

# **COMMONWEALTH GRANTS COMMISSION**

**DISCUSSION PAPER CGC 2001/9**

## **DEVELOPING SIMPLER ASSESSMENTS**

**PRIORITY ISSUES CONFERENCE**

**CANBERRA**

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1. This paper discusses possible changes to how HFE is currently implemented, with a focus on achieving simpler, and if possible better, assessments. It draws on the Commission's previous paper on simplicity (Discussion Paper 2000/7) and the States' reactions to it.

## BACKGROUND

2. Discussion Paper 2000/7 noted that, while current methods have a broad measure of acceptance, States would welcome simpler methods if they helped better understanding of the assessments and gave greater confidence in the results. It stressed, however, that simplification of assessments would lead to changes in revenue shares.

3. The paper noted that a mechanical approach to simplification was possible. It proposed reviewing, and perhaps removing, all assessments, factors or adjustments which redistributed less than a set threshold. For example, an EPC assessment for the 21 categories where the impact on every State's revenue redistribution in the 2000 Update was less than 1 per cent, would have redistributed the amounts shown in Table 1.

**Table 1** REVENUE CHANGE IF NO NEEDS ASSESSED FOR THE 21 CATEGORIES WITH EVERY STATE BELOW THE THRESHOLD

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Revenue effect	46.8	64.3	15.8	7.5	-57.3	-36.2	1.9	-42.8	136.3

4. The paper concluded that a mechanical approach should not be adopted because it would probably not increase confidence in the results for the majority of the stakeholders. The paper said that, on the contrary, simplification should be used to increase the confidence in the assessments. The number of assessments should depend not only on their effect on grant share, but also on the reliability of the data and methods used in the assessments.

5. The main proposal of the paper was to extend the Commission's assessment guidelines by setting criteria to judge the robustness of assessment methods. Although using such guidelines might lead to changes in revenue shares, the Commission believed that the improved methods would make shifts in revenue shares more acceptable.

## STATE VIEWS

6. While all States gave in-principle support to simpler assessments, most rejected mechanical approaches to simplification and opposed simplification at the expense of large reductions in equalisation.

7. Western Australia, South Australia, Tasmania and the Northern Territory argued that reducing the number of categories or disability factors (advantages and disadvantages) would not necessarily lead to greater simplification. Simplifying methods of

calculating factors was seen as a better approach. The ACT was concerned about proposals to use more sub-global measures of revenue bases as a way of achieving simplification. New South Wales asked that the Commission develop specific proposals to simplify assessments for further discussion.

8. Only Victoria supported a straight mechanical approach to simplification (the threshold test). It argued that this would lead to a more scientific approach to grant share determination. As part of this argument, it opposed the Commission's use of judgement in deciding whether simplifying an assessment came at too great a cost to equalisation.

## THE CASE FOR SIMPLER ASSESSMENTS

9. The major issue in relation to simplification of methods is that any changes to the Commission's methods would result in changes in States' revenue shares. If States find no change acceptable, then trying to simplify assessments is a waste of time.

10. However, simplicity is worthwhile if it also strengthens fiscal equalisation outcomes. There are two objectives involved: obtaining greater acceptance of the results, and obtaining greater understanding of them. Changes designed to make the results more acceptable in terms of the HFE principle have the potential to change grant shares, but in an appropriate way. Changes designed to increase the understanding of the results — perhaps through greater transparency — should not influence grant shares.

11. ***Greater acceptance of results.*** The lack of acceptance of the results may come from:

- (i) the use of unsound methods;
- (ii) the use of unreliable data;
- (iii) too much use of judgement;
- (iv) unsupportable complexity in the assessment methods; and
- (v) a lack of understanding of the methods.

12. There are currently a number of quite complex assessments. While it might be difficult to justify the level of complexity in some cases, in others it reflects the need to account for policy influences on the way services are provided. In many assessments, good quality data and sound methods are available to measure State needs. While this may result in complexity, it is justifiable, and moving away from such assessments would diminish fiscal equalisation outcomes.

13. An example of where the current complexity may be justified is the schools education assessments. These are based on comprehensive and reliable data. The Urban Transit assessment is another complex assessment, but, in this case, available data may have been stretched too far to support the theoretical framework upon which it is based.

14. On the other hand, there are some assessments, such as those for Concessions and Other Payments, that may be too simple because of inadequate data. They may not fully recognise all the relevant needs of States.

15. The acceptance of the results comes from the robustness of the methods used in their derivation and from the ability of those methods to recognise needs appropriately. Simplicity should not stop the assessment of clearly identified and material needs.

16. ***Greater Understanding of Results.*** The other aim of simplicity is greater understanding of results. This can come from simpler assessments of needs or from better presentation and explanation of results. The latter is probably the best way to improve understanding. It is the subject of a separate agenda item.

### **SIMPLER ASSESSMENTS FOR GREATER ACCEPTANCE OF RESULTS**

17. The question now is how the assessments might be simplified and equalisation outcomes strengthened. Equalisation outcomes for the next review might be strengthened, and the methods simplified, by:

- (i) re-examining the extent to which States' activities are disaggregated, thereby reducing the number of categories ; and
- (ii) changing the way disabilities and revenue bases are assessed.

18. However, this should not be done without the use of guidelines to ensure appropriate assessments.

#### ***The Number of Categories***

19. State activities are presently divided into about 40 expenditure and 20 revenue categories. Other things being equal, fewer categories should make it easier to understand the assessments. But it would also reduce the ability of the assessments to reflect the details of what States do. Using fewer categories would improve simplicity and transparency only if the assessments reflected broader functions and not the various services that comprise the functions. The expenditure frameworks developed in the 1999 Review might need to be changed significantly, or abandoned.

20. It may be that a reduction in the amount of disaggregation would better reflect the States' broad responsibilities in terms of service provision and taxing capacity. The focus of the assessments would be on the broader responsibilities of the States (health services) — not on how they acquit those responsibilities (that is, whether they deliver hospital or community health services and how those services are provided which, to some extent, are policy choices). A different type of equalisation would be achieved.

21. Discussion Paper CGC 2001/8 *Development of the Standard Budget*, provides another reason for thinking that less disaggregated assessments might be applied in the 2004 Review. The quality of the financial data may be such that the existing assessment

structure cannot be sustained. Changes, such as those proposed in that paper, would have large impacts on grant shares but may be needed to ensure the on-going acceptability of the results, if the data cannot be improved.

22. Reducing the level of disaggregation would result in reduced demands for financial data and improved confidence in financial standards. Its effect on finding appropriate measures of needs is difficult to evaluate, but is likely to be substantial.

### ***Assessment of Disabilities and Revenue Bases***

23. ***The number of disability factors assessed.*** The current detail in individual assessments (the number and range of disability factors or adjustments applied) reflects the view that assessments should be as comprehensive and as precise as possible to measure States' funding requirements appropriately.

24. While the most important disabilities and adjustments are assessed, others are recognised but not assessed. This is because information is not available or because the effects of the disabilities on revenue shares would be small. The assessment of more disabilities or adjustments would result, at most, in marginal gains in HFE outcomes.

25. We have many good assessments supported by quality data. We would not want to lose those. A compromise might be to keep the disabilities and adjustments we have confidence in, and aggregate others where confidence is not as high.

26. ***Assessing fewer disability factors.*** The assessment of fewer disabilities, or making fewer adjustments to revenue bases, would reduce the complexity of the calculations. The implications of doing this might be that the measurement of needs would not be regarded as accurate and comprehensive. However, if the less solidly based disabilities or more speculative adjustments to revenue bases (those based more on judgement) were no longer assessed, it could be argued that needs assessments would become more robust.

27. The complexity of the assessments of needs may not come from the number of disabilities assessed or the number of adjustments made but from the way they are undertaken. It may be that, in the past, an appropriate balance between precision, simplicity and transparency was not achieved.

28. ***Applying broader measures of disability.*** Another approach could be to measure broader disabilities that apply to generally similar types of services. For example, demand disabilities for health services could be measured by the target population of the services (in this case, total population), adjusted by health status, rather than by the usage rates of different health services by different population groups.

### ***Use of Assessment Guidelines***

29. Discussion Paper 2000/7 proposed adding criteria to the Commission's assessment development guidelines to ensure that robust assessments were made. The proposed guidelines are set out in Attachment A.

30. The use of such guidelines would assist in deciding whether a function should be included in the standard budget, whether separate categories should be assessed and, if so, whether separate disabilities or adjustments (to either disabilities or tax bases) were required. The approach envisaged by the guidelines could reduce the number of categories and disabilities assessed and the number of adjustments made. But it is likely to influence grant shares. However, grant shares would be affected only if the assessments used poor quality data or inferior methods or had small effects on revenue distribution. Preventing the use of poor quality data and inferior methods and removing assessments that are not material would strengthen the acceptance of the equalisation outcomes.

### ***Conclusion***

31. Approaching simplicity using mechanical rules to reduce the number of categories and the complexity of the assessments without a reference framework would not improve the acceptability or understanding of the results.

32. There are currently a number of robust assessments, some simple, some complex. On the basis of the present definition of equalisation, to ‘simplify’ them would result in diminished quality of outcomes.

33. It is possible to develop a conceptual framework that will help develop more robust assessments. A thorough review of the assessments, or the development of new ones if required by GFS data considerations, using the assessment guidelines set out in the attachment, will strengthen equalisation.

### ***Issues for Consideration***

34. The discussion above highlights a number of possible ways to proceed. Which of them do Heads of Treasury support?

- (i) no change to the present processes — that is, the Commission keeps going the way it has in the past;
- (ii) the use of mechanical rules to remove assessments/factors/revenue base adjustments that are not material to the results;
- (iii) the use of less disaggregated assessments which, of necessity, will use broader measures of need, at least to the extent necessary because of changes in GFS data (and this might be substantial);
- (iv) the use of the assessment guidelines set out in Attachment A, designed to make the assessments of needs more robust and therefore more acceptable by:
  - avoiding category and/or disability assessments based on questionable data and unsound methods;
  - avoiding category and/or disability assessments that have an immaterial effect on revenue shares; and
  - carefully using judgement to ensure assessments are fair.

ASSESSMENT DEVELOPMENT GUIDELINES

1. To improve the robustness and acceptability of assessments, the use of guidelines in their development is proposed. The proposed guidelines:

- (i) combine the scoping and structuring guidelines developed in the 1999 Review to decide the scope of the standard budget, the categories it should comprise and whether disabilities should be assessed; and
- (ii) extend them to help decide if, and how, a disability or adjustment should be assessed.

*Scope*

2. The scoping guidelines, summarised in Figure A-1, are:

**(1) Does the function have an impact on State budgets?**

**If yes, go to guideline (2), if no, leave outside the standard budget.**

Using this guideline, a function would be included if it had an impact on State budgets. The standard budget should be as comprehensive as possible.

**(2) Can revenues and expenditures related to the function be identified with reasonable confidence for each State?**

**If yes, go to guideline (3), if no, leave outside the standard budget.**

Data need to be comparable across States and capable of being classified, on a consistent basis, to the categories used to dissect the budget. It is expected that, with sufficient resources applied, all functions would pass this guideline.

Guidelines (1) and (2) establish the boundaries of the standard budget. The structuring guidelines in paragraph 3 are used to break the standard budget into categories and the further guidelines in Figure A-2 are used to decide if and how disabilities should be assessed. The remaining scoping guidelines are designed to assist decisions on whether equalisation would be enhanced by assessing differential disabilities for each expenditure function or revenue source.

**(3) Are differential disabilities likely to exist between the States in raising revenues or providing services?**

**If yes, go to guideline (4), if no, apply an equal per capita (EPC) assessment.**

A **no** answer implies that:

- all States could provide the service under consideration at the same standard by spending the same amount per head of population; or
- all States could raise the same amount of revenue per head of population by levying the tax under consideration at the same rate and on the same base.

A **no** answer results in each State's standardised per capita budget figure for the item being equal to the standard figure. A **yes** answer requires the available information to be examined before deciding the assessment treatment of the function.

**(4) Can the extent of the disabilities be subject to sufficiently policy-neutral and accurate measurement?**

**If yes, go to guideline (5), if no, EPC assessment.**

Unless the measures of disabilities are sufficiently accurate and free of policy influence, a differential assessment would not contribute to equalisation, and an EPC assessment would apply. The guidelines in Figure A-2 would assist in this decision.

Provided consistent budgetary figures are available for each State, the standard budget should be comprehensive. Even if a function is to be assessed EPC, it should be included in the standard budget to provide a comprehensive picture of States' fiscal activities. It also makes explicit a judgement that there are no differential effects arising from the function on the States' requirements for Commonwealth assistance.

**(5) Is the proposed assessment likely to increase the degree of fiscal equalisation achieved through the distribution of untied funds and other Commonwealth payments to the States?**

**If yes, differential assessment, if no, EPC assessment.**

The answer to this question depends on:

- the level of confidence that can be ascribed to the data collected and any assumptions made in the process of the assessment; and
- whether the function includes expenditures from any specific purpose payments (SPPs) and whether the Commission considers the SPPs are distributed in a manner consistent with fiscal equalisation.

In calculating differential assessments for a function, it may be necessary to make a number of assumptions or estimates. Their combination in a final assessment may compound the degree of uncertainty. The level of

confidence in an outcome could be so low that it would no longer be clear that the assessment contributed to equalisation. If so, an EPC assessment would be adopted.

A **yes** answer to this guideline implies that the function should be subject to an assessment of disabilities.

### ***Number of Categories***

3. The guidelines to decide the number of categories to be assessed are as follows.

Do the proposed categories within a function:

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

4. If the answer is **yes** to all of the above, then accept the proposed category structure. If the answer is **no** to any of the above, then a different structure should be considered. Inevitably, however, judgement is needed to decide the final structure of the standard budget. The decisions taken on how GFS data are to be used may also have an impact on these guidelines.

### ***Should a Disability be Assessed?***

5. The quality of any disability assessment should be tested and guidelines for doing this will help decisions on whether a disability should be assessed:

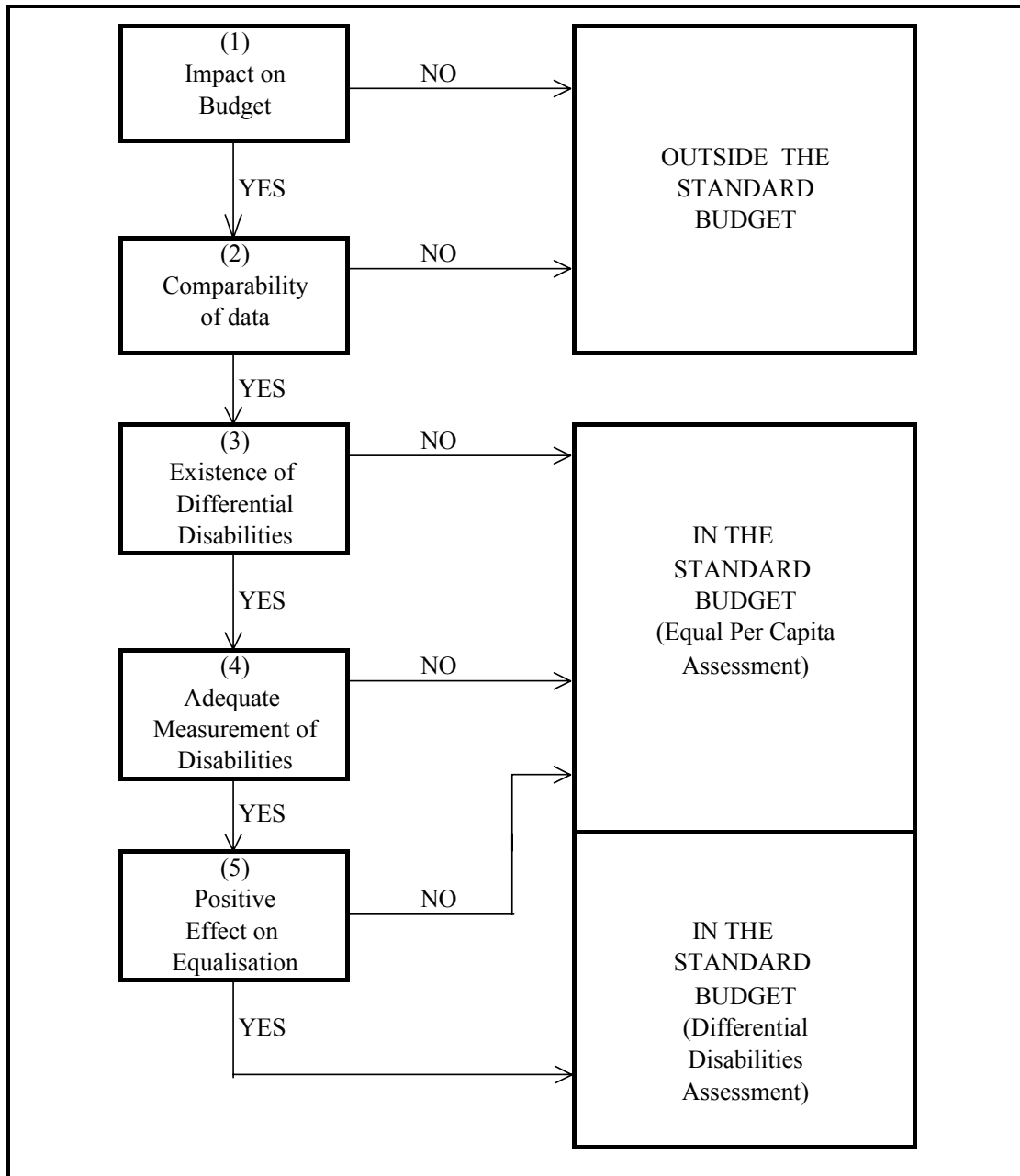
- (i) as a separate factor assessment;
- (ii) as part of another factor; or
- (iii) not at all (EPC).

6. How the disabilities will be assessed should depend on:

- (i) whether the uncertainty attached to the data used in the assessment results in a margin of error smaller than the amount redistributed;
- (ii) whether the uncertainty attached to the methods used results in a margin of error smaller than the amount redistributed; and
- (iii) whether the grant redistribution is greater than the materiality threshold.

7. Figure A-2 shows a schematic presentation of the proposed process to help decide if and how disabilities should be assessed.

**Figure A-1** GUIDELINES FOR DEVELOPING ASSESSMENTS — SCOPE



**Figure A-2** SHOULD A SEPARATE DISABILITY BE ASSESSED?

