



**Australian Government**  

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**Commonwealth Grants Commission**

# **2010 Review of State Revenue Sharing Relativities**

**Progress Report to  
Ministerial Council for  
Commonwealth-State Financial Relations,  
2006**

**Canberra**

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## **REPORT**

Progress Report to Ministerial Council for  
Commonwealth-State Financial Relations, 2006

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**Australian Government**  
**Commonwealth Grants Commission**

Senator The Hon Richard Colbeck  
Parliamentary Secretary to the  
Minister for Finance and Administration  
Parliament House  
CANBERRA ACT 2600

Dear Parliamentary Secretary

As members of the Commonwealth Grants Commission appointed under the *Commonwealth Grants Commission Act 1973*, we have prepared this report on progress with work on the 2010 Methodology Review for the Ministerial Council on Commonwealth/State Financial Relations. Terms of reference asking that the review be done and that this progress report be produced were received from the then Parliamentary Secretary, Dr Sharman Stone, on 26 May 2005.

Yours sincerely

A G Morris  
Chairman

R A Williams  
Member

G P Appleyard  
Member

24 February 2006

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# **ACKNOWLEDGMENTS**

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We are grateful for the ready co-operation extended to the Commission and its staff during this inquiry by Australian and State Treasury officers and by staff of the Australian Bureau of Statistics.

We also acknowledge the dedication and professionalism shown by the staff of the Commission during the period of the inquiry.

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# OVERVIEW

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The Commission has laid the foundations of its approach to the 2010 Review. It has:

- established how it will approach the equalisation task with simpler methods;
- revised and strengthened its assessment guidelines; and
- agreed a programme for reviewing the reliability of data used in the assessments and a protocol for improving the quality of data provided by States and Territories.

In this report to the Ministerial Council the Commission is asked for its:

- preliminary conclusions on assessments that are unreliable because of unsatisfactory data or methods.
  - *Data.* The Commission examined data the ABS considered unreliable. Some concerns were confirmed and assessments modified, to use better data or different methods. Other concerns had little practical impact in areas important to the relativities and after consultation with the ABS have been put aside. The Commission has, with the States, established new procedures to improve data quality in the future.
  - *Methods.* The Commission has also examined methods that the Heads of Treasury (HoTs) review of the implementation of equalisation flagged as potentially unreliable. It has concluded that the concerns raised do not warrant revision through the update process, but they will be addressed when the assessment methods are rebuilt.
- preliminary conclusions on materiality thresholds that could be applied in current and future assessments.
  - After consultation with the States, the Commission has established new materiality and reliability guidelines for use in the 2010 Review, set out in Chapter 5.
- advice on whether any of its conclusions on unreliable assessments and materiality thresholds should be implemented in advance of the 2010 Review Report.
  - The Commission does not consider that the revised assessment guidelines should be applied to the existing methods or that identified concerns with existing methods warrant a change through the update cycle. The better approach is to retain existing methods and devote resources to building a simpler assessment system for introduction as a package in 2010. However, if method changes are the only way of overcoming data deficiencies they should be made, after consultation with the States.
- progress on the other simplification issues mentioned in the reference.
  - Progress on other issues is set out in Chapter 6.

### **Interpreting the 2010 Review terms of reference**

- 1 The Commission received terms of reference from the Parliamentary Secretary to the Minister for Finance and Administration on 26 May 2005 asking it to report by 26 February 2010 on per capita relativities it regards as appropriate to distribute the GST pool among the States after 2009-10. Progress reports to the Ministerial Council for Commonwealth-State Financial Relations were also required in 2006 and 2007.
- 2 The reference asks the Commission to simplify its assessments, provided that doing so is consistent with the principle of horizontal fiscal equalisation. Specifically, the reference seeks:
  - the aggregation of assessments;
  - the elimination of assessments found unreliable because of unsatisfactory methods or data; and
  - the application of materiality thresholds.
- 3 We have interpreted the reference as requiring the Commission to produce recommendations that result in a distribution of the GST pool that achieves equalisation, but this must be achieved in simpler ways than in the 2004 Review.
- 4 We believe simplification is essential. However, we acknowledge that some States are concerned simplification will lead to a reduction in the level of equalisation achieved. We do not share that concern. We think that simplification and equalisation can both be achieved and that achieving simplification will improve the reliability and robustness of the processes and the acceptability of the outcomes.

### **The Commission's strategy for the 2010 Review**

- 5 In consultation with the Australian Treasury and the States, we have developed a strategy and work programme for the 2010 Review, which involve a comprehensive examination of the implementation of the equalisation principle. Essential features of the strategy include:
  - starting with a clean slate when it comes to devising assessment methods;
  - adopting a top-down approach, where State revenues or expenses will be disaggregated into specific services or taxes only if it materially improves equalisation and can be done reliably;
  - establishing new assessment guidelines with stronger reliability and materiality criteria; and
  - introducing the new assessment methods as a package in the 2010 Review Report.
- 6 The Heads of the Australian and State Treasuries (HoTs) are in broad agreement with this strategy.
- 7 We believe that our clean slate, top-down approach will ensure that the methods developed for the 2010 Review will be reliable and as simple as possible.

**Progress during 2005**

- 8 During 2005, we reviewed the assessment guidelines used by the Commission in its 2004 Review Report and strengthened them by including materiality thresholds and criteria for judging the reliability of methods and data. The proposed guidelines are in Chapter 5 of this report. We will rigorously apply the guidelines, especially the reliability criteria and materiality thresholds. The guidelines will also serve as a guide to States in preparing their submissions to the Commission.
- 9 The Commission was asked for its conclusions on eliminating category assessments found unreliable because of unsatisfactory data or methods, and on applying a materiality threshold to existing and future assessments. Given that our clean slate, top-down strategy for the 2010 Review represents a fundamental change in approach, we propose to introduce all the new methods in one package in the 2010 Review report. Devoting resources to this approach is better than reviewing the reliability and materiality of existing methods, which were scrutinised by the States in the course of the 2004 Review. The package approach also avoids the potential for increased uncertainty in the annual updates of State shares of the GST pool and inequitable effects on individual States that could arise from the progressive introduction of method changes.
- 10 HoTs generally agreed with the package approach.
- 11 It was also agreed that exceptions to the package approach would be made if an existing assessment is heavily corrupted by poor data and changing the method is the only way of preserving the intent of achieving equalisation consistent with the principle used in 2004.
- 12 During 2005, together with the States, we established a programme for reviewing the reliability of the main data sets used in the assessments and began that work. The work done during 2005, which is outlined in Chapter 6, indicated that:
- some changes were required in methods and data sets used to calculate State shares of the GST pool for the 2006 Update; and
  - some of the concerns about data raised previously were unfounded or had immaterial effects on the assessments. The ABS has verified those conclusions.
- 13 A protocol for improving the quality of data provided by States, which makes up about 30 per cent of data we use, was agreed with HoTs during the year. That protocol reflects our belief that the ultimate responsibility for State provided data must rest with the States, but also recognises our responsibility to accurately specify our requirements and check data provided to us. We expect States to provide data that are of the best possible quality.
- 14 We also examined the comments made by consultants to the HoTs 2005 review of the implementation of equalisation on some of the Commission's methods. We concluded that, while their comments raise matters that need to be considered as we devise new simplified methods for the 2010 Review, the existing methods are sufficiently reliable to be used in updates prior to 2010.

- 15 Progress on other matters during 2005 included the preparation of a draft strategic plan for the Commission's quality assurance processes. That plan, which will be finalised in early 2006 and implemented between then and 2010, is the first step in our response to that part of the 2010 Review reference which sought improvements in quality assurance processes.

**Work for 2006**

- 16 During 2006, we will seek views from the States on the architecture of equalisation, progress work on devising more aggregated assessment categories and continue the examination of the reliability of major data sets. There is an inter-relationship between that work and the interim guidelines in this report. Our 2007 report to Ministerial Council will outline the findings and proposals stemming from our work during 2006 and any modifications to the interim guidelines that become evident during the year.

# CHAPTER 1

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## INTRODUCTION

- 1 The Commission received terms of reference from the Parliamentary Secretary to the Minister for Finance and Administration on 26 May 2005, which require it to report by 26 February 2010 on a review of the methods used to derive State revenue sharing relativities. The reference also requires progress reports on aspects of the review to be made to the Ministerial Council for Commonwealth-State Financial Relations in 2006 and 2007.
- 2 This progress report to the 2006 meeting of the Ministerial Council covers the Commission's:
  - preliminary conclusions on assessments that are unreliable because of unsatisfactory data or methods;
  - preliminary conclusions on materiality thresholds that could be applied in current and future assessments;
  - advice on whether any of its conclusions on unreliable assessments and materiality thresholds should be implemented in advance of the 2010 Review Report; and
  - progress on the other simplification issues mentioned in the reference.

### **Structure of this report**

- 3 This report outlines the principles we are following in undertaking the 2010 Review, the progress we have made, and the preliminary conclusions we have reached.
- 4 Chapter 2 outlines the requirements of the terms of reference, how we have interpreted them and the approach we are taking to the 2010 Review. It also addresses the issue of implementing changes in advance of the 2010 Review.
- 5 Chapters 3, 4, and 5 provide details of issues relating to the materiality and reliability of the assessments, and the assessment guidelines we propose to apply in the 2010 Review.
- 6 Chapter 6 provides an overview of work done during 2005 on examining the reliability of existing data and methods.
- 7 Chapter 7 reports on progress made in examining other issues, including our proposed approach to devising simpler and more aggregated assessments and improvements to our quality assurance processes.

## **CHAPTER 2**

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### **THE COMMISSION'S APPROACH TO THE 2010 REVIEW**

- 1 The experiences of the 2004 Review convinced the Commission that there is no alternative but to vigorously pursue both equalisation and simplification throughout the 2010 Review. Simplification will involve fundamental changes in the way the Commission operates and how it makes its recommendations to achieve equalisation. Simplification will involve much more than just simplifying the presentation of our results and the descriptions of how we derived them.

#### **BACKGROUND TO THE TERMS OF REFERENCE**

##### **2004 Review**

- 2 In its 2004 Review Report, the Commission noted that while it made simplification of its methods a priority at the start of the review, the methods remained complex and detailed. It said this was partly because its task required an examination of the impact of States' demographic, physical, and economic circumstances on the entire spectrum of services they provide and revenues they raise. Moreover, while the processes were open, inclusive, and fully documented, the detail inhibited the ability of people to understand the Commission's work. It was also not obvious that the detail produced a better equalisation outcome.
- 3 The Commission came to the very strong view that simplification of methods should be a priority going forward. It recommended that the next Commission and the States develop a work programme that would enable the widest possible consideration of the issues. It suggested that such a programme should commence by considering matters such as:
  - whether the current comprehensive assessment of virtually all receipts and expenses in State operating budgets was necessary;
  - whether the current, highly disaggregated approach was necessary; and
  - the robustness and comparability of key data sets.

##### **2004 Ministerial Council**

- 4 At the 2004 Ministerial Council meeting, a majority of States and the Australian Government agreed to a work programme to review the Commission's methods for implementing

equalisation. The Ministerial Council agreed that the work would aim to simplify Commission methods and cover the matters identified by the Commission. The Ministerial Council noted that the work would not examine the underlying principles of equalisation.

- 5 The Ministerial Council decided that the work would be undertaken by the Heads of Treasuries (HoTs), and would draw upon the expertise of the Commission.

### **HoTs process**

- 6 The HoTs work included substantial analysis of the Commission's assessments. It involved consultation with the States and the commissioning of the Australian Bureau of Statistics (ABS) and two external consultants (Dr McHugh and Professor Pincus) to review aspects of the data and methods used by the Commission.
- 7 HoTs concluded that the Commission's approach could benefit from a programme of simplification, providing that to do so was consistent with the equalisation principle.
- 8 HoTs examined a wide range of possible approaches. They found that there were four options that singularly or in combination could result in significant simplification and which deserved further consideration. They were: the aggregation of assessments; the adoption of materiality thresholds; the elimination of unreliable categories; and the use of more general indicators of State's needs. HoTs concluded that more work was required by the Commission to ensure that those options were workable and to the satisfaction of the States. HoTs also noted that other options for simplification may emerge during further investigation.
- 9 HoTs recommended that:
  - the Commission be given terms of reference to conduct a methodology review by 2010;
  - as part of the 2010 Review, the Commission be asked to undertake work on simplification and continuous improvement that is consistent with the equalisation principle and builds on the work by HoTs; and
  - the Commission be asked to report to the Ministerial Council progressively on its conclusions and their implementation.

### **2005 Ministerial Council**

- 10 The 2005 Ministerial Council meeting accepted those recommendations and agreed to terms of reference for the Commission, which were supported by all States. A copy of the terms of reference is in Box 1.

### **Requirements of the 2010 Review terms of reference**

- 11 The task given to the Commission is to recommend per capita relativities it regards as appropriate to use in distributing the combined pool of GST revenue and health care grants (hereafter called the GST pool) among the States after 2009-10.
- 12 The reference also contains instructions and guidance on how the Commission should approach that task. It directs the Commission to simplify its work, having regard to the work

**Box 1 Terms of reference for 2010 Review**

**TERMS OF REFERENCE**

1. Pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973*, I hereby refer to the Commission for inquiry into and report upon, by 26 February 2010 at the latest, the question of per capita relativities which the Commission would regard as appropriate to apply after 2009-10 for the distribution of the combined pool of Goods and Services Tax (GST) revenue and Health Care Grants (HCGs) among the States, the Northern Territory and the Australian Capital Territory (the states).
2. The Commission should commence a work programme for responding to these terms of reference and consult with the states and the Australian Government in deciding the priorities for the work programme.
3. Having regard to the work progressed by HoTs after the 2004 Ministerial Council and providing that to do so is consistent with the principle of Horizontal Fiscal Equalisation, the Commission should simplify its assessments by:
  - (a) aggregating existing assessment categories, components and factors, in whole or in part;
  - (b) eliminating category assessments found unreliable because of unsatisfactory data or methodology; and
  - (c) applying a materiality threshold to current and future assessments.
4. Having regard to the work progressed by HoTs after the 2004 Ministerial Council and providing that to do so is consistent with the principle of Horizontal Fiscal Equalisation, the Commission should consider developing other ways to simplify its assessments, including by:
  - (a) addressing issues relating to quality and fitness for purpose of data used by the Commission, in particular by reducing the reliance on the use of 4 digit GFS data and examining the capacity of making effective use of 2 digit and 3 digit GFS data in the assessments;
  - (b) undertaking a programme of continuous improvement of assessments. This programme includes improvements to the quality and fitness for purpose of both data and methodology; and
  - (c) reviewing the scope for the use of more general indicators of revenue capacity and expenditure need.
5. The Commission should also consider:
  - (a) developing mechanisms to maintain simplification once achieved; and
  - (b) improving quality assurance processes.
6.
  - (a) The Commission will report to the Ministerial Council in 2006 on its conclusions in relation to paragraphs 3(b) and 3(c) and progress in relation to paragraphs 3(a), 4 and 5.
  - (b) The Commission will report to the Ministerial Council in 2007 on its conclusions in relation to paragraphs 3(a) and 4(a) and progress in relation to paragraphs 4(b), 4(c) and 5.
  - (c) The Commission will report to the Ministerial Council in 2006 and 2007 on any conclusions it has reached in relation to paragraphs 6(a) and 6(b) which, in the Commission's opinion, should be implemented in advance of its 2010 Report. In drawing any such conclusions, the Commission should apply the principle of Horizontal Fiscal Equalisation used for the 2004 Review.
  - (d) The Commission will report on the conclusions in relation to the remaining items in paragraphs 3, 4, and 5 as part of its 2010 Report.
7. The Ministerial Council will give further instruction to the Commission on transitional arrangements, if and as necessary.

done by HoTs following the 2004 Review and provided that doing so is consistent with the principle of horizontal fiscal equalisation, by:

- aggregating assessments;
  - eliminating assessments found unreliable because of unsatisfactory methods or data; and
  - applying materiality thresholds.
- 13 The reference also suggests other ways of simplifying assessments be considered, such as:
- addressing issues relating to the quality and fitness for purpose of data;
  - implementing a programme of continuous improvement; and
  - reviewing the scope for the use of more general indicators of revenue capacity and expenditure need.

*We have interpreted the reference as requiring the Commission to produce recommendations based on simpler methods, which result in a distribution of the GST pool that achieves equalisation.*

- 14 The terms of reference raise three important questions for the conduct of the 2010 Review and its outcome. They are:
- what is meant by equalisation;
  - how should achieving equalisation and simplification be jointly achieved; and
  - when should assessment methods be changed?

**What is meant by equalisation?**

- 15 The reference does not contain guidance on how the equalisation principle should be defined, interpreted, or implemented.
- 16 The definition of equalisation, which was used in the 2004 Review, is:
- State governments should receive funding from the pool of goods and services tax revenue and health care grants 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.
- 17 Its implementation reflects three pillars of equalisation:
- the financial capacities of States are equalised, not their performance or outcomes;
  - States are equalised to levels that reflect an average of what all States do; and
  - a State's own policies or choices should not directly influence its share of the GST pool.
- 18 As required by the terms of reference, we will apply this definition of equalisation in the annual updates prior to the completion of the 2010 Review.

- 19 However, there are differences of view among the States on whether the current principles and their interpretation remain appropriate for the 2010 Review and beyond. Some support the existing approach, others believe alternative approaches, for example, which include economic efficiency implications are desirable.

*The Commission considers that the objective of achieving equalisation is implicit in the terms of reference. However, we think it is important that there be an opportunity for those different views of equalisation and how it might be implemented to be considered in the review process.*

- 20 There was a preliminary discussion of equalisation principles during our conference with HoTs in November 2005. The work plan provides for a further opportunity to consider those matters during 2006. They are not discussed further in this report.

#### **Simplification and equalisation**

- 21 The Commission's experiences in the 2004 Review, the conclusions of the HoTs work, and the terms of reference for the 2010 Review all make it clear that simplification must be a focus of the 2010 Review, albeit within an equalisation framework.
- 22 Our consultation with States during 2005 indicated that they accept that simplification must be pursued. However, some are concerned that simplification should not be a goal in its own right. They were concerned that it should not lead to a diminished focus on equalisation.

*The Commission believes that the prime objective of its recommended distribution is equalisation, but as it suggested in 2004, this must be achieved in simpler ways than in the 2004 Review.*

- 23 We believe that strengthening the reliability and robustness of the equalisation process and the acceptance of its results is the underlying intention of the review. We also believe that taking every opportunity to pursue simplification that is consistent with equalisation principles will enhance equalisation because it would:
- ensure the processes do not ask too much of the data;
  - ensure the level of detail is no greater than that required to reliably and robustly identify and measure the important differences between the States in their fiscal capacities;
  - simplify the explanation and understanding of outcomes;
  - reduce the number of 'moving parts', making it easier to understand how the system works, and how emerging conditions in individual States influence revenue shares; and

- reduce the risk of errors.
- 24 Achieving both simplification and equalisation will require a rigorous process that covers:
- the conceptual basis for an assessment;
  - the data and method adopted; and
  - an evaluation of what is finally proposed in the context of the 'real world'.
- 25 Consistent with the work done by HoTs, we are seeking simplification on many levels by considering the interconnected issues relating to:
- reliability of the assessment methods and the data used in them;
  - materiality of the categories, revenue bases and disabilities that are examined;
  - the level of disaggregation in the assessments, including the extent to which revenues and expenses are disaggregated into categories and the range of allowances included in assessing revenue bases and disabilities;
  - the sophistication and complexity of the methods adopted for specific assessments;
  - other approaches that may lead to simpler assessments that are consistent with equalisation principles;
  - simpler and more transparent explanation of our outcomes and the processes used to achieve them; and
  - ways of maintaining simplification once it is achieved.

**When should assessment methods be changed?**

- 26 The reference envisages a staged approach to the simplification of assessments. The Commission is expected to commence the 2010 Review by considering matters relating to the introduction of materiality thresholds and reliability criteria. It is then expected to examine how it could aggregate existing assessments.
- 27 The requirement for this report to include preliminary conclusions on eliminating assessments found unreliable because of unsatisfactory data or methods implies a progressive adoption of more reliable and simpler assessments that also achieve equalisation.

*However, the Commission believes that a piecemeal approach to method change, including the elimination of any unreliable assessments, during the course of the review is sub-optimal in that it may produce relativities that are inconsistent with the overall fiscal capacities of the States. Our strong preference is to change methods only once, and then as a package in the 2010 Report. This will ensure that we can properly take account of the inter-relationships between the many influences that affect State budgets. It will also ensure that individual States are not disadvantaged by the timing in which analysis is done and changes are made.*

- 28 During our November 2005 Conference, HoTs agreed, in a broad sense, that new methods would be introduced as a package in the 2010 Review Report. The package of new methods would be developed in consultation with the States. The consultation process will include the circulation to States of a draft report containing details of proposed methods in 2009 and opportunities for States to make comments before the Commission reaches its final decisions.
- 29 HoTs, however, agreed with us that we might be forced to make an earlier method change if we conclude that an existing assessment is heavily corrupted by poor data and that changing the method is the only way to preserve the intent of achieving equalisation consistent with the 2004 principle.
- 30 The consensus of HoTs was that if data problems necessitated changes ahead of the 2010 Review Report, the Commission should proceed on the basis that:
- new, more reliable data would be used in the first possible update, if method changes were not required; or
  - if overcoming the data problems necessitated method changes, revised methods would be used in the first possible update, subject to consultation with States during that update.
- 31 HoTs agreed with us that such action would help to ensure that the relativities of each update are not based on known deficient data or poor methods. Chapter 6 of this report and the 2006 Update Report contain information on data mandated changes to methods.

## **THE COMMISSION'S STRATEGY**

- 32 The Commission's strategy for the 2010 Review is based on a comprehensive examination of the implementation of the equalisation principle, which includes:
- starting with a clean slate when it comes to assessment methods;
  - adopting a top-down approach, where revenue or expenses would be disaggregated only where appropriate;
  - establishing new assessment guidelines with stronger reliability and materiality criteria; and
  - introducing new assessment methods as a package.
- 33 In deciding how to develop simpler methods for the 2010 Review, we faced a choice between:
- starting with the existing assessments and aggregating similar items and adopting broader measures of the drivers of interstate differences in costs of services or revenue raising capacity to derive assessments that contained fewer moving parts; or
  - starting with a clean slate and beginning with total State expenses and revenues and disaggregating them only when it would have a material effect on the measure of State fiscal capacity, could be done reliably, and in a way that enhances equalisation.

- 34 We have concluded that the clean slate, top-down approach offers the best opportunities for simplifying methods, capturing what is currently important to State budgets and, hence, achieving equalisation. Under this approach the case must be made for greater detail rather than the other way around. The onus of proof will be on demonstrating that capturing the main differences between States requires disaggregation and greater detail rather than on demonstrating that similarities between States facilitates aggregation.
- 35 This top-down approach is most likely to result in larger and broader categories of expenses and revenue. This will in turn require a re-evaluation of the drivers of differences between States and how they are measured. A top-down approach requires that assessment methods start with a clean slate.
- 36 The alternative approaches were discussed with HoTs in November 2005. Some were concerned that a top-down approach could reduce the extent of equalisation achieved by ignoring some influences that create differences between States. However, HoTs agreed that the Commission would follow a top-down approach to the disaggregation of State revenues and expenses and to deriving new assessments for the 2010 Review.
- 37 Applying this top-down approach together with the revised and strengthened assessment guidelines represents a fundamental change in the Commission's approach. It may have large implications for the way we approach the task and for the nature of the assessments we make.

#### **A phased approach to the 2010 Review**

- 38 Following consultation with the States in mid-2005, the Commission distributed a broad plan covering its work to the reporting date in 2010. The plan as amended for changes in some dates is shown in Box 2. The plan contains two stages.
- 39 In the first stage, which began in 2005, we are reviewing and refining the principles we follow in deciding our approach to making assessments.
- 40 The scope of the work includes how we might interpret the equalisation principles, the guidelines we will follow in deciding what revenues, services and disabilities will be examined, how we might determine the reliability of methods and data, and how we might approach the issue of materiality. Much of this work has been progressed during 2005. The resulting proposed guidelines and other conclusions are outlined later in this report.
- 41 Such a guidelines-based approach will improve the clarity and transparency of the Commission's work by providing a structured and consistent process for making decisions and for documenting the reasons for them.
- 42 Establishing the guidelines early in the review will help us ensure that decisions taken throughout the review are reliable and consistent. It will also help the States prepare their submissions in a more focussed way. We expect that State submissions seeking specific assessments or allowances will clearly demonstrate that their proposals pass the guidelines. The Commission will not consider claims unless they are supported by evidence that shows they meet the various conceptual and practical criteria and that they can be implemented

reliably. Imposing those disciplines on ourselves, and the States, will improve transparency and militate against increased complexity in the future.

**Box 2 Work plan for 2010 Review**

<b>2005</b>	September	State submissions due end of month.
	November	Discussions with HoTs focussed on State submissions.
<b>2006</b>	February	Report to Minco.
	February/March	Commission circulates issues papers calling for submissions on: <ul style="list-style-type: none"> <li>• the principles and implementation of equalisation; and</li> <li>• aggregation, data quality, and use of broad indicators.</li> </ul>
	July	State submissions due end of month.
	September	Discussions with HoTs.
<b>2007</b>	February	Report to Minco.
	May	Commission issues paper releasing assessment framework and calling for State submissions addressing details of assessment.
	August	State submissions due end of month.
	November	Discussions with HoTs.
<b>2008</b>	May to October	Workplace discussions on identified assessment issues and State briefing and notes of meeting circulated to States.
<b>2009</b>	June	Release of close to final draft report presenting proposed assessment methods.
	August	State submissions on draft report due end of month.
	October	Discussions with HoTs on draft report.
<b>2010</b>	February	Release of final report.

- 43 The first phase of the 2010 Review will draw on those principles and guidelines to make initial decisions on how State expenses and revenues would be best disaggregated into categories for assessment purposes. This work will be undertaken during 2006. However, some of those initial decisions could be revised in the light of better knowledge gained as we progress through the review and changes in State circumstances.
- 44 We will also examine the fitness for purpose and reliability of the main data sets used in our assessments during the first phase of the 2010 Review. This work will build on an ABS report into a selection of data sets, commissioned by HoTs for their 2005 review of the implementation of equalisation.
- 45 The terms of reference ask us to provide progress reports in 2006 and 2007, but the issues we are asked to cover in each of those reports do not stand alone. There is an inter-relationship

between the interim guidelines covered in this report, the work on disaggregation to be done during 2006, and the ongoing work on data quality. Our 2007 Report to Ministerial Council will outline the findings and proposals stemming from our work on disaggregation and on any modifications to the proposed guidelines that become evident as that work progresses in consultation with the States.

- 46 In the second stage of the review, we will use the principles and guidelines to develop assessment methods for each expense and revenue category. In deriving those methods, we will address the issues raised by Dr McHugh and Prof Pincus in their reports to the HoTs review of the implementation of equalisation.
- 47 HoTs have generally agreed with the work plan for the review and the two-part approach on which it is based.

## CONCLUSIONS

*We have concluded that:*

- *our strategy of a clean slate, top-down approach will ensure that the methods developed for the 2010 Review will be reliable;*
- *all the new methods should be introduced in one package in the 2010 Review report. Devoting resources to this approach is better than reviewing the reliability and materiality of existing methods, which were scrutinised by the States in the course of the 2004 Review. Reviewing existing assessments would lead to progressive method changes, which would introduce an extra source of uncertainty into the update process and is not favoured by a majority of States, although methods may be changed in updates if data deficiencies invalidate existing methods;*
- *future assessment and disaggregation proposals should be rigorously subjected to the assessment guidelines covering reliability and materiality to ensure the appropriateness and simplicity of 2010 methods.*

48 *We have also established criteria for assessing the reliability of data and a work programme for evaluating the main data sets used in our work.*

## CHAPTER 3

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# ISSUES OF MATERIALITY AND RELIABILITY

### INTRODUCTION

- 1 Implementing equalisation requires many decisions about what transactions to include in the assessments, which of the influences that affect State fiscal capacities should be taken into account, and how those influences should be measured. Those decisions must be transparent, consistent, and supported by a strong conceptual case and good evidence, if the recommendations built on them are to be credible and acceptable.
- 2 In the 2004 Review, the Commission applied a set of assessment guidelines to increase the transparency and consistency of its decisions. Those guidelines required the Commission to explain how it came to decisions by making explicit the conceptual case it had accepted, the data available and whether it had used judgment. The guidelines also required it to consider the materiality of an assessment and whether it adequately reflected the real world.
- 3 One of the external consultants engaged by HoTs to help with their review of the implementation of equalisation said that those assessment guidelines were logical and had the support of the States, but that their application sometimes caused disagreement.
- 4 Much of the current debate about the Commission's methods arises from those disagreements that often relate to the many assessments that have small effects on the distribution of the GST revenue among the States. Avoiding those assessments, and concentrating on the important influences on the fiscal capacities of the States, would be consistent with the intent of the terms of reference and the underlying aim of improving the acceptance and transparency of equalisation outcomes.
- 5 We consider that clarifying and strengthening the assessment guidelines by, among other things, including sound materiality and reliability criteria is a logical first step in addressing the requirement of the reference to simplify the assessments.
- 6 The rest of this chapter outlines our proposals for dealing with materiality and reliability in the assessments. Chapter 4 considers issues related to the quality of data. Chapter 5 incorporates our conclusions on materiality, and reliability of methods and data into the strengthened assessment guidelines we propose using in the 2010 Review.

## MATERIALITY

- 7 Achieving equalisation requires a focus on matters where there are differences between States in the ability to raise revenue, the use of services and the cost of services. In this context, applying materiality considerations should be seen as a way of focussing the analysis on taxes and services which are important in State budgets or where there are big differences between the States in their revenue bases or costs of providing services.
- 8 In their written responses to the Commission's issues paper on materiality and reliability<sup>1</sup> and at the November 2005 Conference, all States recognised the need for simplification through the application of materiality thresholds. However, States were divided on the size of the thresholds and how rigorously they should be applied. Some thought that existing assessments that accurately reflected State circumstances should remain, even if their effect on State shares of the GST were small.

*We think that a strict and rigorous application of materiality thresholds is essential.*

- 9 A rigorous application of materiality thresholds is necessary to help to:
- achieve consistency in decision making;
  - focus assessments on the important influences on the financial capacities of the States and remove detail that has little effect on outcomes; and
  - maintain simplification over time.

### Setting the thresholds

- 10 Having decided to apply thresholds, it is necessary to consider where they should be applied and their size.
- 11 The Commission's work requires decisions on:
- how the revenues and expenses of States should be disaggregated into groups (or categories) of similar activities or activities that are affected by similar influences; and
  - what influences (disabilities) should be taken into account and how they might be measured.
- 12 Since these two groups of decisions have different effects, materiality tests should be applied separately to each group of decisions. Different thresholds are required for each group.

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<sup>1</sup> Commonwealth Grants Commission, *Issues Paper CGC 2005/01, Materiality and Reliability*, June 2005.

- 13 **Category materiality thresholds.** The Commission's work relates to the distribution of the GST pool among the States, so it makes sense for the materiality thresholds to concentrate on the size of the effects assessments have on that distribution. States generally agree with this view. It is the focus of the proposed thresholds.
- 14 While the category structure plays an integral role in the assessment process by grouping together expenses or revenues where common influences lead to interstate differences, it also aids transparency by identifying the main revenues and expenses and the links to the influences that cause them to differ.
- 15 Given this dual role of the category structure, the aim of avoiding a proliferation of small categories and the mechanics of the assessment process<sup>2</sup>, we have concluded that measuring category materiality requires two thresholds:
- one that relates to the level of the all-State average revenue or expenses per capita in the category (a size of category threshold); and
  - another that relates to its effect on the distribution across the States of the GST per capita (an amount redistributed threshold).
- 16 Experience indicates that the size of a category, measured in terms of its average per capita expenses or revenues, is not always a good guide to its effect on the distribution of the GST pool. Categories that contain relatively low average expenses or revenues can redistribute large amounts of GST if the differences between States in the drivers of expenses and revenues are large. To allow for this event, the Commission will include categories that pass either a size of category threshold or an amount redistributed threshold.
- 17 **Disability materiality thresholds.** Disabilities, and the adjustments that are often made in measuring them, are what drive the differences between States in the distribution of the GST revenue. It is logical for materiality thresholds to be based on the amount of GST a disability assessment redistributes. No State disagreed with this approach and we intend to adopt it.
- 18 A disability (such as the allowance for diseconomies of scale in administration) may affect many services and categories. To ensure that the effects are fully reflected in our assessments the disability materiality thresholds will be applied to the total effect of the disability across all categories where it is assessed, not to the assessment in each category. However, achieving simplification implies that the disability would be assessed only in those categories where there is a rigorous conceptual justification.
- 19 Ensuring that the assessments accurately measure the intended disabilities requires the data on which they are based to be as comparable as possible. But the data are not always comparable. If information is available, the Commission adjusts the data to improve their interstate comparability. However, those data adjustments also increase the complexity, and

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<sup>2</sup> Decisions on category structure must be made, at least on a preliminary basis, before the effect on GST distribution can be calculated.

- reduce the transparency, of the assessments. Consistent with the simplification aspects of the terms of reference, we consider a materiality threshold should be applied to data adjustments to exclude trivial adjustments that have little effect on the distribution of the GST pool.
- 20 ***The size of the thresholds.*** Decisions on the size of materiality thresholds inevitably involve a judgment about the effect eliminating small assessments might have on achieving equalisation. There are no objective criteria to guide that judgment.
- 21 We have evaluated the differing State views on the size of the redistributive impact that should form the basis of the materiality threshold. Like the States, we consider the threshold should be based on the impact on individual States, and that it should be expressed on a per capita basis. We do not accept that a very small disability threshold, say \$1 per capita, would be sufficient to exclude trivial complexity from the assessment process. We also consider that large disability thresholds, say \$20 per capita, risk excluding influences that would improve equalisation. We propose a middle course.
- 22 Discussion at the November 2005 Conference with HoTs confirmed support from all States for the use of materiality thresholds. It also examined potential thresholds and how they might be applied in conjunction with the top-down approach the Commission proposes to follow in the 2010 Review.
- 23 The conference noted the Commission's intention to apply the thresholds in an iterative fashion. That is,
- preliminary decisions would be made to disaggregate expenses and revenues into major functional groups and into smaller groups within them on the basis of the size of the proposed disaggregated category and its expected effect on the GST distribution;
  - materiality thresholds would be reapplied when assessments of the disabilities for the proposed assessments are completed;
  - if the disaggregated categories met the thresholds, they would be retained. If not, the expenses or revenues would become part of an aggregated category at the next higher level or be assessed on an equal per capita basis.
- 24 In this way, the process of examining potential assessments would often examine matters at one level of disaggregation below that finally applied. Doing so will help to ensure that no major influences on the distribution of the GST revenue are omitted and that the assessments are confined to the major influences.
- 25 Against this background, there was a consensus at the conference and confirmed by subsequent written comments on the draft guidelines, that work should proceed on the basis of the middle course thresholds proposed by the Commission, subject to a review of them in the light of knowledge gained through their application.

*The thresholds we propose to apply are as follows:*

- *a category will be considered for inclusion in the assessments if it is expected to:*
  - *contain average revenue or expenses that are greater than \$50 per capita; or*
  - *redistribute more than \$30 per capita for any State;*
- *a disability assessment will be included in the calculation of relativities if it redistributes more than \$10 per capita for any State in the reference period. Where a disability influences more than one category the materiality threshold will be applied to the total impact it has on the redistribution of funds;*
- *an adjustment to data aimed at improving their interstate comparability should redistribute more than \$3 per capita for any State in the reference period; and*
- *once assessments have been made, the category level redistribution threshold of \$30 per capita would be reapplied. Any preliminary categories that did not pass it would either remain part of an aggregated category that has similar, often broader, disabilities or be assessed on an equal per capita basis.*

*To keep the thresholds up-to-date, we will index the values for movements in price levels up to the time when final decisions are made for the 2010 Review.*

- 26 ***Cumulative materiality tests.*** Some States were concerned that the application of materiality thresholds may result in the omission from the assessments of many small influences that together would have a significant effect on the fiscal positions of one or more States. To address this possibility, they sought a cumulative materiality test. Other States argued any such cumulative test was unnecessary and impractical.
- 27 We do not propose to adopt any cumulative materiality tests. In our view, they would be impractical and counter to the intention to use more aggregated assessments to measure the current fiscal capacities of the States. Because the 2004 methods may not do that, they do not represent a logical base to use in evaluating the methods developed for the 2010 Review. Cumulative tests, by requiring some continuation of the current detailed and micro level assessments, would also hinder the pursuit of simpler, more reliable and broader assessments.
- 28 ***Materiality tests for allocation of grants changes over time (dynamic materiality).*** The issues paper on materiality and reliability discussed the idea of introducing tests for the materiality of changes in the allocation of the GST pool over time. The aim of such tests

would be to reduce workload by not updating assessments that did not lead to material changes over time.

- 29 Most States argued that dynamic materiality tests could not be implemented simply and effectively and may even increase complexity by necessitating examination of previous reviews and updates to check for the size of the yearly changes. They doubted that there would be a significant reduction in workload.
- 30 We agree with those views and do not intend to devise any dynamic materiality tests.

### **The next steps**

- 31 The work plan for the 2010 Review provides for us to circulate:
- an issues paper in February/March 2006 seeking State views on an appropriate disaggregation method and category structure; and
  - our proposed category structure in early 2007.
- 32 Consistent with our intention to rigorously apply materiality thresholds, we will propose assessments only where there is a reasonable expectation that they will have a material effect on the distribution of GST revenue.

### **RELIABILITY**

- 33 Reliability is broadly interpreted in terms of consistency of quality, soundness, dependability, predictability, accuracy, and certainty. In the Commission's context, different considerations are most relevant in discussing reliability of methods and reliability of data.

#### **Reliability of methods**

- 34 **Concept of reliability.** The November 2005 Conference with HoTs resulted in broad agreement that reliability is not a black and white issue, but rather a concept that involves a spectrum of possibilities. The issue for the Commission is to decide where in the spectrum an assessment becomes so unreliable that it should not be retained.
- 35 HoTs and the Commission also agreed that a reliable assessment method should have each of the following features.

*Conceptual rigour.* In designing an assessment, the real world is translated into a simplified model. That model must clearly identify the links between State expenses and revenues and the non-policy influences that cause them to vary. It should be based on sound theory, relate to what States do, and be as simple as possible.

*Implementable.* The conceptual model underlying an assessment is implemented by quantifying the influences driving differences between States. The measures used in that quantification process need to accurately reflect the influences that, in concept, drive State revenues and expenses.

*Track reality.* An assessment must reflect what is happening in the real world in the assessment period and over the period the assessment method is likely to be used. The results should be consistent with conclusions that could be drawn from examining other information that reflects the real world.

*Robustness.* A reliable method should not be unduly affected by small variations to the data employed, or the judgments made during the assessment process. This can be tested by sensitivity analysis.

- 36 ***Evaluating reliability.*** Judging the overall reliability of an assessment is a subjective process that combines information on all the aspects of reliability. Given this and the practical limitations on the data available, it is inevitable that some decisions about reliability will require the exercise of judgment. This need for judgment is reflected in the proposed assessment guidelines.

*We think that a vital step in ensuring the reliability of assessment methods is to continue, and enhance, the Commission's usual approach of exposing proposed methods to scrutiny by stakeholders and relevant experts before they are locked into place.*

- 37 During the 2010 Review, we will involve the States and, where necessary, Australian Government agencies in the development of assessment methods through a variety of means, including:

- providing papers on specific methods to the States for comment and, where appropriate, to external experts for their evaluation;
- regular conferences with HoTs;
- staff level working parties on important topics to identify the issues and consider alternative methods of addressing them; and
- preparing a draft report to facilitate external evaluation of proposed methods before the Commission makes its final decisions.

- 38 We will also:

- refine and extend reality checks to test whether assessments reflect real world influences, and track real world changes; and
- undertake sensitivity analysis to gauge how the outcomes of an assessment vary in response to small changes in the measures of its drivers, and in the judgment it incorporates. Such testing would involve changing data or judgments that enter the assessment inputs and seeing how that affects State shares of GST revenue. How the results are interpreted would, in turn, depend on such things as:
  - the total amount redistributed by the assessment; and

- the confidence the Commission has in the data and the method — if the data and the method are reliable, greater sensitivity may not be an issue. If data are mainly derived by judgment, sensitivity to change would be more an issue.
- 39 Some States and one of the external consultants engaged to help HoTs in their review of the implementation of equalisation advocated the use of statistical tests of confidence limits as a means of making decisions on the reliability of data and assessment results. However, most States argued that they would increase complexity and that the information needed to implement them was often unavailable.
- 40 We acknowledge that statistical tests have merit in certain circumstances and will use them where those circumstances exist. However, we do not propose to use them as a general approach because there are methodological problems and their use would increase the complexity of our processes. Moreover, we think that the proposal for the increased use of sensitivity testing and reality testing will provide simpler and more effective guidance on the reliability of assessments.

# CHAPTER 4

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## DATA ISSUES

### INTRODUCTION

- 1 The Commission's recommendations depend heavily on the available data and how they are used. For governments to have confidence in those recommendations, the data used in preparing them need to be robust, reliable, comparable, and up-to-date.
- 2 In very broad terms, the Commission uses data:
  - to establish Australian averages or standards, which may be:
    - average revenues and expenses for each assessment category;
    - Australian average use of services, which is usually sub-divided by population groups; and
    - Australian average unit cost of providing services to each population sub-group.
  - to measure the circumstances of each State, which often requires State-specific data on:
    - the revenue base in each State for each tax; and
    - population and other data<sup>1</sup> for each State, which are often sub-divided to identify groups where the use of services and the cost of providing them are different from the average.
- 3 In the 2004 Review, Australian Government agencies supplied about 65 per cent of Commission data. Of these agencies, the ABS was the single largest provider, providing about 35 per cent of all data. States were the second most important source of data, providing about 30 per cent of data<sup>2</sup>.
- 4 The 2004 Review Report expressed some concerns about data used by the Commission. Partially in response to those concerns, the review of the implementation of equalisation conducted by HoTs following the 2004 Ministerial Council meeting examined, among other things, the fitness for purpose of the data used by the Commission. That work concluded that, generally, the data sets used were fit for purpose, although there were some concerns and further work was needed to improve the coverage and quality of the data.

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<sup>1</sup> There are also data on other variables that reflect the number of services provided, such as the number of primary industry and manufacturing businesses, road lengths, numbers of pensioners.

<sup>2</sup> This excludes data obtained from the ABS but which came originally from the States.

- 5 The terms of reference for the 2010 Review require the Commission to undertake that further work. In early 2005, we established a data working party of Commission, ABS, and State officials to help us with that work.
- 6 That working party reported in September 2005. Its report advised us on:
- the considered views of working party members on the technical criteria that should be used in deciding whether data were of sufficient quality to be used in the Commission's assessments;
  - how to deal with unsatisfactory data in the assessments;
  - a programme for the continuous improvement of the most unsatisfactory data; and
  - a protocol, to which the States were prepared to commit, for improving the quality of State provided data.
- 7 ***Deciding the suitability of data.*** The working party recommended that the Commission address data quality issues by explicitly including the following questions in the 2010 Review assessment guidelines:
- **Are the data relevant or fit for the purpose?** Do they capture the influence the Commission is trying to measure? Do they provide a valid measure of States' circumstances?
  - **What is the quality of the data?** Are there problems in the collection process, the sampling techniques (which influence the extent and type of error), are the data consistent across the States and over time, are they subject to large revisions?
- Whether any flaws in the data sets invalidate their use will depend on the purpose for which they are used (in deriving an average or a disability) and how sensitive the outcome is to variations in the data.
- 8 We have accepted that advice. To further improve the transparency of Commission processes, we will ensure that the evaluation of data against these questions is documented in working papers.
- 9 ***Guidance on the use of data.*** Consistent with the advice of the working party, the Commission will aim to obtain data that are fit for purpose, are of a high quality, and are from a reputable source. However, recognising that it will not always be possible to achieve that aim, lesser quality or qualitative data may be used in an assessment where:
- there is a strong conceptual case to support the assessment;
  - the problems of the data do not invalidate the assessment (the margin of error is acceptably small);
  - the results are supported by other information and accord with the Commission's understanding of State circumstances; and
  - the Commission is confident that making an assessment is more consistent with the equalisation principle than not making one.

*Dealing with unsatisfactory data in existing assessments. If investigations indicate that data used in existing assessments are unsatisfactory, the Commission will need to decide what changes should be made in the assessments used in the updates. The response we decide upon will need to reflect the circumstances of the assessment in which the data are used.*

- 10 Specifically:
- where the assessment is unlikely to be material, it will not be pursued;
  - where the data are fit for purpose and can be improved with reasonable effort, we will do so;
  - where it is not practical to improve the data quality, alternative data and / or methods will be sought;
  - where this is not possible, an assessment could be made using the original data in a way consistent with their quality (for example, a conservative assessment could be made or an adjustment to the data made to compensate for their deficiencies); and
  - where suitable data are not available and a judgment cannot be made with sufficient confidence, an equal per capita assessment or, if there are limited differences between States in their policies on the range and standard of services provided, an actual per capita assessment would be adopted.
- 11 ***Improving the most unsatisfactory data.*** The data working party proposed examining the data sets used by the Commission as part of a programme for continuous improvement. That schedule focuses on the data sets that have a major impact on State revenue shares and in relation to which serious concerns have been raised by the States or the ABS and other external consultants to the HoTs review of the implementation of equalisation. The schedule aims to move more quickly on data sets important to updates.
- 12 We propose that the schedule recommended by the working party (set out in Attachment A) be followed over the period of the 2010 Review. We will monitor the schedule and vary it in the light of our experience during the updates. For example, our experience in the 2006 Update of State GST shares indicated that data on criminal court appearances used in the assessments for Administration of Justice require more immediate examination. We will bring forward the examination of those data to 2006.
- 13 Progress on examination of data and proposals for overcoming any deficiencies will be documented in the report to Ministerial Council in 2007, reports of updates and the 2010 Review Report.
- 14 ***Improving the quality of State provided data.*** About 30 per cent of the data used by the Commission are provided by the States. Most of those data are by-products of data collection

processes intended to meet individual State administrative needs. As noted in the report by Dr McHugh to the HoTs review of the implementation of equalisation, those data are likely to be non-comparable due to different recording and classification procedures and different assumptions where estimations are required. While meeting State needs, non-comparable data pose difficulties for the accurate calculation of State shares of the GST.

- 15 State members of the data working party acknowledged that most of the data States provide to the Commission are not quality assured to the same extent as data produced in budget documents or provided to ABS. But, as a minimum, most Treasuries check the variance of the data and investigate outliers or large movements.
- 16 The data working party considered processes that could be feasibly and cost-effectively introduced to help improve the quality and comparability of data provided by the States.
- 17 The working party recommended protocols which the States were prepared to implement. Those protocols, which are summarised in Table 1, allocate responsibility for improving the accuracy and quality of specifications of data requests, data collection, and verification processes to the parties most directly involved.
- 18 The Commission will follow those aspects of the protocols for which it is responsible and it will continue to check the quality of the data it receives. However, the ultimate responsibility for the quality of State data must rest with the States.

*The Commission expects the States to provide data that are of the best possible quality.*

- 19 The data working party will have an ongoing role in the data improvement process. That role will include facilitating the examination of data sets in accordance with the agreed schedule, and monitoring the effectiveness of the protocols for improving State provided data.

#### **Specific data issues**

- 20 Consistent with the agreed schedule for examining data sets and concerns raised in the reports of the ABS and external consultants to the HoTs review of the implementation of equalisation, we examined some specific data issues during 2005. Our conclusions and proposals based on that work are discussed in Chapter 6.

**Table 1 Protocol for improving quality of State provided data**

Stage in process	Responsibility	Protocol
Data specification	Commission, with assistance of States	<p>Improve data requests by:</p> <ul style="list-style-type: none"> <li>• circulating draft data request annually for comment;</li> <li>• clarifying definitions; and</li> <li>• earlier specification of data needs.</li> </ul>
Data collection	States	<p>Improve quality of data collected by:</p> <ul style="list-style-type: none"> <li>• adhering to specifications<sup>(a)</sup>;</li> <li>• performing basic checks of data;</li> <li>• explaining large variations where required<sup>(b)</sup>;</li> <li>• provision of timely data; and</li> <li>• provision of disclosure statement which includes: <ul style="list-style-type: none"> <li>- name of the data set, source and date of collection;</li> <li>- the State's purpose for collecting the information;</li> <li>- whether they conform to the specification (and if not, how);</li> <li>- known problems with the data;</li> <li>- explanations for large variations; and</li> <li>- whether they have been checked by the agency and represent the best available data.</li> </ul> </li> </ul>
Verification after provision	Commission	<p>Evaluate data quality by:</p> <ul style="list-style-type: none"> <li>• checking the changes in the data over time and differences between States;</li> <li>• checking disclosure statements for consistency of approach and making adjustments as required; and</li> <li>• confirming adjusted data with States and providing feedback for the following year;</li> </ul> <p>With agreement of the working party, improve quality of data set by:</p> <ul style="list-style-type: none"> <li>• including it in the schedule for examining data sets; or</li> <li>• for data sets with serious problems, audit data at source (no data sets have been identified at this stage).</li> </ul>

(a) Adhere as closely as possible to the specifications and document divergences from them.

(b) The level of variation requiring explanation is left to the discretion of treasuries.

## CHAPTER 5

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# INTERIM ASSESSMENT GUIDELINES FOR THE 2010 REVIEW

- 1 Following the November 2005 Conference with HoTs we incorporated our views on materiality thresholds and reliability criteria into revised and strengthened assessment guidelines. Those draft assessment guidelines were circulated to the Australian Treasury and the States for comment in December 2005.
- 2 Comments by the Australian Treasury and the States on the draft guidelines were generally supportive.

### **Interim guidelines**

- 3 After taking account of the State comments on the draft guidelines, the interim guidelines we envisage applying in our 2007 progress report to Ministerial Council are set out below.

### **INTERIM ASSESSMENT GUIDELINES**

These interim guidelines have been developed in response to calls to clarify and strengthen the Commission's decision making process, especially the aspects relating to the materiality and reliability of proposed assessments.

The interim guidelines will be reviewed in the light of the experience gained in their use. Revised guidelines will be included in the Commission's 2007 progress report to Ministerial Council.

### **Introduction**

- 1 The guidelines provide structure, rigor and transparency to the process of making assessments. They do this by:
  - defining the sequence of decisions;
  - specifying what information is needed at each step; and
  - establishing the quality of the information the Commission requires.
- 2 The guidelines assist in:
  - achieving consistent and appropriate standards in the assessment of disabilities and the development of categories, consistent with the principles of fiscal equalisation; and
  - doing this in the simplest, most transparent way possible, leading to assessments with fewer moving parts.
- 3 In operation, the guidelines set a clear hurdle that both individual disability assessments and expense or revenue category assessments have to pass before they are included in the calculation of relativities. The guidelines contain materiality thresholds that will be indexed as required.

- 4 The guidelines also form a key part of the quality assurance process. They allow the Commission to be confident that all relevant information has been used in making preliminary decisions, and allow external parties to follow the decision processes used by the Commission.
- 5 The Commission plans to follow an iterative process in building and finalising its assessments. It will:
  - apply prospective materiality thresholds to make preliminary decisions about category structures and disabilities using historical information;
  - build the assessments using data relating to the assessment period for the review;
  - confirm the reliability of methods, including through the use of external reviews of important assessments; and
  - confirm the materiality of all its category and disabilities assessments at the conclusion.

#### **Structure guidelines**

- 6 The Commission proposes to structure expense and revenue categories starting with large aggregates and disaggregating only where that is expected to improve the HFE outcome.
- 7 A function (expense or revenue item) will be considered for separate category assessment, if:
  - the service provided or revenue source is clearly a major State service or revenue source distinct from others;
  - it is affected by disabilities that are markedly different from those of other categories;
  - data used to estimate the average expense or revenue are satisfactory;
  - it is expected that satisfactory assessments of disabilities can be made; and
  - the category is expected to be material, which is defined as:
    - the average expense or revenue is greater than \$50 per capita; or
    - the assessment is likely to redistribute more than \$30 per capita for any State.

#### **Assessment guidelines**

- 8 The Commission organises its work by making assessments for individual categories.
- 9 The Commission will include a disability in a category when:
  - A presumptive case for the disability is established.
    - A sound conceptual basis for these differences exists.
    - There is sufficient empirical evidence that differences exist between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues.
  - A reliable method has been devised that is:
    - conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral);
    - implementable (the disability can be measured satisfactorily); and
    - where used, consistent with external review outcomes.
  - Data are available that are:
    - Fit for purpose — do they capture the influence the Commission is trying to measure? Do they provide a valid measure of States' circumstances?
    - Of suitable quality — are there problems in the collection process, are the sampling techniques appropriate, are the data consistent across the States and over time, are they subject to large revisions?

Data will be adjusted where necessary to improve interstate comparability. The Commission will not make small data adjustments unless they redistribute more than \$3 per capita for any State.

- Where a case for including a disability in a category is established but the Commission is unable to make a suitable assessment of its impact, the options are:
  - to discount the impact that has been determined; or
  - to make no assessment.

The option chosen needs to reflect the specific circumstances of the assessment. It will depend on:

- the particular concerns about the assessment;
- the strength of the conceptual case for assessing the category or the disability;
- the reliability of the method and data;
- the sensitivity of the assessment to the data used, measured in terms of the likely impact on State revenue shares of an error in the data; and
- consistency with State circumstances.

- 10 The Commission will include the disability in its final assessments if it is material.
  - A disability assessment must redistribute more than \$10 per capita for any State in the reference period to be included in the calculation of relativities.
  - Where a disability influences more than one revenue or expense category, the materiality test will be applied to the total impact it has on the redistribution of funds.
- 11 A category assessment will be included in the final assessment if:
  - the assessment cannot be made simpler without reducing its conceptual rigor and reliability;
  - the Commission considers the methods are reliable and has confidence in the results:
    - the results are consistent with the real world;
    - where used, external review highlights that the approach is reasonable; and
    - the assessment is robust, that is, it is not unduly sensitive to the change in inputs.
  - the average expense or revenue is greater than \$50 per capita or the category redistributes more than \$30 per capita for any State. Categories that do not meet one of these thresholds will either remain part of an aggregated category that has similar, often broader, disabilities or be treated equal per capita.
- 12 Once assessments have been finalised, the Commission will ensure the outcomes at the proposed level of disaggregation are materially different from, and conceptually superior to, the assessment at the higher level. If not, it would use the assessment at the higher level of aggregation.

- 4 We intend to apply the guidelines in all aspects of the work leading to the development of assessment methods for the 2010 Review, including the evaluation of existing methods, the evaluation of State submissions and in reaching decisions on new assessment methods. We also expect that the States will adopt them in presenting their cases for new or revised assessments.

## **CHAPTER 6**

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# **PROGRESS REPORT ON RELIABILITY OF DATA AND METHODS**

### **INTRODUCTION**

- 1 This chapter provides a progress report on work during 2005 to examine the reliability of data and methods. As part of that work, we have examined the reports of the ABS, Prof Pincus and Dr McHugh to the HoTs review of the implementation of equalisation to see if they had implications for the updates.

### **DATA**

- 2 As noted in Chapter 4, we agreed to follow the work schedule developed by the data working party for examining the reliability of the main data sets used in Commission assessments. Consistent with that schedule, during 2005 we:
  - examined the reliability of data, extracted from the Australian Business Register, on the number of businesses in each State;
  - examined the ABS advice that there could be ‘unintended effects’ in using disaggregated Census and other data;
  - examined the potential problems identified by the ABS in the Commission’s use of ABS Government Finance Statistics (GFS) data;
  - aimed to improve the comparability of State road length and use data; and
  - aimed to obtain comparable information from each State on the value of land used for non-principal places of residence.
- 3 Because the assessments of State capacity to raise mining royalties have a very large effect on State shares of the GST pool, we also examined the implications of comments by ABS on the data on the value of mining production.

*We have concluded that:*

- *the data on number of businesses from Australian Business Register are unfit for our purposes and in the 2006 Update of State shares of the GST pool we have either replaced the data with more reliable data or varied the assessment method;*
- *the potential problems with the use of disaggregated Census data, detailed GFS data and value of mining production data had immaterial practical effects on the assessments, so we will continue existing methods for the updates, but will examine alternative approaches for the 2010 Review;*
- *in practice it is not possible to improve the interstate comparability of data on the value of non-principal places of residence, so we have decided to retain existing methods for the updates and seek alternative approaches for the 2010 Review; and*
- *problems with the interstate comparability of road length and use data could not be resolved during 2005, but we will continue to examine ways of improving the data.*

#### **Australian Business Register data**

- 4 The size of the tasks States face in providing services to the primary industry, mining and manufacturing industry sectors and in regulating water suppliers and business in general were measured using data on the number of businesses in the relevant parts of State economies.
- 5 The data the Commission used for this purpose were obtained from the Australian Business Register maintained by the ABS. In its 2005 report to HoTs the ABS said that the data, particularly the number of agricultural business entities, were not fit for the Commission's purposes. We have examined the assessments and the data they use. That work confirmed that the data from the business register are unreliable and so are unfit for our purposes. We also considered potential alternative data sources and, where they were not available, possible changes in method to overcome the problem.
- 6 Following consultation with the States during the November 2005 Conference and in subsequent correspondence, we decided to make the following changes in the calculations for the 2006 Update of State shares of the GST pool.
  - In the assessment for services provided to primary industry, the method established in the 2004 Review has been retained, but business register counts have been replaced with establishment counts from the ABS's publication *Agricultural Commodities* (catalogue 7121.0). The ABS advised that these data are more reliable than the business register data. We considered the new data to be sufficiently comprehensive and fit for purpose.

- Data on the number of establishments from the business register have been replaced with data on factor income for the mining, fuel and energy industries in the assessment for services provided to those industries and by data on Gross State Product (GSP) in the assessment for general regulatory activities within the General Public Services. We made this change to the assessment methods because the data on factor income and GSP provide an alternative indicator of the size of the relevant tasks and the ABS has advised that the data are reliable.

Before finalising that decision, as suggested by some States we examined more recent data on the number of mines and other businesses from the publication *ABS Business Register* (catalogue no. 8161.0.55.001). However, the ABS advised those data suffered from the same deficiencies as the original data used in the 2004 Review and 2005 Update assessments. We concluded they could not be used to replace the original data.

- In the assessments for services provided to manufacturing and other industry and for the regulatory tasks associated with the water, sanitation and protection of the environment sector, we were unable to find an alternate source of data to measure the number of locations at which services are required. Therefore, we varied the assessment method by replacing the calculations that used business register data with equal per capita comparisons. We considered that this change was not inconsistent with the 2004 Review equalisation principle and its impact on GST revenue shares was immaterial.

#### **Disaggregated Census and other data**

- 7 In its 2004 report to HoTs, the ABS concluded that the Commission should:
  - cease using very large cross-tabulations because they might have ‘unintended effects’ on the assessments, and limit the size of cross-tabulations; and
  - consider an alternative to using large cross-tabulations, such as the use of separate key socio-demographic variables.
- 8 The Commission uses cross-tabulations of Census data together with matching cross-tabulations of use and cost data to calculate the effects of socio-demographic features of State populations on the use and cost of providing services. The Commission adopted this approach because it provides a conceptually sound way of accurately capturing the interacting effects of population features, such as age, Indigenous status, income, and place of residence.
- 9 We examined the potential ‘unintended effects’ of using cross-tabulations arising from the effects of the ABS’s process of randomising data in cells with very small counts, mismatched cells, and volatility of the values in small cells. Our research showed that any ‘unintended effects’ arising from the use of large cross-tabulations of 2001 Census data were immaterial.
- 10 The results of that work were provided to the ABS for comment. The ABS examined our analysis, endorsed the findings and said it now had no statistical concerns about the Commission’s use of the 2001 Census tables.

- 11 We have so far been unable to see the viability of the ABS alternative of using separate key socio-demographic variables (such as age, Indigeneity, location) instead of large cross-tabulations. Specifically, we have been unable to devise a sound way of combining the separate effects of the key variables that eliminates the potentially large double-counting.
- 12 Therefore, we have decided to continue to use the existing cross-tabulations of Census and use rate data in the assessments for updates prior to the 2010 Review. However, as part of the simplification and aggregation of methods for the 2010 Review, we will identify the major socio-demographic drivers of the costs for the main services (education, health, law and order) to help us devise alternative assessments that rely on fewer cross-tabulations.

#### **ABS Government Finance Statistics data**

- 13 The data on average expenses incurred by States on each service they provide are obtained from the ABS GFS data collection. In its 2005 report to HoTs, the ABS said that the quality of GFS data had improved since the introduction of accrual accounting and that it would improve further over time. It concluded that GFS data were generally fit for the purposes for which the Commission used them. However, the ABS was concerned that the detailed 4 digit Government Purpose Classification (GPC) data used to identify expenses on many services were unreliable and not fit for purpose.
- 14 The terms of reference ask us to consider ways of simplifying the assessments by, among other things, 'reducing the reliance on the use of 4 digit GFS data and examining the capacity of making effective use of 2 digit and 3 digit data'. During 2005, we examined the extent of our use of 4 digit GPC data and the way the data are used. That analysis indicated that detailed 4 digit GPC data are not used extensively in our assessments. Most services are already defined in terms of the more aggregated 2 and 3 digit GPCs. While some of the detailed data are not as reliable as we would like, the fact that they are used only to calculate averages of the expenses incurred by all States means that our recommended State shares of the GST pool are not very sensitive to potential errors in the data.
- 15 We have concluded that the use of detailed 4 digit GFS data does not introduce major errors into Commission recommendations. After considering our work, the ABS agreed with our conclusion.
- 16 Nevertheless, the top-down approach we intend to apply in the 2010 Review will lead to broader, more aggregated groupings of State services being used in the assessments. Those broader categories will, as requested by the reference, result in a much-reduced need for 4 digit GFS data and a greater use of 2 and 3 digit data.
- 17 The intervening updates, however, will continue to be based on the existing assessment category structure. This approach is consistent with the view of HoTs that method changes should not be introduced in updates. To ensure that this approach does not adversely affect the results of the updates, the States, the ABS, and the Commission have agreed to work

together to improve the quality of GFS data, including those 4 digit classifications that are currently used. This work will follow a set of protocols agreed by the data working party.

- 18 The ABS report to HoTs also contained some other detailed comments and recommendations relating to the use of GFS data. Those issues have been examined and views reported to the States through their members of the data working party. Where changes were considered necessary, they have been implemented in the 2006 Update and are discussed in our 2006 Update Report.

### **Road length and use**

- 19 In the 2005 Update, the Commission raised concerns about the volatility and interstate comparability of data on the length and use of arterial roads. For that update, it decided to retain the data used in the 2004 Review and to examine means of improving their interstate comparability during 2005.
- 20 Considerable work on this issue was done during the year. However, that work has not overcome the main concerns. Therefore, we decided to continue to base the roads assessments for the 2006 Update on the road length and use data used in the 2004 Review and the 2005 Update.
- 21 The Commission will continue to examine ways of improving the comparability of the data. However, the experience so far indicates it will be difficult to obtain data from existing data bases that are comparable across States and are not influenced by the different decisions individual States may make on:
  - the extent and nature of their road network; and
  - the allocation of responsibility for funding the road maintenance task between the State and local governments.
- 22 Options that may be examined include collecting data on road length and use from States or other bodies (such as the Public Sector Mapping Agencies) based on specifications defined by the Commission, or seeking alternative indicators of the underlying determinants of the size of each State's road maintenance task. Such options may require changes to the assessment method.

### **Land revenue**

- 23 In the 2004 Review Report, the Commission said that it would work on improving the quality and comparability of data on non-principal residential land used in assessing State capacities to raise revenue from land tax. The work done on this issue included extensive discussions with the State Treasuries, State Valuers-General, State Revenue Offices, and the Australian Valuation Office. Those discussions indicated that data collected by State revenue offices appeared to provide the best means of improving the assessment. However, our examination of the data indicated that there were substantial comparability issues, which could not be overcome — primarily because important data from New South Wales were unavailable.

- 24 In this context, we have decided to cease that work and to retain the current approach to estimating the value of land used for non-principal residential purposes for all updates prior to the completion of the 2010 Review. However, we will examine alternative methods and data for assessing State capacities to raise land tax during the 2010 Review.

#### **Mining data**

- 25 The 2004 ABS report to HoTs said that data on the value of mining production used by the Commission in assessing the capacity of States to raise revenue from mining royalties may be being used beyond their confidence levels.
- 26 We examined the data, in conjunction with the Australian Bureau of Agriculture and Resource Economics (ABARE) (which provided the data) and the ABS. In the light of that work, the ABS said that it was now satisfied that the minerals data supplied by ABARE are being used within confidence limits, and that appropriate fuel mineral values are being used by the Commission.

#### **THE RELIABILITY OF METHODS AND JUDGMENTS**

- 27 The reports of Prof Pincus and Dr McHugh to the HoTs review of the implementation of equalisation raised some issues relating to the reliability of methods and judgments.
- 28 Prof Pincus expressed confidence in the work done by the Commission, but he was concerned that the breadth of the Commission's research was wider than the resources available to pursue it. He said there was a need to simplify the assessments and to increase the external scrutiny of research. He also made comments on specific issues in some assessments.
- 29 Dr McHugh noted that some of the Commission's processes were inherently complex and were likely to remain so because of the demands by the States for greater transparency and accuracy. He said the data available to the Commission were often limited, which reduced confidence in the subsequent analysis and led to the extensive but conservative use of judgment. He made suggestions about how data might be improved and also commented on specific issues in some assessments.
- 30 The comments of Prof Pincus and Dr McHugh reinforce the need to simplify the assessments, to remove immaterial assessments and improve processes that affect the reliability of methods and data. The general issues they raised are directly addressed by the proposals outlined earlier in this report for simplification and the strengthening of the assessment guidelines.
- 31 Their comments on individual assessments were often used to illustrate their points about complexity, detail, and the extensive use of judgment. However, they also raised specific issues with the methods in some assessments.
- 32 We have made a preliminary examination of those specific issues and will revisit them in redeveloping assessments for the 2010 Review. However, we have concluded that the issues

they raised do not indicate that the methods are sufficiently unreliable for us to stop using them in updates. In reaching this conclusion we were mindful that the 2004 Review methods were developed following extensive consultation with all States. As some States have noted, they are the best that could be developed at the time and with the information available.

- 33 If, however, work in the future indicates that the methods are no longer appropriate, we will change them. As noted in our 2006 Update Report, developments relating to State expenses on debt charges have raised questions about the continued appropriateness of the current method of assessment. We propose to consult with the States during 2006 about whether the assessment method is appropriate for future updates.

# CHAPTER 7

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## PROGRESS REPORT ON OTHER ISSUES

### INTRODUCTION

- 1 Previous chapters contain details of our proposals, conclusions and progress on issues relating to materiality thresholds, reliability of methods and data. Clause 6(a) of the terms of reference for the 2010 Review also requires us to report progress in relation to:
  - aggregating existing assessment categories, components and factors;
  - use of more general indicators;
  - developing mechanisms to maintain simplification;
  - continuous improvement of assessments; and
  - improving quality assurance.
- 2 This chapter reports progress on these issues.

### AGGREGATION

- 3 As noted previously, we believe strongly that the use of more aggregated assessment categories and more broadly defined revenue bases and disabilities offers the greatest scope for achieving simplification that is consistent with equalisation.
- 4 Throughout 2005 we have focussed on establishing a broad, top-down approach to aggregation and on developing strengthened assessment guidelines. During 2006 that approach and the guidelines will be used to establish the proposed categories of expenditure and revenue to be assessed and reported on in 2010. State views on the most appropriate category structure for the 2010 Review assessments will be sought during 2006.
- 5 Explicit in our clean slate, top-down, guidelines based approach is the view that the structure of the revenue and expense categories used in the assessments should reflect the minimum disaggregation possible that is consistent with achieving equalisation.
- 6 In implementing this approach the Commission will start with very broad groups of expenses and revenues. Those groups would be disaggregated only if:
  - doing so would materially improve the equalisation outcome, implying that the influences that drive State expenses or revenues classified to the disaggregated categories are materially different; and

- the disaggregated expenses or revenues and the associated disabilities or revenue bases can be measured reliably.
- 7 This process of deciding the appropriate level of disaggregation will be informed by the Commission's consideration of:
- 'what States do' — that is, what services they provide (or revenues they collect), the objectives they aim to achieve in providing those services, and how they provide (or collect) them; and
  - the main non-policy reasons why expenses incurred, or revenue collected, differ across States — this may in part be informed by knowledge gained from the existing assessments.
- 8 On the expense side of State budgets, the starting point for the disaggregation process would be the four major groups of services provided — that is, education, health, law and order, and all other services. The first three are the largest and most important areas of State services and robust ABS GFS data are available at the 2 digit level to support the derivation of average expenses. They also have distinctive users and costs:
- Education is mainly for 4 to 18 year olds.
  - Health is provided for all groups in the population, but age, sex, where people live, and Indigeneity have quite different implications for use and the costs of providing services.
  - Law and order services are provided for all groups in the population, but use and costs of providing services are affected by some groups of people that are different from those for education and health.

#### **USE OF GENERAL INDICATORS**

- 9 The top-down approach to considering the appropriate category structure will have implications for the way the influences on costs of providing services and revenue bases are measured. All other things being equal, it will lead to broader measures of them.
- 10 The broad approach to the determination of appropriate measures of cost drivers and revenue bases will be similar to that for the category structure. That is, the Commission envisages starting with broad measures and seeking narrower measures only if:
- that is necessary to capture material differences between States in circumstances that affect the use of services, the cost of providing them or the capacity to raise revenue; and
  - they can be reliably measured.
- 11 The existing assessments indicate that some of the largest influences on the use and cost of services stem from differences in the characteristics of State populations (age, Indigeneity, income and so on) and the location of where people live (remote areas, large cities).

- 12 Commission staff have commenced preliminary work on exploring the scope for using broader indicators in the assessment of some of these cost drivers and on identifying the features of State populations that have the greatest effects on service use and costs. States have already agreed to the formation during 2006 of some working groups of officials to progress the work by identifying the issues, identifying potential indicators of the various cost drivers and beginning the processes of preparing and evaluating alternative measures of them. At this stage, the Commission is taking steps to establish working groups to examine:
- socio-demographic influences; and
  - location-based influences.

#### **MAINTAINING SIMPLIFICATION**

- 13 The zero sum nature of the GST sharing arrangements provides incentives for States to make more sophisticated and complex arguments to justify increases in their shares. Consequently, we accept and appreciate that there is a need to ensure the simpler processes developed in this Review are maintained after 2010.
- 14 The continued rigorous application of the strengthened assessment guidelines proposed in Chapter 5, together with transparent decision making processes, will provide a strong check against future ornamentation of the assessments with unnecessary detail.
- 15 The need for extra processes will be considered later in the review.

#### **A PROGRAMME FOR CONTINUOUS IMPROVEMENT**

- 16 The terms of reference require the Commission to consider a programme of continuous improvement of its assessments, covering improvements in the quality and fitness for purpose of both data and methods.
- 17 The conclusions of work done during 2005 on this matter were described in the previous chapter.

#### **Issues to be examined in 2006**

- 18 In addition to further work on some of the issues discussed in Chapter 6, such as roads data, the Commission will work with States during 2006 to:
- check the comparability of data on the value of property transfers that are subject to Stamp Duty on Conveyances;
  - check the comparability of data on expenses incurred in relation to administration and compensation for Native Title claims, Northern Territory Land Rights legislation, and Services to Indigenous Communities;

- check the comparability of data on expenses that are affected by the isolation of a State from the large markets and sources of supply in south-east Australia;
  - improve the comparability of data on visitors to national parks; and
  - improve the comparability of data on court appearances used in the Administration of Justice assessments.
- 19 The issue of how assessments might be revised after 2010 needs to be addressed towards the end of the review process. Experience suggests that there might also be a need to balance continuous improvement, stability of methods, transparency of changes, and maintaining simplification. The Commission will consult with the Australian and State Treasuries on this issue in due course.

## **QUALITY ASSURANCE**

### **Background**

- 20 The terms of reference require the Commission to consider means of improving its quality assurance processes.
- 21 Existing Commission quality assurance processes aim to provide internal guarantees of the quality of work and to avoid errors in calculations. Improving and broadening the processes is necessary to further improve the reliability and accuracy of our assessments, increase transparency and allow us to demonstrate to the States and other external parties that comprehensive quality assurance processes are in place and that they have been followed.
- 22 In 2005, quality assurance work aimed to continue existing processes and develop a quality assurance strategic plan for the 2010 Review. The work included:
- reviewing the existing processes to identify areas of greatest risk and where better practices could be adopted; and
  - developing processes for improving the quality of data, especially data provided by the States, an area where the Commission has previously signalled concerns.

### **Quality assurance strategic plan**

- 23 To enhance the quality assurance process, the Commission has reviewed its present processes and developed a draft quality assurance strategic plan. As part of the developmental process:
- views were sought from the Australian Treasury and the States on desirable features of a quality assurance process for the Commission; and
  - an independent expert was engaged to review the Commission's risk assessment and to evaluate the draft strategic plan against best practice criteria.
- 24 That advice is being evaluated and where necessary will be reflected in the final strategic plan.

- 25 **Features of the draft strategic plan.** The Commission and its staff follow many features of a quality assurance process. However, those processes are not always fully integrated into day-to-day activities and there are some gaps in their coverage. Nor is the existence of the processes and their application clearly documented and regularly demonstrated to external stakeholders.
- 26 The draft strategic plan aims to address such issues. It covers all aspects of our work and emphasises the need to follow systematic practices and to ensure their existence and implementation is fully and clearly documented.
- 27 Some of the main features of the draft strategic plan are outlined below.
- 28 **Assessment guidelines.** The development and implementation of the proposed assessment guidelines discussed in previous chapters of this report is crucial to improving the reliability and transparency of the Commission's work and to strengthening the acceptability of equalisation. The guidelines are therefore vital to the Commission's quality assurance process. They will provide a structured and consistent approach to decision making that builds in benchmarks and criteria that must be met before assessments are made. They also provide for enhanced documentation to improve transparency and accountability.
- 29 **Better evidence and more reliable data.** The quality and reliability of evidence and data that enter the decision making and calculation processes are vital to the quality of the Commission's recommendations. As discussion in previous chapters indicates, there are concerns about the quality and reliability of some data.
- 30 Our proposals for improving the reliability of methods provide for better-targeted evidence from States by making it clear that arguments for new assessments or the continuation of existing ones must meet the benchmark standards of materiality and reliability before they are accepted.
- 31 In his 2005 report to the HoTs review of the implementation of equalisation, Dr McHugh suggested that the Commission audit problem data sets at source. This proposal was put to States but was not supported, mainly because it was not cost effective.
- 32 Consequently, the data working party and the Commission examined other options for improving data. That work culminated in a programme that provides for existing processes of reviewing and improving data sets to be made more systematic and comprehensive. The proposed programme identifies problem data sets (including some State provided data) and when they will be reviewed. In undertaking the work, we will follow the protocol recommended by the data working party for processes that aim to improve the quality of data provided to the Commission by the States.
- 33 The draft quality assurance strategic plan emphasises the importance of the evaluation of data and the documentation of the outcomes. However, the Commission's role is not one of a data collection agency. It does not have the capacity to systematically audit the accuracy of raw data provided to it. The primary responsibility for data quality must rest with the providers of

that data. Nevertheless, the Commission accepts that it must use data responsibly and in accordance with its limitations. It also accepts that its processes should provide for data requirements to be clearly articulated, for data to be checked and for any issues of concern to be raised with providers.

- 34 **Broader use of external expertise.** The Commission's work is criticised on the basis of its complexity and the limited number of people from the Australian Government and the States who are involved in the development and evaluation of methods. As part of the processes for increasing the reliability and transparency of methods and data, the Commission and the States have agreed on the need for greater use of external expertise to review methods in important areas or to help in their development. States have been asked to nominate people suitable for those roles.
- 35 **Improved documentation.** The Commission provides extensive documentation of its processes and methods through its reports and supporting documents and working papers. All Commission reports and technical papers have been published on its web site since 1999 when the site was established. Submissions by States and other parties are also published if approval is received from them to do so.
- 36 Despite the extent of the documentation and ongoing efforts to improve its quality and accessibility, improvements could be made in areas, such as:
- more clearly identifying the reasons for decisions and judgments;
  - reworking written outputs to use less jargon to make them more transparent and accessible to readers;
  - reducing the volume of written outputs and restructuring them to better meet the differing needs of the different groups of internal and external users; and
  - improving the accessibility of the assessment system by annual training for Commission and State users, improved design and improved user guidelines.
- 37 **Verification of quality.** The draft strategic plan provides for verification to the Commission and external parties that quality assured processes are in place and have been applied. In part, this will be done through improved performance reporting by the Commission and its staff, especially the increased transparency and documentation of decision making processes and reasons for decisions and judgments.
- 38 However, it will also require some external evaluation of the processes and their application. The involvement of external experts in the development of the strategic plan begins the process. Some States have said that an independent audit of decision making processes, the assessment system and data inputs would be the most satisfactory verification tool. The draft strategic plan envisages an external evaluation of decision making processes once in each review and more regular evaluations of our calculation processes.

## Implementation

*The focus of quality assurance work for 2005 was on laying the foundations for future efforts. We have a draft strategic plan, which will be finalised in early 2006 and implemented and monitored between 2006 and 2010.*

- 39 In 2005 and early 2006, we began implementing the improvements to current processes shown in Table 1.
- 40 In 2006 we will continue to implement new strategies, including:
- finalising the assessment guidelines;
  - implementing the protocol for improving the quality of State provided data;
  - continuing to work with data providers to improve the quality of priority data sets;
  - reviewing the assessment system to facilitate easier use and better understanding; and
  - developing reporting mechanisms that could be used to verify that we have quality processes in place.

**Table 1**      **New activities undertaken in 2005 and early 2006**

Task	Activity
Decision making	Developed improved assessment guidelines.
Calculation	Worked with States, ABS and Australian Treasury to develop a protocol for improving the quality of State provided data.  In consultation with the States identified priority data sets to be improved.  Worked with data providers to improve the data sets for GFS, roads and land.
Documentation	Developed new presentation of material explaining the relative fiscal positions of the States for the 2006 Update.  Began implementing new presentation of working papers in the 2006 Update.  Changed some of the key terms used by the Commission to use less jargon and make products more transparent and accessible to readers.

# ATTACHMENT A

## SCHEDULE FOR EXAMINING DATA SETS

1 Table A-1 summarises the work programme for examining data sets developed by the data working party. It lists the data sets to be examined, the work proposed and when the outcomes from the work will be reported, or commenced.

**Table A-1 Schedule for examining data sets**

Assessment/Data set	Work to be done	When
GFS GPC — 4 digit and other issues	Respond to concerns of ABS: (i) continue improving data for updates; (ii) preliminary response to ABS report; (iii) revise scope and structure of adjusted budget; and (iv) if necessary, improve quality of required GPCs with assistance from States and ABS.	Updates, Minco Report 2006, Minco Report 2007, March 2007, and 2010 Review
Disaggregation of AIHW Inpatient and Census data	(i) preliminary response on ‘unintended effects’; (ii) examine volatility of data; and (iii) identify main drivers of the costs of providing inpatient services.	Minco Report 2006, Minco Report 2007 and June 2009
Land valuation data	Improve interstate comparability of valuation data on non-principal places of residence. Continue usual audit of commercial and industrial land values by the Australian Valuation Office.	Update and Minco Reports 2006
Roads data	Improve interstate comparability of road length and use data with the assistance of the States.	Update and Minco Reports 2006
Business Register data	Consider interstate comparability of data and, if necessary, look for alternate source or new method.	Minco Report 2006
Mining data	Investigate comparability of data and suitability of new data framework being developed by ABS.	Minco Report 2007
Population	Continue to work with ABS to improve reliability of estimates by improving the <i>Indigenous Enumeration Strategy</i> and understand the effects of this on population estimates. Consider adjusting Census tables to account for non-Indigenous under-enumeration when category structure is determined.	Minco Report 2007 and on-going Minco Report 2007

Assessment/Data set	Work to be done	When
National Health Survey	Investigate ABS concern and proposed alternate sources of information.	Minco Report 2007
Stamp duty on conveyances	Improve specification and check comparability across States.	Minco Report 2007
Native title, land rights and services to Indigenous communities expense	Improve specification and check comparability across States.	Minco Report 2007
National parks data (visitors, biodiversity)	Work with States to attempt to achieve greater comparability in visitor numbers. Investigate if recent biodiversity data are available.	Minco Report 2007
Court appearances	Check basis of collection in each State and comparability across States.	2008 Update
Isolation (freight, labour related costs)	Investigate how these assessments can be made more reliable, based on data from more States.	Commence 2006 for 2008 Update
Socio-demographic composition disabilities	Investigate how these assessments can be simplified, made more reliable, based on data from more than one State, and assessed in more aggregated ways.	Commence 2005
Urban influences, vandalism	Investigate how these assessments can be made more reliable and based on data from more than one State.	Commence 2005
Survey of Education and Training data	Consider the use of the EEBTU data and whether adjustments made deal adequately with risks posed by small sample sizes for small States.	Commence 2005
Education, Health, Law and Order	Review how States are providing services and assessment frameworks in preparation for decisions on data requirements for 2010 Review.	Commence 2005
Dispersion indexes	Expand sample data used to derive them.	Commence 2006
Scale	Consider whether the assessment could be materially improved through the collection of more data.	Commence 2006
Capital assessments	Review how States are providing services and assessment frameworks in preparation for decisions on data requirements for 2010 Review.	Commence 2006
Special data collections	Consider requirements in consultation with States.	Commence 2007 for collection in 2008 or 2009
Urban transit data	Improve comparability of data on which assessment is based (subsidies, component weights, fleet characteristics) or change method.	Commence 2007
Climate, natural hazards	Consider whether future work is likely to yield materially better results.	Commence 2007
Data for other specific assessments	Consider how these data sets might be improved as part of the review process after a decision has been taken on whether the categories/factors/influences will continue to be assessed separately.	Commence post-2007

Source: Data Working Party, Report to Commonwealth Grants Commission, *Dealing with Unsatisfactory Data*, September 2005.