



**COMMONWEALTH GRANTS COMMISSION**

**DISCUSSION PAPER CGC 2000/5**

**STATE POLICIES AND DISABILITIES**

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## SYNOPSIS

The Commission has investigated State<sup>1</sup> concerns that its methods do not adequately distinguish between policy and disability influences on State revenues and expenditures. It has done this by examining specific State arguments relating to the Hospitals expenditure and Mining and Payroll Tax revenue assessments, and a number of factors. It has concluded that:

- (i) the standard used by the Commission facilitates the achievement of equalisation as it is presently understood;
- (ii) distinguishing between disability and policy influences on State revenues and expenditures can be contentious, but the present approaches avoid any systematic bias;
- (iii) the review and annual update process ensures relativities are responsive to changes in policies and disabilities; and
- (iv) the use of a best practice benchmark and the measurement of disabilities from such a standard is outside the Commission's mandate for the 2004 Review.

On the basis of the work undertaken, the Commission has come to the view that wholesale changes to its methods are not needed. It proposes that concerns over the way it distinguishes between policies and disabilities be handled on a case-by-case basis within the normal review processes.

## GENESIS OF PROJECT

1. Some States are concerned that the Commission's approach does not always correctly distinguish between the effect of disabilities and the effect of policy choices on State expenditures and revenues. In broad terms, disabilities are defined by the Commission as differences in **unavoidable** influences on States' per capita costs of providing services or capacities to raise revenues. This distinguishes them from 'avoidable' differences due to policy influences, which also result in different levels of per capita revenue or expenditure. A State's actual per capita expenditure or revenue differs from the standard or Australian average experience because of differences in the disabilities it faces and the policies it implements.

2. The identification of State policy and disability differences underpins horizontal fiscal equalisation. Some States believe that the Commission accepts evidence of disabilities too much at face value.

- (i) Victoria argues that the Commission does not adjust disabilities sufficiently to remove the influence of government policy differences

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<sup>1</sup> In this paper, States mean the six States, the ACT and the Northern Territory unless the context indicates otherwise.

on service delivery costs. It argues that where a State is operating less efficiently, the disabilities of that State should be discounted for inefficient input use. Those States should not continue to be 'subsidised under the pretext of disabilities'. 'Subsidies' should only be provided to a benchmark price. In other words, to encourage States to operate more efficiently, we should measure disabilities against best practice standards (both financial and policy), rather than against the Australian average standard.

- (ii) Western Australia and Victoria have said that the Commission does not fully exclude the effect of State policy differences from revenue bases. Western Australia argues that it pursues policies, different from other States, which result in a higher level of economic activity. This increases its assessed revenue bases, particularly for mining revenue. Victoria has argued that its out-sourcing policies have increased the size of its private sector employment and hence increased many of its revenue bases, particularly payroll tax.
- (iii) New South Wales and Victoria have both argued that administrative scale, service delivery scale and dispersion disabilities are very much influenced by policy choice. This is because States have the opportunity to achieve cost savings by technology, sharing policy development, sharing corporate systems and the introduction of competition. They are concerned that the Commission's processes entrench the distinction between disabilities and policy, and thus inefficiencies in service delivery. Victoria has asked that disabilities be based on the most appropriate delivery mechanisms.

3. The Commission recognised the need to address these concerns and included a project to consider them as a priority issue in the 2004 Review work program.

4. This Discussion Paper:

- examines what is presently meant by fiscal equalisation and the boundaries that establishes for the Commission;
- explains how financial standards are derived and what they represent;
- explains how the effects of disabilities and policy differences are recognised in the assessments (especially how policy neutral measures of disability are sought and used);
- considers the cases put by Victoria on hospitals expenditure, Western Australia on mining revenue capacity and Victoria on Payroll Tax;
- looks at whether the Commission's processes entrench disabilities; and
- responds to Victoria's view about the use of best practice benchmarks.

## WHAT FISCAL EQUALISATION MEANS

5. The principle of fiscal equalisation directs the Commission's work. In the 1999 Review, it was defined as follows.

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>2</sup>

6. The principle implies equalisation of State governments to the 'same' levels of revenue effort, operational efficiency and standards of services. The Commission has long defined 'same' in terms of Australian<sup>3</sup> average benchmarks because, in accordance with the principle, it bases its assessments on the per capita average of the actual experience of the States. This grounds equalisation firmly in the context of what States actually do.

7. The principle espouses equalisation of capacity, not equality of outcomes. States are free to spend their untied Commonwealth funding however they choose. They are free to decide their own priorities, to make different revenue efforts, to provide a different level of service and to operate at the level of efficiency they choose. The ability of States to vary their policies according to the wishes and needs of their citizens is seen as one of the virtues of a federal system of government.

## THE AUSTRALIAN AVERAGE STANDARD

8. The Commission uses a population-weighted average standard. The average financial standard implicitly reflects an average level of State characteristics and an average of State policies. This is because the level of service provided to (or revenue impost faced by) each Australian receives the same weight in calculating the standard. Because there are more people in some States, the policies of those States have a larger influence on the standards. For example, the absence of land tax in the Northern Territory has practically no impact on the population-weighted average amount of land tax raised.

9. The use of this internal standard means the Commission does not have to make judgements on matters that impinge on State sovereignty. It does not need to make assumptions about what States should, or could, be doing.

10. Using this standard also means that the Commission satisfies requirements of its terms of reference by calculating relativities that will achieve equalisation of fiscal capacity. The average standard is consistent with the accepted definition of equalisation.

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<sup>2</sup> Commonwealth Grants Commission, *Report on General Revenue Grant Relativities, 1999 Volume 1, Main Report*, page 4.

<sup>3</sup> In this context, Australian average means the population weighted average of the experience of the States, the ACT and the Northern Territory.

11. Furthermore, the current financial standard is policy neutral and neither encourages nor discourages efficiency. If a State spends less than the standard due to its efficiency, it is given the capacity to operate at the standard level, after taking account of its disabilities. Its above-average level of efficiency does not affect its grant and it can use its savings elsewhere. Similarly, where a State operates at below the average level of efficiency, its grant is not increased. It is given the capacity to provide services at the standard level, allowing for its disabilities. Its inefficiency is a real cost to its budget.

12. The standard reflects a range of State policies and practices from the least efficient to the most efficient State. Because it does not reflect solely the most efficient policies and practices, it could be said it does not discourage inefficiency. On the other hand, a State does benefit by its above average efficiency and, over time, efficiency gains increase the standard level of efficiency to which all States are expected to operate. Overall, the Commission's assessments are efficiency neutral.

## **THE ROLE OF DISABILITIES IN THE COMMISSION'S ASSESSMENTS**

13. Actual per capita expenditures and revenues differ from State to State. Differences are attributable to either disabilities or policy differences. The Commission's assessments aim to be policy neutral and to recognise only the effects of disabilities.

### ***What is A Disability?***

14. In broad terms, disabilities arise because of differences between States in their physical, economic, social and demographic characteristics that are not under the control of State governments. Disabilities reflect the differential impact of those conditions on States' costs and revenue capacities. They are relative, not absolute measures.

15. The Commission has defined policy differences to be those things over which governments have direct control and that have an impact on States' budgets — a decision on whether to impose a tax; a decision on whether to provide 12 or 13 years of school education.

16. There is a question, however, about how much influence governments have, over the long-term, on their economic, social and demographic situation — for example, the abolition of death duties by Queensland influenced the location choices of retirees, and hence Queensland's on-going demographic profile. Often, judgement is required on where to draw the line between policy and disability.

17. Expenditure disabilities are those things that require a State to spend more (or less) per capita than the Australian average to provide the average level of service at the average level of efficiency. They affect the level of demand for services and the unit cost of providing them. The Commission identifies over 20 different disabilities, which it has detailed in past Working Papers. A number of them, such as input costs, administrative scale and service delivery scale, are common to many services. Expenditure disabilities can

influence either levels of demand or unit costs, and are explicitly measured. Examples of disabilities are:

- (i) the higher needs of specific population groups such as those of indigenous or non-English speaking background — a higher than average proportion of indigenous Australians results in higher per capita average costs in delivering health services; and
- (ii) labour and office accommodation costs in Sydney are higher than in other cities — resulting in a higher unit cost of providing services.

18. Revenue-raising disabilities are those influences that result in a State raising more or less revenue per capita than the standard when it makes the average effort to use its revenue bases. They arise from differences in such things as employment, production, income, spending and asset values in each State. These general influences in turn affect the bases for State taxes such as value of payrolls, value of motor vehicles sold and value of commercial/industrial land. The Commission measures the size of these rather than examine the individual reasons for differences in per capita revenue bases. In most cases, revenue-raising disabilities are implicit. Examples include:

- (i) differences in proportions and size distribution of private sector employers above the taxable threshold — these affect payroll tax capacity;
- (ii) differences in value of property turnover — these affect capacity to raise revenue from stamp duty on conveyances; and
- (iii) differences in mining production — these influence the capacity to raise mining royalty revenue.

### ***Expenditure Assessments***

19. Expenditure assessments start with the standard per capita cost and increase or decrease it for disabilities. Adjustments are not made for policy differences in the level of service or in the efficiency of service provision. For example, States transport children in rural areas to a centrally located school. States with relatively more children in such areas have a level of demand that results in a disability. States with longer distances over which to transport children have a cost disability from extra fuel costs per trip. Their expenditure requirements would be calculated by increasing the standard by these disabilities.

20. However, if the standard policy of the States were to pass the cost of this transport on to parents, State governments would not incur the extra costs and no disability would be assessed for any State, even if one State continued to provide a free service.

### ***Revenue Assessments***

21. Revenue assessments aim to calculate State taxable capacities directly. The Commission tries to find policy-neutral revenue bases. ‘Policy’ usually refers to

immediately identifiable differences in tax provisions, explicit in legislation or regulation; for example, differences in the treatment of goodwill for conveyance duty, or in tax rates.

22. Revenue bases may be actual taxable activity, transactions or event data from each State (actual tax bases), where necessary adjusted for material policy differences. For example, because all States except Victoria tax goodwill when levying conveyance duty, the total value of transactions attracting duty in Victoria is increased to make its base comparable with those of other States. No attempt is made to measure revenue-raising disabilities as, once adjustments are made for the identified policy differences, the revenue bases capture the effect of those disabilities.

23. Where we cannot remove tax policy differences, such as on the range and promotion of legal gambling, we use broader indicators of capacity as the revenue base (sub-global bases), such as household disposable income, which are less susceptible to State policy influence.

24. **Conclusions.** Both the factor assessment approach used in expenditure assessments and the direct approach to revenue assessments are designed to produce policy neutral results.

### ***Distinguishing Between Policy and Disability***

25. In practice, it can be difficult to draw the line between disabilities and differences in policy choice because they may be inter-dependent. Disabilities arise from the characteristics of States, but their extent reflects the average way States respond to them. Suppose only one State used air-conditioned buses to transport school children. This could be a policy difference, but it could also be a disability if it was in response to a much hotter climate. It is a matter of judgement.

26. The standard policy informs the nature and size of disabilities. For instance, all States exempt employers below a minimum payroll threshold from payroll tax. That is clearly the standard policy and therefore the revenue base of each State excludes such small employers' payrolls. If one State were to tax small employers, the payrolls of its small employers would still be excluded from its revenue base because it would be treated as a policy difference and not as a revenue raising advantage.

## **STATE ARGUMENTS**

27. Some States have argued that the Commission is too inclined to attribute differences in States revenues and expenditures to disabilities rather than to different policies and efficiencies. States have raised specific assessments in this regard.

## *Hospital Services*

28. Victoria is concerned that the Commission treats differences in costs of providing hospital services as evidence of disability, and does not recognise that efficiency and policy differences might be driving these cost differences. It argues that it has increased the efficiency of its hospital services, resulting in reduced costs. It believes that the other States could also lower their costs and hence their disabilities.

29. In assessing Hospital expenditure disabilities, the Commission has used Australian average data. The major disabilities are due to differences in the socio-demographic composition of State populations and hospital costs, by location.

- (i) The socio-demographic composition factors are calculated by applying Australian average utilisation rates derived from Australian Hospital Morbidity and Census data to each State's population characteristics. The resultant disabilities reflect differences in age-sex, Aboriginality and low fluency in English, not differences in State utilisation rates.
- (ii) The hospital costs factor is calculated by applying Australian average costs of treatment in each type of region to the standardised utilisation of each State's population in that type of region. Again, differences in actual costs between States do not affect the resultant disability.

30. We tested the possibility that we might be attributing too much of the difference in costs to disability rather than policy, using the Productivity Commission data referred to by Victoria. Attachment A provides details. We found that Victoria's costs in acute hospital services have been low in recent years and that reforms to its health system, especially its introduction of casemix funding, could have contributed to this.

31. The Productivity Commission data suggested that, for comparable services, Victoria's costs in public hospitals in 1997-98 were about 18 per cent lower than those of New South Wales. Commission data showed that Victoria spent about 10 per cent less on hospital services on a per capita basis. However, the disability assessed for Victoria indicated that it could provide standard services for about 2.8 per cent less per capita than New South Wales. Thus, only a small part of Victoria's lower costs were attributed to differences in disability. The majority of the difference was attributed to policy differences and Victoria's budget benefited accordingly. This suggests that Victoria might have been providing a more efficient service than other States<sup>4</sup>.

32. In this example, our assessment attributed most of the observed differences in cost between New South Wales and Victoria to policy differences. We used actual expenditures only to derive the financial standard, and we used Australian averages to derive disability factors. This is the approach we use in all assessments. Thus, we do not think the Commission's methods indiscriminately attribute cost differences to disabilities. However, we will continue to be vigilant in our efforts to avoid this. Although suggested by Victoria that we might use the Productivity Commission data on efficiency and

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<sup>4</sup> Other possibilities were a lower level of service or a different mix of services.

effectiveness to better assess policy neutral disabilities, we are not sure how this might be done.

### ***Revenue Assessments***

33. Western Australia and Victoria have said that the Commission does not exclude all the effects of policies on revenue bases, even on broader measures of bases, when doing its revenue assessments.

34. Western Australia's general concern is that the Commission's approach to this issue fails to recognise State's policy differences. It says that it pursues policies, different to other States, which result in a higher level of economic activity. The Commission's failure to recognise and adjust for this is said to be inconsistent with policy neutrality.

35. Victoria believes that State revenue bases should be adjusted for the impact of policies on out-sourcing and privatisation on the size of States' private sectors.

36. ***Industry Development.*** The relationship between government policy in economic management and the economic outcome is difficult to quantify. All State governments provide assistance to encourage industry development and economic growth. We would expect States with a comparative advantage in an industry to assist that industry because, on a cost-benefit test, it is likely to be worthwhile. We would expect States without a comparative advantage in that same industry not to do so because, on the same test, it is not likely to be worthwhile. But such States might choose to promote a different industry. This may reflect the same pro-development policy — to promote the industry in which they have a comparative economic or natural advantage.

37. In any event, it is difficult to make allowances for such broad economic policy differences. For example, Queensland's historically low taxation policies have had a pervasive effect on development in Queensland, affecting employment levels, wage levels, industry structure, land values, population growth, age-sex structure and so on. It would be difficult to quantify the effect the low payroll tax policies have had on general economic activities in that State.

38. Assistance to industry can be through:

- direct grants;
- tax exemptions; and
- provision of services and infrastructure.

39. The Commission's approach has been to recognise grants and service provision costs on the expenditure side of its standard budget. Leaving to one side the difficulty of unravelling the different State approaches, the Commission's approach has been to classify grants and the cost of service provision to the Services to Industry categories. Any infrastructure expenditure for in-scope expenditure functions would be included within the Depreciation assessment. At present, the Commission's assessments do

not capture tax exemptions, except as they translate into lower average tax rates, as these tend to be covered by commercial-in-confidence arrangements.

40. There is an argument that the expenditure assessments we make may not adequately recognise the disabilities faced by States in promoting economic development. We accept that there are disabilities in administering services to industry. However, traditionally, the Commission has been reluctant to assess differential allowances for promotional and developmental expenditure. In 1993, it said that:

for activities of a developmental character, it is not clear, on either equity or economic grounds, that a State government embarking on an expenditure program intended to expand its economic base should in effect be reimbursed by other States which have their own developmental objectives.<sup>5</sup>

41. **Mining.** An example used by Western Australia to illustrate the case it makes is the assessment for the Mining Revenue category. Western Australia has suggested that the revenue base used by the Commission in assessing its above standard mining revenue capacity should be reduced to take account of the expense it incurs in its effort to foster its mining industry. It is possible that Western Australia has the highest mining revenue base per capita because of the assistance provided by the State Government, but it is very well endowed with natural resources.

42. We have looked at Western Australia's concerns regarding the mining assessment and compared the mining revenues and expenditure on support for mining activities for Western Australia and Queensland, which has the second highest revenue base per capita and the highest effective tax rate. We have also compared mining revenue and export prices. Our analysis suggests that export prices are by far the more important influence on mining revenue.

43. We have also reviewed Western Australia's arguments that:

- the mining revenue base should be adjusted to include a rate of return on capital and exploration expenditures;
- the mining revenue bases of Queensland and New South Wales should be adjusted for their inefficient transport and labour market policies which impact adversely on their coal industries; and
- the cost of assistance provided to the mining industry should be offset against mining revenues.

44. The Commission said in the 1999 Review that the first adjustment was not necessary, as it was not attempting to estimate 'economic rent' as the revenue base. It was attempting to calculate mining revenue that could be taxed. In relation to the second adjustment, the Commission said it was too difficult to adjust for the differences from the standard in the transport and labour market policies applied in Queensland and New South Wales. It was, however, able to adjust the mining revenue base for quasi-royalties on black

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<sup>5</sup> Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1993*, para 4.100, page 287.

coal (collected as above standard freight charges). Another review of the Mining Revenue assessment is necessary as part of the 2004 Review.

45. In the 1993 Review, the Commission moved away from net assessments because it believed that any negative (positive) disabilities that were applicable to expenditures on a function were often different to any positive (negative) disabilities that applied to revenue from user charges associated with the function. Our preference would not be to net assistance to the mining industry from mining revenue. It would be to continue to combine it with other industry assistance and assess needs for it on the expenditure side of the standard budget. Clearly the assessment in these categories will need to be reviewed.

46. **Payroll Tax.** Victoria has argued that State tax bases should be adjusted to remove differences between the States caused by their different use of out-sourcing or privatisation of government service provision. Victoria submitted at the last Review that its payroll tax base should be discounted for the effect of its out-sourcing policies. In the event, we made no allowance because there was no evidence on the extent to which differences in out-sourcing policies (in the general government sector) affected relative capacity to raise payroll tax. But the argument was considered.

47. **Conclusions.** We already consider policy influences in assessments for each revenue category. Our analysis does not reveal any systematic bias in this approach. It is not clear that a different approach would prove more beneficial.

48. One possible way of attempting to exclude policy influences from revenue bases would be to adopt a factor assessment-like approach, such as that used in expenditure assessments. In such an approach, the average per capita revenue would be adjusted for explicit revenue raising disabilities. However, we doubt that such an approach would be feasible. It certainly would not be simple. States may wish to comment on this.

## ENTRENCHING DISABILITIES

49. Some parties have argued that equalisation payments permanently entrench States' disabilities. In effect, they see the equalisation payments not as compensation for disabilities, but as payments to be used to overcome those disabilities.

50. This argument presupposes that disabilities are temporary and governments can overcome them through particular policies. For example, during the 1999 Review, New South Wales and Victoria argued that the Commission should no longer recognise that less populous States had diseconomies of small scale because changes in the way services could be provided, improved competition and the use of technology had changed disabilities. They argued that service delivery scale and dispersion disabilities were also much reduced.

51. These arguments did not seem to adequately acknowledge that the changes in service provision were also changing what services were provided (more could be provided for the same cost) and how the more populous States were providing them.

52. We agree that the extent of disabilities should change over time as services, methods of delivery and cost structures change. The use of technology may overcome some disabilities by providing services in a different and more cost efficient way. All these changes should be captured by the annual change in financial standards and other data that can be updated, and in the re-determination of disability relationships that occurs in each five yearly review.

53. In the last Review, in re-examining the proportion of costs affected by administrative scale disabilities, the Commission was aware that there had been changes in the ways States delivered services. It recognised that not all services were affected to the same extent by scale disabilities by estimating the scale-affected expenditures for each category. Overall, the administrative scale disability now has a smaller effect on grant redistributions.

54. In calculating the service delivery scale factors in the last Review, the Commission assumed that services would be provided on a standard policy basis to the existing locational distribution of State populations. As expected, this was able to be done better in some categories than others because of differences in data availability.

55. The dispersion factor was also changed in the 1999 Review to reflect changes in the way States provide services. The cost functions for each component of the factor — telephone, freight and travel costs and locality allowances — were re-estimated using the most up-to-date data on State expenditures and cost structures. The category-specific expenditure weights for each component were also updated.

56. It cannot be expected that States will extinguish all cost disabilities over time. For example, the underlying distribution of the population that gives rise to dispersion disabilities is on-going and is very difficult for States to influence.

57. Some parties have suggested that, if States spent their equalisation grants according to the Commission's assessed needs of particular socio-economic groups, these needs would be met and the disabilities disappear. It is difficult to generalise about this: it is a disability by disability issue. For example, meeting the current cost of translation services does not reduce the long term problem of low fluency in English.

58. On the revenue side, it is unlikely that Tasmania can rapidly bring its revenue capacity up to the Australian average, which is heavily influenced by the more industrial States and States with more natural resources. Equalisation payments resulting from low revenue raising capacity probably are likely to continue into the future.

59. In general, through the annual update and five-yearly review processes, disability factors change as government policies, service delivery methods and revenue-raising approaches change.

## AN ALTERNATIVE BENCHMARK?

60. A final issue for consideration is whether the Commission could adopt a different benchmark to the average standard it presently uses. Victoria says that ‘subsidies’ should only be provided to a benchmark price, reflecting a requirement to achieve productive efficiency. In other words, a best practice standard could be adopted in the assessments, with disabilities measured from this to encourage States to operate more efficiently. Such a principle could be considered, but it would be a different concept of fiscal equalisation to that which has guided our work to this time. The Commission does not believe it has a mandate to change the fiscal equalisation concept embodied in the *Intergovernment Agreement on the Reform of Commonwealth-State Financial Arrangements*, signed in June 1999. All States have agreed that this question is outside the scope of the 2004 Review.

61. This is not to say that another type of standard could never be considered. There is, however, an immediate question that flows from the approach raised by Victoria. Would such an approach be consistent with the provision of untied funds to the States?

62. In Commonwealth-State financial relations, the Commonwealth provides both untied and tied funding. The tied funding is intended to achieve particular outcomes. The use of untied funds is at the discretion of State governments.

63. The use of average standards means that the Commission does not have to make judgements about the policies and practices of the States. The proposal to use best practice benchmarks would change the concept of equalisation as it has been applied. It would lead inevitably to the Commission making value judgments about how States should be spending their money. This would be a far-reaching change to the current approach to equalisation and would require the sanction of governments. It would need to be made explicit in our terms of reference.

64. There would also be quite significant practical difficulties in such an approach. The benchmarks could reflect the policies of the most efficient State(s), which could differ from service to service. Their calculation would be practically impossible due to the existence of disabilities, differences in service standards (including quality and quantity) between States. This would almost certainly add contention to the equalisation process.

## CONCLUSIONS AND THE WAY FORWARD

65. Distinguishing between State policies and disabilities is at the core of the Commission's relativities.

66. We think that the principles embodied in our assessment framework are sound. We should measure disabilities in the context of the average revenue effort and the average level of service provision, assuming the average level of efficiency. Disabilities are a relative index of the needs of one State against another, and it makes sense to measure

them from the actual average experience of States, that is, using internal per capita standards. These standards are policy neutral in that they reflect State policies on a population weighted basis. They are not policy free.

67. We accept that the line between disabilities and policies can be contentious. It is not always easy to define what a government can and cannot control. The accurate assessment of disabilities depends on the data that are available. We aim to calculate disabilities from Australian average cost and use data so that we do not build a State's policy choices into its assessment.

68. We acknowledge that our processes do not of themselves encourage the use of the most efficient practices by States, but neither do they discourage them. The use of policy-neutral data to assess disabilities means that, in principle, equalisation grants fund States to average levels of efficiency. While some States may be impatient with the policy choices of others, diversity of policy choice has been seen as a valuable part of our federal system. The average standard approach is consistent with the principle of equalisation that guides the Commission's work. To use a different standard is beyond the current principle of equalisation and usual Terms of Reference.

69. As long as the presumption is that States must show the Commission that disabilities continue to exist and can be measured, we believe that the review process and the use of updated data in annual calculations ensures that the relativities are sufficiently responsive to change. Disabilities cannot necessarily be overcome by the adoption of different policies, even if they can be reduced. To the extent that they are reduced, they change the standard on which future assessments are based.

70. We have concluded that the methods used in the assessments are unlikely to have systematic biases. This does not mean they are perfect, but it suggests that any shortcomings would be best dealt with on a case-by-case basis. We consider that it would not be worthwhile to pursue this topic further as a priority issue of principle under the current terms of reference. However we welcome comments from the States on this.

### CASEMIX ADJUSTED COST DATA FOR NEW SOUTH WALES AND VICTORIAN HOSPITALS

1. The cost data for the period 1993-94 to 1997-98 in Table A-1 indicate that there were cost differences between Victoria and New South Wales in acute public hospitals. The recurrent hospital costs per case mix adjusted separation in Victoria were lower than those of New South Wales. The cost differences ranged from 2 to 27 per cent during that period.

**Table A-1** TOTAL RECURRENT HOSPITAL COSTS PER CASE MIX ADJUSTED SEPARATION, 1993-94 TO 1997-98

	New South Wales	Victoria	Ratio
	\$	\$	
1993-94	2348	2307	1.02
1994-95	2542	2268	1.12
1995-96	2877	2261	1.27
1996-97	2586	2252	1.14
1997-98	2637	2227	1.18

Source: Productivity Commission Report 2000

2. The data show that the cost differences between the two States were almost negligible in 1993-94 and peaked in 1995-96. They tended to be lower in 1996-97 and 1997-98.

3. Table A-2 presents the recurrent costs per casemix adjusted separation in acute public hospitals in 1997-98. This shows that the largest contributors to the difference in costs between Victoria and New South Wales in 1997-98 were nursing labour costs (\$146) and VMOs (\$85). Other data indicate that there were relatively fewer nurses in public hospitals in Victoria and that their average wages were lower than in New South Wales.

4. The costs of visiting medical officers (VMOs) in New South Wales were much higher than in Victoria, although the costs of salaried/sessional staff were lower in New South Wales. Indeed, the differing costs of VMOs contributed significantly to the cost differentials between the two States. Victoria's policy of having salaried medical officers does appear to be cheaper than the VMO policy of New South Wales.

5. Part of the cost differentials between Victoria and New South Wales could be due to the different funding mechanisms the two States have used since 1993-94. The data in Table A-1 suggest that New South Wales's average hospital costs increased significantly from 1993-94 to 1995-96 but reduced in 1996-97 and 1997-98. The average costs in Victoria decreased slightly after the introduction of casemix funding. This seems to suggest that there could have been efficiency dividends to Victoria through the introduction

of the casemix funding. However, it seems New South Wales caught up a little in the second half of the study period.

**Table A-2** RECURRENT COST PER CASEMIX ADJUSTED SEPARATION, 1997-98

	New South Wales	Victoria	Ratio of NSW/Vic	Aust
	\$	\$		\$
Non medical labour costs				
Nursing	698	552	1.26	691
Diagnostic/allied health	187	168	1.11	199
Administrative	172	158	1.09	183
Other Staff	226	234	0.97	215
Superannuation	148	84	1.76	131
<b>Total non-medical labour cost</b>	<b>1431</b>	<b>1196</b>	<b>1.20</b>	<b>1419</b>
Other recurrent costs				
Domestic services	52	55	0.95	66
Repairs/maintenance	60	51	1.18	65
Medical supplies	178	175	1.02	186
Drug supplies	121	111	1.09	123
Administration	35	19	1.84	31
other recurrent costs	111	96	1.16	126
Other	107	94	1.14	88
<b>Total other recurrent costs</b>	<b>664</b>	<b>603</b>	<b>1.10</b>	<b>685</b>
Medical labour costs				
Public patients				
Salaried/sessional staff	262	283	0.93	280
VMO	161	76	2.12	114
private patients(est)	119	69	1.72	77
<b>Total medical labour cost</b>	<b>542</b>	<b>428</b>	<b>1.27</b>	<b>471</b>
<b>Total recurrent costs</b>	<b>2,637</b>	<b>2,227</b>	<b>1.18</b>	<b>2,575</b>

Source: Productivity Commission, Report on Government Services 2000, Vol 1, pp 333-335.

6. Differences in quality of services may render the comparison of unit costs less meaningful. Quality of services, however, is difficult to measure and is especially hard to compare across States. Data from the Australian Institute of Health and Welfare and from the Productivity Commission suggest that New South Wales scored better in some quality indicators and Victoria in others. The Report on Acute Health Services Under Casemix from Victoria's Audit General's Office in 1997 appears to indicate that the quality of care in hospitals deteriorated following the introduction of the casemix funding. The greater use in Victoria of salaried medical officers who are more junior and cheaper to employ than VMOs may also say something about service quality. However, it is hard to draw useful general conclusions in this area of comparison.