparable — other transactions can be included if their inclusion would improve comparability³.

The 2001 Priority Issues Conference

7. Questions relating to the scope and structure of the 2004 Review were discussed at the September 2001 Priority Issues Conference. The consensus reached at the conference was that the scope and structure of the equalisation budget for the 2004 Review should be broadly similar to that currently in use. The Commission has given considerable weight to this consensus in its evaluation of subsequent State submissions on scope and structure issues.

Discussion Paper 2001/12

8. The Commission outlined its proposals for the scope of equalisation in its Discussion Paper 2001/12 *Scope and Structure of the Standard Budget*, which was circulated to States in November 2001. They were as follows.

- (i) The scope of the equalisation budget should be broadly similar to that used in the 2002 Update.
- (ii) All operating revenues and expenses, including the operating cost of capital, should be included in the equalisation budget.
- (iii) The equalisation budget should focus on the general government sector, including transactions between that sector and the public trading enterprise sector. The operating revenues and expenses of public trading enterprises would be generally out of scope. They would be included, however, where there are differences between the States in the institutional arrangements adopted to provide the services (such as social housing) or where identifying the net impact on the general government sector is impractical.

³ This is part of the reason why some Commonwealth Own Purpose Outlays (COPOs) are included in the Commission's equalisation budget.

- (iv) Data would be defined predominantly on an accounting basis, as reflected in the ABS GFS collections. This would not preclude the use of economic costs for particular categories if the case could be made that these would better support the assessment of disabilities.
- (v) For transparency, all services and revenues of each State's general government sector would be included in the equalisation budget. However, transactions which reflect a non-standard policy and cannot be justified by special circumstances would be assessed on an equal per capita basis so that policy choices of individual States do not affect their grant share.
- (vi) State operating statements would be the primary source of data, although some other transactions may be included if they improve interstate comparability.

THE 2004 REVIEW SUBMISSIONS

9. Generally, the States supported the proposals outlined in Discussion Paper 2001/12. New South Wales proposed a different approach to determining the scope of services for which States were to be given equal capacity. Western Australia stated its preferences on the use of economic costs, the inclusion of economic development expenses and the substitution of roads depreciation expenses for road rehabilitation costs. The Northern Territory proposed extending the scope of equalisation to include Commonwealth assistance to Local Government and Medicare Benefit payments.

Restrict the Scope of Equalisation to Merit Goods

10. New South Wales proposed restricting the scope of equalisation to those services where there is a recognised right of citizens to a certain standard of services and a demonstrated effect on equity. It said such services must be public goods. It expressed its arguments in terms of the notion of 'merit goods' which it described as those services that:

- have a direct and significant effect on quality of life;
- all governments provide to all citizens as part of their obligation to provide universal access to core services (that is, they are not discretionary services);
- are routinely discussed at intergovernmental Ministerial meetings; and
- are generally provided at a similar level throughout each State.

11. New South Wales submitted that the scope of the standard budget should be restricted to the Education, Health, Law and Order, Housing, Welfare and Transport

categories. It said that Services to Industry, and Culture and Recreation categories, should be excluded.

12. Subject to the outcomes of the 2002 Conferences, we are not inclined to take these proposals further because:

- (i) the definition of merit goods proposed by New South Wales does not appear to be robust and it is unlikely to lead to a consensus among the States on what is or is not a merit good;
- (ii) limiting the scope of equalisation in the way proposed would omit services that all or most States provide and would not be consistent with reflecting 'what States do' in the equalisation process — it would not give States the capacity to provide the average level of all services that States provide; and
- (iii) it would not be consistent with the consensus at the Priority Issues Conference that the scope of equalisation should remain broadly similar with that currently in use.

13. In addition, it is noted that a decision to omit a service from the equalisation budget has the same effect on State per capita relativities as a decision to include the service and assess equal per capita needs for it. However, a decision to include expenses on a service in the equalisation budget does not mean that the Commission will assess different per capita needs for each State for that service. That is not a question of scope or structure, but is fundamental to the 2004 Review. To include all services in the equalisation budget improves transparency of the Commission's procedures by making the assessment decisions explicit.

Commonwealth Assistance to Local Government

14. The Northern Territory proposed extending the scope of equalisation to include Commonwealth assistance provided under the *Local Government (Financial Assistance) Act 1995* because it claimed:

- inequities in the interstate distribution of that assistance mean that it has to provide greater financial support to its local government bodies than other States; and
- its needs in this area were not fully recognised.

15. Subject to any further argument, we are not inclined to accept this argument because:

- (i) the provision of untied assistance for local government is a Commonwealth function (only the Northern Territory provides such assistance from its own resources);

- (ii) including expenditure on a Commonwealth function would go beyond the aim of equalisation of what States do; and
- (iii) to include it in the equalisation budget for the 2004 Review would be inconsistent with the consensus of the Priority Issues Conference that the scope of equalisation should remain broadly similar with what is currently in use.

Medicare Benefit Payments

16. The Northern Territory also proposed extending the scope of equalisation to include Medicare Benefit payments, arguing that:

- these payments are a substitute for States' own purpose outlays;
- inequities in the interstate distribution of Medicare payments impacts directly on State budgets and the Territory's needs in this area are not fully recognised; and
- Medicare payments are similar to Primary Health Care Access Program (PHCAP) payments which the Commission treats by inclusion.

17. At this stage, we are not inclined to accept this proposal because:

- (i) Medicare payments are payments to individuals or the proxies of individuals (doctors) and are a Commonwealth responsibility — they do not arise from services normally provided or funded by the States; and
- (ii) including expenditure arising from a Commonwealth function would go beyond the aim of equalisation of what States do.

18. We acknowledge that the uneven per capita distribution of Medicare Benefits payments has an impact on State budgets (by, say, necessitating additional State expenditure on the provision of community medical or hospital emergency services). We attempt to reflect these differences in the disabilities assessed. Currently, we assess differential disabilities for this influence in its Hospitals and Community Health assessments. The extent to which the assessed disabilities reflect the relative needs of the States to provide more or less services because of differences in the private provision of medical services will be considered as part of the review of the assessments for the relevant categories.

19. The treatment of all SPPs will be re-examined as part of the 2004 Review. *Inter alia*, that examination will address the Territory's concerns about an inconsistency between the treatment of Medicare and PHCAP payments.

Other Issues of Scope

20. Other issues raised by the States which affect the scope of the equalisation budget are dealt with in other discussion papers. Subject to any further arguments that may be raised during the October and November conferences, preliminary views on those issues are summarised below.

- (i) ***The treatment of capital grants from the Commonwealth.*** *Discussion Paper 2002/11, The Treatment of Capital Grants* indicates an inclination to apply the usual procedures for deciding the treatment of Commonwealth specific purpose payments to capital grants. This would imply that some capital grants would be included in the equalisation budget and treated as though they were available to finance part of each State's requirement for assistance (including that arising from its need to fund depreciation).
- (ii) ***Superannuation.*** *Discussion Paper 2002/39, The Superannuation Assessment*, indicates an inclination to continue the existing approach of including in the equalisation budget, transitional allowances for the unfunded superannuation liabilities that existed at the time accrual accounting practices were adopted in preparing the ABS GFS data.
- (iii) ***Roads Rehabilitation Expenses.*** *Discussion Paper 2002/34, The Roads Assessment*, indicates that subject to any further argument, Commission staff intend recommending to the Commission that roads rehabilitation expenses be replaced in the equalisation budget by roads depreciation expenses.
- (iv) ***Economic Development Expenses.*** *Discussion Paper 2002/6* discusses a number of issues associated with the treatment of economic development expenses in the equalisation assessments. It indicates that as far as possible all expenses incurred by the general government sector in relation to economic development activities are included in the standard budget (although not all are assessed differentially).

ISSUES RELATING TO THE STRUCTURE OF THE EQUALISATION BUDGET

21. The structure of the equalisation budget deals with how the Commission breaks expenditures and revenues into manageable chunks. That is, it deals with questions of the level of disaggregation and the Commission's category structure.

22. The consensus reached at the Priority Issues Conference was that the classification of State expenses and revenues for the 2004 Review should contain a level of detail similar to that currently in use.

23. Since the Priority Issues Conference, Heads of Treasury have agreed that tables prepared and published in State budget documents under agreements relating to a uniform presentation framework will contain a more detailed functional dissection of expenses. The new level of detail will be consistent with the Commission's proposals on the structure of the equalisation budget outlined in Discussion Paper CGC 2001/12.

THE 2004 REVIEW SUBMISSIONS

24. Generally, the State submissions supported the Commission's proposals on the structure of the equalisation budget outlined in Discussion Paper 2001/12. Table 1 contains a summary of the cases where the proposed structure differs from that used in the 1999 Review and subsequent updates. The Discussion Paper indicated that many of the proposals were intended to better align the categories the Commission used in its assessments with the classifications in the ABS GFS collection — the only practical source of almost all the financial data required for the preparation of at least the expenses side of the equalisation budget.

25. In most cases these proposals attracted little comment from the States. In some, however, there were concerns about whether the classifications could be achieved on a consistent basis across all States. For example, South Australia argued that the nature of hospital services made it difficult to accurately separate expenses attributable to inpatient services from those for outpatient and emergency services. Subject to any further discussion, we intend to implement the proposed structure because:

- (i) it can better reflect the disabilities associated with different services (the disabilities associated with outpatient and emergency services are more like those for community health services than those for inpatient services);
- (ii) financial data are currently available to support the proposed structure; and
- (iii) while there are some doubts about the present comparability of that data, it is expected to improve.

26. South Australia also argued that juvenile corrective services were different from adult corrective services and should remain in the Family and Child Welfare category. The GFS classification definitions have included juvenile corrective services with adult corrective services for some time and it is not clear that the data the Commission has been using for Family and Child Welfare in recent years fully conformed with its present definition. The proposed change to the Commission's definition was therefore made to better align that definition with the GFS. South Australia's argument that the nature of juvenile and adult corrective services (and hence the associated disabilities) are different can be addressed by identifying a juvenile corrective services component in the Corrective Services category.

Table 1 CATEGORIES WHERE THE PROPOSED STRUCTURE IS DIFFERENT FROM THE 1999 REVIEW

1999 Review Category	Proposed Category	Change in coverage
Insurance Taxation	Insurance Taxation	Includes taxation on motor vehicle third party insurance
Other Vehicles Registration Fees and Taxes	Other Vehicles Registration Fees and Taxes	Excludes taxation on motor vehicle third party insurance
Drivers Licence Fees	<i>No category</i>	Treated as Roads user charges
Hospitals	Inpatient Services	Includes mental health institutions and psychiatric wards
Mental Health	<i>No category</i>	Expenses reallocated
Community Health	Non-inpatient and Community Health Services	Includes community mental health and other community health services
Nursing Homes	<i>No category</i>	Included in Aged and Disabled Services
Family and Child Welfare	Family and Child Services	Excludes juvenile corrective services
Aged and Disabled Welfare	Aged and Disabled Services	Includes nursing homes and payments for concessions to pensioners for local government rates
Other Welfare, COP – Other Concessions	Homelessness and General Welfare	Includes miscellaneous concessions to people with low income
Aboriginal Community Services, Regulatory and Other Services	Community Development	Includes community development previously included in Aboriginal Community Services and Regulatory and Other Services
Housing	Housing	Includes depreciation
Aboriginal Community Services	<i>No category</i>	Included in the categories for each type of services
Corrective Services	Corrective Services	Includes juvenile corrective services
Electricity and Gas	Electricity and Gas	Includes expenses on regulation of enterprises and services on Aboriginal communities
Water Supply and Sewerage	Water, Sanitation and Protection of the Environment	Includes expenses on regulation of enterprises and services on Aboriginal communities
Freight, Non-urban Passenger Transport	Non-urban Transport	Includes freight and passenger services and expenses on regulation of enterprises and services on Aboriginal communities
Urban Transit	Urban Transit	Primarily concessions and subsidies
Other Trading Enterprises	<i>No category</i>	Expenses reallocated
Other Concessions	<i>No category</i>	Expenses reallocated
Primary Industry	Primary Industry	Includes expenses on regulation of the industry
Mining, Fuel and Energy	Mining, Fuel and Energy	Includes expenses on regulation of the industry
Tourism	Tourism	Includes expenses on regulation of the industry
Manufacturing and Other Industry	Manufacturing and Other Industry	Includes expenses on regulation of the industry
Debt Charges	Debt Charges	Excludes debt charges incurred on behalf of PTEs
Depreciation	Depreciation	Excludes Housing, Roads, Urban Transit and depreciation incurred on behalf of PTEs
Regulatory and Other Services	<i>No category</i>	Expenses reallocated

27. The following sections outline cases where the proposals attracted discussion from the States. At this stage, it is intended that the proposals in Table 1 be implemented, except where they are varied by the following discussion.

Level of Aggregation

28. In its submission, Western Australia proposed that the Commission adopt a broader, more aggregated, budget structure rather than the existing one which reflects in detail the types of services States provide. It said that the existing degree of disaggregation within expenditure categories has the effect of obscuring States' broader policy objectives:

- to deliver reasonable outcomes in public services for their entire community; and
- to improve service delivery outcomes.

29. It also argued that the existing approach:

- ignores the interconnectedness of services; and
- assumes that a standard mix of services is provided rather than a basket of services which best achieves a standard set of broad outcome objectives.

30. It suggested the Commission take an aggregated approach to assessments — one revenue assessment and global measures of expenditure need. New South Wales also supported a global assessment of State revenue.

31. The issue of a global revenue assessment is considered in Discussion Paper CGC 2002/4. In that paper, the Commission indicated that its preliminary decision was to continue the existing tax-by-tax approach rather than adopt a global revenue assessment. It reached this preliminary conclusion because it considered a global assessment would not adequately reflect what States do. In particular, it would not reflect the constraints that apply to the range of taxes States can actually impose and would therefore not adequately measure the differences between States in their relative capacities to raise revenue.

32. Subject to any further arguments that may arise at the October or November 2002 conferences, the Commission is not inclined to adopt aggregated expenditure assessments. Aggregated expenditure assessments would imply a form of equalisation that differs substantially from the existing one. The disabilities would be higher level and broader measures of differences between States which would abstract from the way States provide services and from the influences on demand and cost that they face. On the whole, the current approach to the expenditure assessments captures well the way States respond to the demands of their population for services. It allows the Commission to measure the differences between States in the demand for services and the influences on the unit costs of services given the standard approach to delivering them. To the extent that individual States may provide a mix of services that differs in some ways from the standard mix, the benefits (or costs) of doing so are retained (or borne) by that State unless they can be associated with special circumstances that are accepted as being needs-based.

33. Continuation of a detailed approach to expenditure assessments is also consistent with the outcomes of the Priority Issues Conference where the consensus of the parties was that, for the 2004 Review:

- (i) the equalisation principle should be interpreted in a way that was current at the time the States signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*; and
- (ii) the scope and level of detail in the Commission's equalisation budget should remain broadly similar with what is currently in use.

Changeable Component Weights

34. Under the expenditure assessment framework adopted for the 1999 Review, expenditure categories are partitioned into components that reflect the different types of services or expenses included in the category. This partitioning of categories is done to enable disabilities to be better matched with the expenses to which they relate. The partitioning is based on the best available information on expenses arising from each service or type of expense in the category. Because of the approximate nature of the partitioning and to keep the information demands for future updates to a minimum, the Commission decided in 1999 that category component weights applied in the 1999 Review should be retained in subsequent updates.

35. During the 2000 Update, the Commission confirmed that:

- changes to expenditure component weights would not generally be made in updates; but
- it would review this decision if it became evident that changes in State policies were having a large impact on State expenditure patterns.

36. In its 2004 Review submission, Queensland proposed that category components be allowed to grow at different rates between reviews because they are likely to grow at different rates in the same way that different categories grow at different rates. Victoria also argued that the practice of fixing the size of components between Reviews (especially the component for scale affected expenditure) in each category should be re-examined.

37. The range and size of components in each expenditure category will be considered as part of the 2004 Review against the background of the changes in the definitions of categories and changes in State expenditure priorities. Whether component sizes should be varied in updates after the 2004 Review depends on what is permitted under the terms of reference for those updates and on whether the evidence available at the time suggests that there have been material changes in State expenditure patterns.

Aboriginal Community Services

38. The Commission has used this category in previous reviews because of the specific nature of the services and because the disabilities associated with those services and the interstate pattern of the disabilities are very different from disabilities assessed for other services. However, the category is not supported by the purpose classification definitions used in the GFS collection. The necessary data were collected from each State using special data requests.

39. In Discussion Paper 2001/12, the Commission proposed to discontinue assessing this category and to reallocate the expenditure to other categories where it better aligns with the GFS collection. Based on the composition of the existing Aboriginal Community Services category, implementing this proposal would result in about 70 per cent of the expenses being classified to the new Community Development category and the remaining 30 per cent being allocated among the categories that relate to the delivery of essential services (Electricity and Gas; Water, Sanitation and Protection of the Environment; and Non-urban Transport). In each case, the assessments would recognise the disabilities associated with Indigenous communities.

40. In its submission, Queensland argued that the Aboriginal Community Services assessment should continue to reflect the appropriate level of service delivery disabilities. It was concerned that the disabilities faced in providing services to Indigenous communities may not be fully recognised if the category was discontinued.

41. The Northern Territory also argued that relocating the expenditure would not result in a better assessment of the cost and demand disabilities — the current structure reflects the nature of disabilities associated with the delivery of the service and not the nature of the people served. It said the Aboriginal Community Services category contains expenditure driven by the same key disabilities and that is sufficient justification for the category to be maintained.

42. Western Australia said the Aboriginal Community Services category tended to lock in the much lower standard of government services available in regional areas and to Aboriginal communities by equalising capacity to this lower standard. It said a uniform standard of outcomes for all would better enable States such as Western Australia to bridge the existing service level gaps.

43. New South Wales, Victoria and Tasmania supported the deletion of the Aboriginal Community Services category and its absorption into the relevant mainstream service categories. South Australia also broadly supported the Commission's proposals.

44. The Commission has not yet reached a preliminary decision on whether the Aboriginal Community Services category should be retained or the expenses allocated across the other relevant categories. Regardless of the approach finally decided on, it will be necessary to collect details from each State on the expenses it incurs in providing essential services, community management, planning and other local government-type services in Aboriginal communities. Such data would be required to:

- (i) enable expenses to be excluded from the ABS GFS categories to create a separate Aboriginal Community Services category if the existing approach is retained; or
- (ii) enable the identification of the Aboriginal community components of expenditure classified to the Community Development; Electricity and Gas; Water, Sanitation and Protection of the Environment; and Non-urban Transport categories.

45. The final decision on whether or not the current Aboriginal Community services category is retained will depend in part on issues of transparency and simplicity. Will it be more transparent if there is one assessment for all expenses related to Aboriginal community services? Are the disabilities closely related to those incurred in providing services to non-Indigenous communities? Are there presentational advantages in the figures the Commission uses in preparing its expenditure standards being similar to those published by the ABS in its GFS publications.

Regulatory and Other Services

46. In the 1999 Review, the Commission used this category to include, among other things, the increasing level of expenses States were incurring in regulating all business enterprises under the National Competition Policy and any other regulatory expenses. This category is not supported by the current disaggregation in the GFS collection where regulatory expenses are combined with other State expenses relating to a particular service. For example, costs incurred in regulating water authorities are included in the category that contains other expenses relating to water supply, and expenses relating to the regulation of electricity authorities are included with other State expenses on electricity services.

47. In Discussion Paper 2001/12, the Commission proposed to discontinue this category and to adopt the ABS GFS classification.

48. Victoria supported that proposal because it would increase the transparency of the structure of the equalisation budget. South Australia gave tacit support to the proposal but insisted that the disabilities assessed for the present category be retained in the new assessments.

49. The ACT also gave qualified support for the re-allocation of Regulatory and Other Services expenditure to the appropriate functional categories, but added that relativities should not change because of movements of expenditures between categories. It asked that the Commission identify and note the causes of any changes to the relativities that result from expenditure reallocations such as this.

50. No other State made specific comments about this proposed change.

51. Like Aboriginal Community Services, the Commission's options are constrained by the availability of data from the GFS collection. A regulatory services category is not supported by the GFS classifications. The retention of a separate category would therefore require additional data to be collected from the States.

52. In this case, and subject to any further discussion at the October and November conferences, we are intending to follow the GFS classification processes — that is, discontinue the separate Regulatory and Other Service category and allocate the expenses to the relevant functional categories. Relevant disabilities can be assessed in the functional categories and the approach should be simpler, more transparent and practical than the alternative of retaining the separate category.

Debt Charges for Public Trading Enterprises

53. Discussion Paper CGC 2001/12 indicated that if data permitted, debt charge expenses incurred by the general government sector on behalf of public trading enterprises would be allocated to the relevant functional categories. Such data will not be available. Consequently, all debt charge expenses incurred by the general government sector will be included in the Debt Charges category.