



# **COMMONWEALTH GRANTS COMMISSION**

**DISCUSSION PAPER CGC 2002/23**

**THE ADMINISTRATIVE SCALE FACTOR**

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## **INTRODUCTION**

1. The assessment of administrative scale has been one of the most problematic of all disability factors. The concept of economies of scale is universally accepted, but it is difficult to apply to the provision of government services and it is difficult to quantify. Because an administrative scale factor is applied in many expenditure categories (nearly thirty at present), it is important in shaping State grant outcomes.

2. Since the very first review in 1981, the assessment of the administrative scale factor has been contentious and a number of approaches have been tried. During the 1999 Review, the Commission developed a broad approach that sought to define the nature of the disability with more consistency and precision than before and to make the quantification more transparent. The Commission calculated basic indexes of the effect of administrative scale disabilities for fixed costs and for scale-affected variable costs. These indexes were then applied to each assessment category according to the nature of the function and the importance of total scale-affected costs for that function. This approach expressed the estimate of the total scale affected costs in each category as a proportion of total costs for that category to derive a 'scale disability component weight'. Inevitably, the estimates required judgement. Ultimately, the results must be evaluated in the light of State actual expenditures. Difficulties with compiling the standard budget across functional categories affect the ability to make such checks.

3. This paper reflects the current views of the Commission's staff on the administrative scale disability and what can be done to assess it for the 2004 Review. The views are preliminary at this stage, pending the discussions at the staff conferences in November.

## **DESCRIPTION OF THE FACTOR**

4. The administrative scale factor is assessed to recognise that in providing a full range of State-type services to their populations, each State needs to establish a basic administrative structure. That structure needs to cover the costs of core head office functions of departments and services that must be provided for the whole of the State, the costs of which are inevitably greater in per capita terms to less populous States.

5. In the 1999 Review, the Commission considered administrative scale disabilities applied to fixed costs and to scale-affected variable costs. Fixed costs were head office costs for the minimum amount of corporate services and policy and planning — whole of State services; while scale-affected variable costs were described as expenses on corporate services and policy and planning additional to fixed cost, but still subject to some diseconomies of small scale. It assessed different indexes of relative disability for fixed costs and for scale-affected variable costs.

### ***Fixed Cost Disability Index***

6. The calculation of the fixed cost index of disability assumed that each State needed to spend the same absolute amount to provide the minimum sized central office. The index was calculated as the inverse of State population shares; effectively the same as calculating the index from the relationship between the absolute costs of the minimum sized central office in per capita terms.

**Table 1** ADMINISTRATIVE SCALE – FIXED COST DISABILITY INDEXES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Population (million) <sup>(a)</sup>	6.242	4.585	3.369	1.783	1.477	0.474	0.309	0.184	18.423
Population share	0.339	0.249	0.183	0.097	0.080	0.026	0.017	0.010	1.000
Inverse of pop shares	2.951	4.018	5.468	10.334	12.474	38.847	59.708	99.869	8.000 <sup>(b)</sup>
General fixed cost index (not weighted) <sup>(c)</sup>	0.36893	0.50229	0.68347	1.29177	1.55922	4.85594	7.46347	12.48364	1.00000

(a) 1996-97 mean resident populations.

(b) Population weighted average.

(c) Calculated by dividing the inverse of population shares by 8.

7. This index was weighted by the estimate of the proportion of fixed costs to total scale-affected costs in the category. The estimate of fixed costs was based on the size of the central office expenditures in the smaller States. This involved a review of the nature of the services in each category, analysis of annual reports and budget papers, and a judgement on the amount of fixed costs. The larger the size of the minimum establishment, the larger the resultant needs for the fixed scale disability. Attachment A contains the estimates of fixed costs and scale-affected variable costs at the 1999 Review.

### ***Variable Cost Disability***

8. The variable cost index of disability was estimated by:
- (i) establishing a value for the Northern Territory by reference to data on education departments;
  - (ii) setting the factors for New South Wales, Victoria and Queensland to 1.0000;
  - (iii) interpolating factors for the other States by reference to their population size and their actual expenditures; and
  - (iv) rescaling the index so that the population-weighted Australian average was 1.0000.

**Table 2** ADMINISTRATIVE SCALE VARIABLE COST INDEXES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Variable Cost Indexes	1.00000	1.00000	1.00000	1.15000	1.20000	1.40000	1.60000	3.00000	1.07092
Variable Cost Indexes – Rescaled	0.93378	0.93378	0.93378	1.07384	1.12053	1.30729	1.49404	2.80133	1.00000

9. This index was weighted by the proportion of scale-affected variable costs to total scale-affected costs in each category.

10. The variable scale cost disability for the ACT was reduced to 1.5 for the following categories where the client base serviced by the ACT was affected by cross border demand:

- (i) all education categories;
- (ii) all health categories except Nursing Homes;
- (iii) all law and order categories except Public Safety & Emergency Services;
- (iv) all welfare categories;
- (v) Culture and Recreation; and
- (vi) National Parks & Wildlife Services.

11. The variable cost scale factor for the ACT was reduced to zero for those categories where the ACT had very low expenditure requirements:

- (i) Aboriginal Community Services;
- (ii) Primary Industry; and
- (iii) Mining, Fuel and Energy.

12. Tasmania's variable cost scale factor was also reduced to zero for Aboriginal Community Services.

**Table 3** ADJUSTED FIXED AND VARIABLE COST FACTORS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Adjusted fixed cost factors —								
ACT set at zero	0.42164	0.57405	0.78111	1.47631	1.78197	5.54964	0.00000	14.26702
Adjusted variable cost factors —								
ACT set at zero	0.95774	0.95774	0.95774	1.10140	1.14929	1.34084	0.00000	2.87322
Adjusted variable cost factors —								
ACT and Tasmania set at zero	0.99198	0.99198	0.99198	1.14078	1.19038	0.00000	0.00000	2.97594

**Overall Scale Factor**

13. A single administrative scale disability factor was calculated by combining both fixed costs and scale-affected variable cost indexes, weighted by the proportions of fixed costs and variable costs in total scale-affected costs. For example, for the Other General Public Services category, total scale-affected expenditure was \$50 million, consisting of \$30 million in fixed costs (60 per cent) and \$20 million in scale-affected variable costs (40 per cent). The overall administrative scale factor weighted the disability indexes accordingly.

**Table 4** CALCULATION OF ADMINISTRATIVE SCALE FACTOR FOR OTHER GENERAL PUBLIC SERVICES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Fixed cost index (Table 1)	0.36893	0.50229	0.68347	1.29177	1.55922	4.85594	7.46347	12.48364
* 0.6								
<i>Equals</i>	0.22136	0.30138	0.41008	0.77506	0.93553	2.91356	4.47808	7.49019
<i>Plus</i>								
Variable cost index (Table 2)	0.93378	0.93378	0.93378	1.07384	1.12053	1.30729	1.49404	2.80133
*0.4								
<i>Equals</i>	0.37351	0.37351	0.37351	0.42954	0.44821	0.52291	0.59762	1.12053
Total category factor	0.59487	0.67489	0.78359	1.20460	1.38375	3.43648	5.07570	8.61072

14. In assessing the category disability factor, the composite factor was weighted according to the proportion of scale-affected costs in the category — the relative importance of central office and State-wide services for each category. Thus, for Other General Public Services, the scale-affected costs of \$50 million represented 27.1 per cent of total costs for the category of \$184.5 million (calculated as one-eighth of the five year Australian average expenditure of \$1 476.2 million for the years 1993-94 to 1997-98). Attachment A also shows the proportion of scale-affected costs in each category. The proportion was highest for Other General Public Services and lowest for education categories. In the Commission's terms, the weight of 0.271 for Other General Public Services represents the administrative scale component weight.

## IMPORTANCE OF THE FACTOR

15. At the 1999 Review, administrative scale factors redistributed \$475 million, in total. Of this, the fixed cost factor redistributed \$423.5 million. Table 5 shows the impact of the factors for each State.

**Table 5** GRANT EFFECT OF ADMINISTRATIVE SCALE 1999 REVIEW

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust <sup>(a)</sup>
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Fixed cost factor	-230.7	-131.4	-61.2	30.9	46.4	101.8	112.5	131.9	423.5
Variable cost factor	-24.7	-16.3	-12.1	5.9	8.3	8.9	8.9	18.7	51.8
Total	-255.4	-147.7	-73.3	36.8	54.7	110.7	121.4	150.6	475.3
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Fixed cost factor	-36.21	-28.13	-17.54	16.79	31.15	216.23	362.79	681.65	22.49
Variable cost factor	-3.88	-3.49	-3.47	3.21	5.57	18.90	28.70	96.64	2.75
Total	-40.09	-31.62	-21.01	20.00	36.72	235.13	391.49	778.29	25.24

(a) Total redistributed.

16. While the estimates of scale-affected variable costs were of comparable magnitude to fixed scale costs (see Attachment A), the variable cost disability indexes of the States were less dispersed from one than the fixed cost indexes (see Table 6).

**Table 6** RELATIVE INDEXES OF DISABILITIES (Aust = 1.0000)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Fixed cost index	0.36893	0.50229	0.68347	1.29177	1.55922	4.85594	7.46347	12.48364
Variable cost index	0.93378	0.93378	0.93378	1.07384	1.12053	1.30729	1.49404	2.80133

17. For the 2002 Update, the administrative scale factor redistributed \$576.7 million in total, a larger amount reflecting the increase in the size of the pool to be distributed.

**Table 7** GRANT EFFECT OF ADMINISTRATIVE SCALE 2002 UPDATE

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust <sup>(a)</sup>
\$m	-308.5	-179.7	-88.5	49.8	69.4	131.4	143.3	182.8	576.7
\$pc	-47.01	-37.04	-24.21	25.88	46.11	280.17	457.83	914.00	29.60

(a) Estimated using simulator.

## DEVELOPMENTS SINCE THE 1999 REVIEW

### *Discussion Paper CGC 2001/16*

18. In its 1999 Review Report, the Commission said that the levels of minimum fixed costs and scale affected variable costs associated with head office type services would benefit from further attention. In November 2001, the Commission produced *Discussion Paper CGC 2001/16 – Administrative Scale*, which compared the estimates of fixed costs with new information (including a literature review, an analysis of education head office structures, the Review of Commonwealth/State Service Provision<sup>1</sup>, State departments' annual reports for education and police). It concluded that the estimates of fixed costs were reasonable.

19. The Commission considered increasing the estimates of fixed costs to take into account inflation and wage increases, but noted the impact of increased efficiencies may be a balancing factor. The Commission proposed to make no change to the existing estimates unless States could produce better information.

20. *Discussion Paper CGC 2001/16* noted that it was difficult conceptually to substantiate the case for scale affected variable cost disabilities, that no new information was available on the costs and that the existing estimates were not robust. The paper concluded that it was hard to justify the continued assessment of this component, especially in the light of the new assessment guidelines that asked whether the level of uncertainty attached to the method and data used to calculate a disability would result in a margin of error greater than the amount redistributed. In view of the relatively small contribution of the scale affected variable cost factor (see Table 5 above), the Commission proposed removing this element from the assessment.

## ISSUES IN STATES' MAIN SUBMISSIONS

21. States' reactions to the proposals in *Discussion Paper CGC 2001/16* were mixed. Their positions are summarised in Attachment B.

22. New South Wales and Victoria thought the estimates of fixed costs were too high and that the extent of the disability should diminish over time with reforms in public administration, including use of technology and outsourcing, the adoption of more efficient work practices, and population growth.

23. Victoria also submitted that the estimates should be updated annually to reflect changes in spending priorities and restructuring of departments.

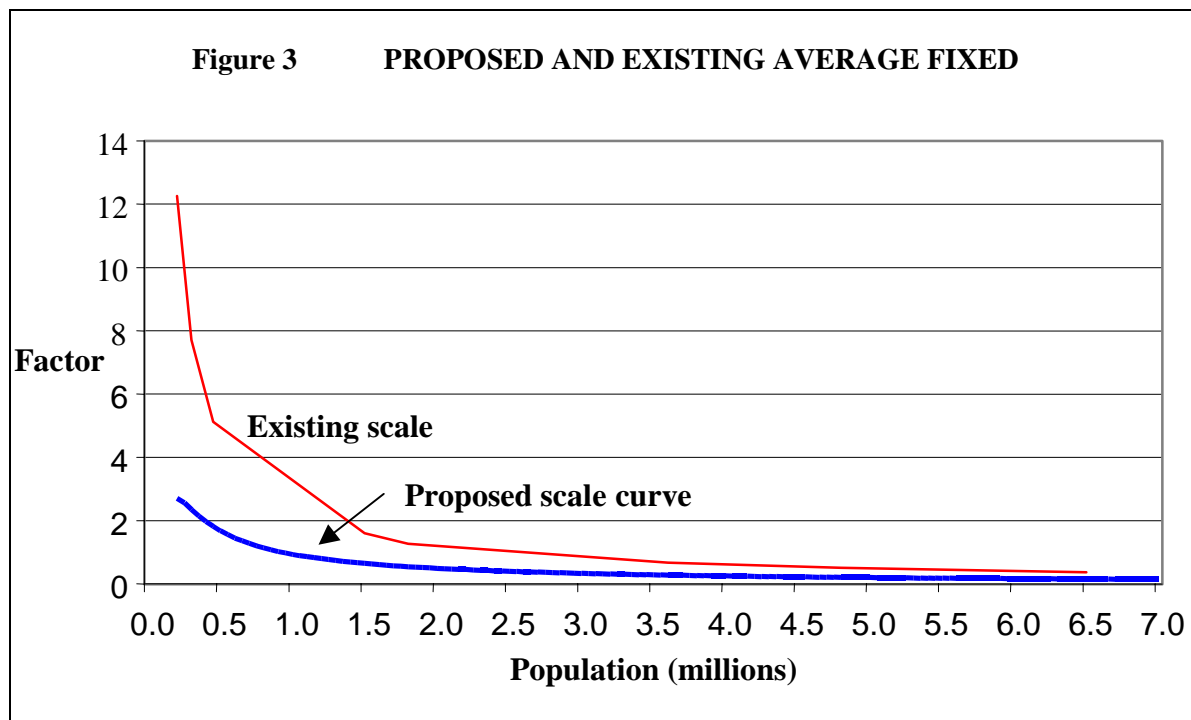
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<sup>1</sup> SCRCSSP (Steering Committee for the Review of Commonwealth/State Service Provision) 2001, *Report on Government Services 2001*, AusInfo, Canberra.

24. Queensland thought the estimates were reasonable, but was unhappy with the level of grant redistribution they gave rise to. It also submitted that the index of disability should be partly related to the geographic size of the State (20 per cent weight) as well as population size (80 per cent weight).

25. The other jurisdictions thought that the estimates of fixed costs were too low. A number took issue with the Commission’s view in proposing no change to the estimates because inflation and wage increases might be balanced by increasing efficiencies. Western Australia pointed out that the Commission had said elsewhere in *Discussion Paper CGC 2000/16* that there was no evidence that public administration reforms were reflected in reduced head office costs. Western Australia argued that the assessment of fixed costs should also include the effect of Indigenous education programs and dispersion issues that the Commission overlooked.

26. South Australia submitted that the Commission had oversimplified the relationship between fixed costs and population because it was more likely that such costs were incremental. It believed that the scale disabilities for the smaller States were overstated because they did not experience all the fixed costs that were incurred by larger States. It submitted that the scale curve was flatter at small population sizes and steepest in the middle range where States have the most to gain from small increases in population.



Source: South Australia Submission April 2002, page 39.

27. Tasmania noted that administrative reforms had shifted costs from service delivery areas to head offices: for example, the use of the Internet to disseminate information. It believed that the proportion of fixed costs in the provision of services was in fact increasing as a result of technological change and increasing complexity of core administrative functions.

### ***Variable Costs***

28. Four States (New South Wales, Victoria, Queensland and Western Australia) supported the Commission's proposal to discontinue the assessment of scale-affected variable costs and accepted the reasons for doing so. Tasmania was opposed but would accept it if the estimates of fixed costs were increased to compensate. The ACT offered qualified support depending on how the Commission assessed the fixed cost component. The Northern Territory submitted that the Commission's difficulty in defining variable costs could be overcome by thinking of them in terms of 'non-fixed' costs that are additional to usual service demands, such as Indigenous programs. These costs could be specific to particular jurisdictions. (A similar argument to Western Australia's position on fixed costs).

### ***Grant Share Effect***

29. Victoria, Queensland and South Australia argued that the size of the scale disability should be reassessed because of the grant share effect. Victoria submitted that the impact of the factor was magnified because of the growing grant pool over time. It believed that the way to overcome this was to review the use of fixed weights over the assessment period, presumably reducing the proportion of scale affected costs in each category. Queensland pointed out that the Commission estimated fixed costs of \$113.5 million for the Northern Territory, yet the grant share effect in the 1999 Review was \$131.5 million. South Australia too believed the grant effects for the less populous States were disproportionate.

### ***Alternative Methodologies***

30. Victoria proposed a different assessment framework to that used by the Commission. Its proposals resulted from a Tasman Economics Report on Administrative Scale, commissioned by the Victorian Department of Treasury and Finance. Victoria proposed the regression of head office expenditure against State population for each assessment category. The intercept would estimate the average fixed costs across all States and incorporate the average of all States' efficiency into the assessment. For education, its trial analysis suggested that education head office expenditures were \$9 million, not \$12 million. It also proposed the use of overseas experience for the UK, Jersey and Canadian evidence. Such approaches, it believed, were better than the approach used by the Commission.

## ISSUES TO BE ADDRESSED

### *Assessment Framework*

31. The existence and extent of administrative scale disabilities has been contentious since the first review in 1981. There are sound reasons to assess an administrative scale disability, but the appropriate assessment method has been elusive.

32. The Commission has put considerable effort into refining its administrative scale assessment and to making it as transparent as possible, notwithstanding the fact that there is little objective data from which to calculate the factor. This has included a review of the method at each review (1981, 1982, 1985, 1988, and 1993), and research projects in 1995 and 1996 leading to the 1999 Review, and subsequent discussion papers.

33. Commission staff think that the current assessment framework provides a reasonably transparent basis in which issues can be identified and progressed. Most States seem to support or are reconciled to this approach. The suggestion that the disability should be quantified from regression analysis is not new — the Commission itself raised it in the 1996 research report — but there are too few States, too much variation in the coverage of departmental functions and hence in expenditures, and too much distortion in the data from the effect of other factors to rely on the results of such an approach. Similarly, overseas experience is of limited validity to the Australian situation because of the differences in the nature of service delivery responsibilities.

34. Staff intend to recommend that the Commission retain the current approach to the measurement of the fixed cost disability.

35. This approach has two key parts:

- (i) establishing an index of relative disability; and
- (ii) weighting that index appropriately according to the importance of scale-affected costs in each category (the size of the component weight).

### *Fixed Costs – Index of Disability*

36. Commission staff think that, in principle, it is reasonable to assume that there is a minimum central office establishment to provide corporate services, policy and planning functions or whole of State services (the grey area of the following diagram). Each State department would need to provide that establishment irrespective of the size of the client population or disabilities.

37. The administrative scale disability concentrates on central office fixed costs; there is a service delivery scale disability to take account of the disability of scale as it affects regional units and service delivery units. Disability factors for other influences on service delivery costs — socio-demographic composition, dispersion, and so on — take into

account influences on all other expenses excluding fixed costs, whether such expenses are in the central, regional or service delivery units. There is no need to recognise special costs in assessing fixed cost administrative scale disabilities because the disabilities that cause them are assessed within another component of a category.

**Figure 1** SIMPLIFIED MODEL OF SERVICE DELIVERY COSTS

CENTRAL OFFICE			REGIONAL OFFICES		SERVICE DELIVERY UNITS	
Fixed	Special	Variable	Fixed	Variable	Fixed	Variable

38. In reality, it is extremely difficult, if not impossible, to identify a function for which the central offices of each State are the same. There will be differences in allocation of responsibilities across departments, with less populous jurisdictions having to match departments to the sizes of their legislatures, different administrative structures and nomenclatures. But the existence of an underlying minimum level of fixed costs is supported by economic theory. It follows that, whatever the absolute size of the fixed costs, its relationship with population size gives an index of relative disability.

39. The submission from South Australia theorises that fixed costs are not the same for all jurisdictions but are lumpy or incremental. This assumes that the policy and core administrative responsibilities are not the same for all States, but depend on the size of the population. Thus a very small jurisdiction would forego curriculum development and piggyback on the work done by other jurisdictions; their legislatures would have fewer representatives. In South Australia’s view, the 1999 Review assumption of the same level of fixed costs for the less populous States is incorrect — the size of the shaded area in Figure 1 could, arguably, be different for each State.

40. It is true that the less populous States tend to have smaller legislatures than the larger States but this, of itself, does not mean that there is not a minimum size of a legislature. Similarly, though less populous States may choose to use the work of other jurisdictions on curriculum development, this option is available to any State, and it does not mean that the less populous State has no need to resource that function. It should not be dependant on the work of other jurisdictions because that would imply a reduction in its independence and, arguably, a reduction in its capacity to provide the standard level of service<sup>2</sup>. Also, it is difficult to know where to draw the line below which States are not entitled to the same minimum level of central office and State-wide services as other States. For these reasons, the South Australian proposal is problematic, both theoretically and practically.

***Fixed Costs – Component Weights***

41. Component weights are very important to the overall effect of the administrative scale disability. They were calculated by relating the estimates of fixed costs

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<sup>2</sup> In some functions, the ACT has no need to incur expenditures at all and zero fixed costs are appropriate.

in 1996-97 to expenditures averaged over the years 1993-94 to 1997-98. By holding the component weights constant between the 1999 and 2004 Reviews, the Commission effectively increased the underlying estimates of fixed costs at the same rate as expenditure increased in each update. Thus, while the Commission assessed fixed costs in 1996-97 dollars, the real value of those fixed costs was implicitly increased each update. However, the relative importance of fixed costs in the assessments did not change.

42. There are two issues with component weights:

- (i) the size of the fixed costs estimates from which component weights are calculated at the 2004 Review; and
- (ii) whether the component weight should be recalculated at each subsequent update.

43. *Estimates of fixed costs.* The estimates of the fixed costs for the 1999 Review were made after a review of the size of the smaller establishments in the smaller States and other material. The Commission put considerable effort into checking these estimates in *Discussion Paper CGC 2001/16* by a close examination of the structure of education departments and police departments using annual reports and other material. It also used information from the Steering Committee for the Review of Commonwealth/State Service Provision (SCRCSSP) report. The results of that work suggested that the 1999 Review estimates were reasonable for those functional areas and, by implication, for other functional areas. For the 2004 Review, the question is whether those estimates should be reduced, held constant, or increased to take account of increases in wages and salaries or the impact of technology, for example.

44. Reductions in the existing estimates of fixed costs, when related to expenses for 1997-98 to 2001-02 would result in reduced component weights and, in turn, reduced impact of administrative scale disabilities on grant distributions. Some States would support this outcome because they believe that the Commission's estimates of fixed costs were too high initially, and should diminish over time as new technologies, efficiencies and reform in public administration enable savings to be made. This view assumes that government central office corporate, policy and planning functions are unchanging in nature and all States are able to achieve lower costs with growth in population size and as they make productivity gains.

45. Retention of the same estimates, when related to updated expenses, would reduce component weights to a lesser extent. However, if the estimates of fixed costs can be interpreted in terms of numbers of persons necessary for central office and State-wide functions, there is a case for increasing the estimates at least by the rate of wage increases. Such inflation of estimates would result in something like the current component weights (depending on how the rate of wage increases compared with increases in expenses overall)<sup>3</sup>.

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<sup>3</sup> If this outcome were desired, it would not be necessary to review the estimates themselves but simply retain the existing scale-affected proportions. This would maintain the importance of administrative scale disabilities at

46. However, there is also an argument that the estimates of fixed costs should be increased because the nature of fixed cost activities has changed. For example, the less populous States submit that the complexity of policy advice has increased in the face of changing circumstances and administrative reforms. This might encompass greater participation in inter-government forums, implementation of national competition policy and so on. Some have suggested that technology in service provision has resulted in a shifting of costs from service providers back to central office, which bears the costs of planning and co-ordinating the technological infrastructure and some operational costs.

47. In any case, there will be a need to review the estimates of fixed costs for those categories that are affected by the proposals to change their scope in the equalisation budget for the 2004 Review. For example, the abolition of a separate category for Regulatory and Other Services and the reallocation of expenses to other functional categories will require a review of the fixed costs estimates in the affected categories.

48. Staff intend to recommend to the Commission that the estimates be reviewed to reflect the latest situation with regard to the staffing of central offices and State-wide functions. Ideally, the Commission needs to know how much States must now spend on a minimum sized central office with comparable responsibilities for each functional department. Staff would also like information on how the nature of central office functions has changed since 1996-97 and what implications changes have had on staffing levels. Past experience suggests that asking States for this sort of information across all functions would be too resource intensive and would result in ambiguous outcomes.

49. Commission staff propose to limit the collection of information to the major functions of education, health and police, and to Treasury as an indicator of disability for general public services. Staff intend to review annual reports of the relevant departments for all States. The results of this more limited exercise would be used to update the 1999 Review fixed costs estimates for all assessment categories.

### ***Variable Costs – Index of Disability***

50. The Commission proposed removing this element from the calculation because of the difficulty of specifying the nature of the disability. It was described in *Discussion Paper CGC 2001/16* as expenses on corporate services and policy and planning in excess of the fixed costs but which are still affected by some diseconomies of small scale. The index of relative disability was established from data for the Northern Territory education department, and interpolating the results for the other States. Staff intend to recommend that this proposal be adopted. If it is, it follows that there would be no need to estimate scale-affected variable costs.

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the current levels, though changes in the composition of the equalisation budget and increases in the size of the pool would change the amount redistributed.

### *State-specific Central Office Functions*

51. Some States have suggested that administrative scale costs are affected by other characteristics of the State that may impact on central office structures. (These have been labelled as ‘special’ in Figure 1.) Queensland suggested its greater physical area was relevant to the level of fixed costs; Western Australia suggested that additional administrative costs arose from the impact on central offices of Indigenous education and dispersion disabilities, while the Northern Territory raised the impact on administration of the need for special Indigenous policies. The Northern Territory suggested that these sorts of problems might be specific to particular jurisdictions. Certainly, the existing scale-affected variable cost index does not capture the effect of size or Indigenous population sizes. On those counts, the ACT should have a relatively small variable cost scale factor.

52. Commission staff accept that other disabilities will impact on central office administrative functions but not on the minimum fixed costs. By definition these represent the resources any State needs to provide services regardless of its population size. States may require additional resources in their head offices to develop policies relevant to their service delivery needs defined by the characteristics of their populations. It is for this reason that disability factors that capture differences in population characteristics are applied to all service delivery expenses that include special programs administered by head offices. Disabilities such as dispersion and social composition factors are assessed separately and their impact on central offices and regional offices is taken into account in setting the component weight to be applied to those disabilities. Staff intend to recommend to the Commission that there be no change to the assessment of administrative scale disability to try to incorporate such impacts. This is because we have defined minimum fixed costs as relating only to those activities that are common to the central offices of all jurisdictions.

### *Frequency of Updating*

53. Victoria submitted that the assumptions and data used in estimating scale-affected costs should be updated each year so as to maintain the relevance of the disability factor to current rather than historical circumstances. In principle, there is a case to do so as the nature of administration changes over time. But, we are not convinced that the rate of change is fast enough to justify such an exercise each year, given the difficulty of obtaining data and the contentiousness of assumptions about minimum costs. We are not inclined to contemplate revising component weights annually because we believe that any minor revisions would introduce a level of spurious accuracy.

54. South Australia submitted that the population data should be updated annually in calculating the basic scale disability indexes because the process is essentially arithmetic. The reservation we have is whether the differences in rates of population growth are sufficient to make much difference and whether, balanced against simplicity and transparency, the additional process is worthwhile. However, over the course of a five-year period, the effect for the less populous States can be important. The following table compares the annual indexes of disability, allowing for population changes each year.

**Table 8**      **UPDATING OF DISABILITY INDEX FOR POPULATION DATA**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
1999 Review index	0.36893	0.50229	0.68347	1.29177	1.55922	4.85594	7.46347	12.48364
1997-98	0.36940	0.50288	0.67966	1.28412	1.56683	4.92644	7.56932	12.35700
1998-99	0.36978	0.50278	0.67651	1.27645	1.58065	4.99506	7.63244	12.30441
1999-2000	0.37027	0.50247	0.67322	1.27211	1.59205	5.05850	7.67667	12.26687
2000-01	0.37066	0.50197	0.66970	1.26965	1.60611	5.12385	7.70756	12.26341

55. Staff intend to recommend that basic scale index be updated each year to reflect population changes. This means that the fixed costs indexes in Table 1 will be recalculated each year and the administrative scale disability would be slightly different in each update.

### ***Grant Share Effects***

56. Some States have suggested that the administrative scale disability has led to unintended grant share implications — that it has overcompensated States for the estimated scale affected costs.

57. Commission staff think that though fixed costs are calculated in dollar terms, they are not absolute measures that are unchanging irrespective of changes in States' service responsibilities and expenses. We interpret the estimates of fixed costs as a tool to estimate the relative importance of States' expenses that are affected by administrative scale in the years of the assessment period. By maintaining the same component weight for the administrative scale disability in each update, the underlying estimate of fixed costs is effectively increased to reflect the rate of change in the expenditure standard. We are inclined to keep the component weights constant over the period between reviews.

58. The same type of reasoning can be applied to the grant share effect resulting from increases in the size of the pool. The estimates of fixed costs are made in the context of the States' expenses in the five years of the assessment period. Such expenses reflect the funding available to States from their own sources and from the Commonwealth in that period. In illustrating the grant share effects of the administrative scale disability, however, the Commission uses an estimate of the pool in the application year, which is outside the assessment period by several years. If the pool increased commensurately with inflation, we would expect the grant share effects to increase over time to reflect the effects of inflation on fixed costs. In practice, the application pool has been increasing at a rate higher than inflation in recent years, and the grant share effects of the administrative scale disability is larger than expected.

59. If the pool of general revenue grew in line with inflation and population growth, Commission staff would consider the changes in grants share effects appropriate. However, in the current context, the high rate of growth in the general revenue pool may be resulting in the administrative scale factor bearing a larger influence than it should be. We do not see any easy solutions to this problem.

60. One possible solution would be to decrease the fixed cost amount and/or component weights over time to achieve the desired grant share outcome. We do not favour this approach because it is against the logic of the administrative scale factor. Another possibility would be to make some kind of manual adjustment to State grant shares. We ask States for their views on this issue.

61. For information, there is a general discussion on the effects of changes in the size of the general revenue pool on the amounts redistributed in *Discussion Paper CGC 2002/2, Contemporaneity and Equalisation Over Time*.

## SUMMARY

62. Staff intend to recommend to the Commission that it retain the basic approach to assessing the administrative scale disability by starting with the concept of minimum fixed costs and assessing States' relative disadvantage by reference to population size.

63. The fixed costs established at the 1999 Review appear reasonable and have been corroborated to a large degree by the work detailed in *Discussion Paper CGC 2001/16 – Administrative Scale*. Those estimates reflect 1996-97 dollar values, but their value has been maintained by keeping the component weights constant.

64. However, given State views, we propose to re-examine the level of fixed costs in each category. As States' expenses have increased since the last review, we accept that it is inappropriate simply to recalculate component weights using the same estimates of fixed costs. They should be increased by the rate of change in wage levels at least. At the same time, the component weights should be reviewed if there has been a change in the underlying nature of the fixed costs themselves. We propose to review central office establishments for education, health, police and Treasury from departmental annual reports and budget documents to gauge whether the initial estimates of scale-affected fixed costs and more importantly, the component weights, are now too high, or too low, or still about right. Depending on the result of discussions at the November conference, we will invite States to provide quantitative data on staffing establishments for those functions and how those establishments have changed since 1996-97.

65. Staff intend to recommend that the component weights for categories should not be reviewed individually, but that the conclusions with respect to the major functions be used as a guide in determining the component weights for the other categories, taking into account the changes in the structure of the standard budget for the 2004 review.

66. We intend to recommend that the Commission take this opportunity to simplify the assessment of administrative scale disabilities by removing the component for scale-affected variable costs because we are not satisfied that such a component can be specified conceptually or measured practically.

**ATTACHMENT A**

**Table A- 1** FIXED AND SCALE-AFFECTED VARIABLE COSTS 1999 REVIEW

	Fixed Cost	Scale-affected Variable Cost	Total Scale-affected Expenditure	Proportion of Scale-affected Expenditure
	\$m	\$m	\$m	%
<b>Education</b>	<b>12.0</b>	<b>10.0</b>	<b>22.0</b>	
Pre-school education	0.2	0.1	0.3	0.78
Government primary education	3.3	2.1	5.4	0.78
Non-government primary education	0.8	0.5	1.3	0.78
Government secondary education	2.8	1.8	4.6	0.78
Non-government secondary education	0.8	0.5	1.4	0.78
TAFE	4.0	5.0	9.0	2.70
Transport of rural school children	0.0	0.0	0.0	0.00
<b>Health (excluding Public Health)</b>	<b>10.0</b>	<b>18.0</b>	<b>28.0</b>	
Hospital services	5.4	2.0	7.4	0.64
Nursing home services	0.3	0.1	0.4	0.64
Mental health services	0.7	0.3	0.9	0.64
Community health services	1.7	0.6	2.3	0.64
Public health	2.0	15.0	17.0	24.01
<b>Law and Order</b>	<b>13.0</b>	<b>13.0</b>	<b>26.0</b>	
Police	5.0	5.0	10.0	2.83
Administration of justice	4.0	4.0	8.0	5.37
Corrective services	2.0	2.0	4.0	3.74
Public safety and emergency services	2.0	2.0	4.0	4.28
<b>Welfare</b>	<b>8.0</b>	<b>8.9</b>	<b>16.9</b>	
Family and child welfare	1.2	1.4	2.6	2.42
Aged and disabled welfare	2.3	2.9	5.2	2.42
Other welfare services	0.5	0.6	1.2	2.42
Housing	4.0	4.0	8.0	4.87
<b>Culture and Recreation</b>	<b>9.0</b>	<b>9.0</b>	<b>18.0</b>	
Culture and recreation	7.0	7.0	14.0	14.72
National parks and wildlife	2.0	2.0	4.0	10.30
<b>Community Development</b>				
Aboriginal Community Services	0.4	0.4	0.8	4.84
<b>General Public Services</b>	<b>30.5</b>	<b>21.5</b>	<b>52.0</b>	
Superannuation	0.5	1.5	2.0	0.42
Other general public services	30.0	20.0	50.0	27.10
<b>Services to Industry</b>	<b>11.6</b>	<b>8.0</b>	<b>19.6</b>	
Primary industry	2.8	2.0	4.8	3.41
Mining, fuel and energy	2.8	2.0	4.8	16.53
Tourism	3.0	2.0	5.0	17.76
Manufacturing and other industry	3.0	2.0	5.0	12.56
<b>Transport</b>				
Road maintenance	4.0	4.0	8.0	2.95
<b>Regulatory and Other Services</b>				
Regulatory and other services	15.0	10.0	25.0	19.44
<b>Total</b>	<b>113.5</b>	<b>102.8</b>	<b>216.4</b>	

Source: Commonwealth Grants Commission, 2001 Update, Working Papers Volume 3, March 2001.

**ATTACHMENT B**

**Table B- 1 STATES' POSITIONS ON COMMISSION'S PROPOSALS**

	Retain existing assessment framework	Retain existing estimates of fixed costs	Remove the scale-affected variable cost component
NSW	Reality checks are essential.	Disabilities will diminish over time with population growth.	Supported. Variable costs increase with increasing scale.
Vic	No, data limitations affect the results. The Commission extrapolates too much from the experience of smaller States.  Commission should use regression analysis to estimate fixed costs.  Commission should also use overseas experience.	Commission's analysis and estimates of head office costs need to be transparent.  Estimates should be updated as policies and departmental structures change.  Fixed costs are falling over time and the use of constant component weights is inappropriate.	Supported
Qld	Supported, but proposes that scale problems also arise from physical size of State.	Fixed costs are reasonable but methods should be reviewed as they redistribute too much. Fixed costs for the NT are estimated at \$113.5 million yet the factor increases its grant by \$131.5 million	Supported
WA		Fixed costs too low. For example education costs do not allow for Indigenous education, facilities and capital works, and effects of dispersion. Estimate of 80 staff should be more like 200.  Commission's experience should show that fixed costs are higher over time.	Supported.
SA	Commission's scale curve is wrong. Costs are incremental. Disabilities for the smaller jurisdictions are overstated.	Estimates of fixed costs are unreasonably low. Grant outcomes are implausible.  Many reforms in public administration increase costs.  Factors should be updated annually for population changes.	Not supported.
Tas		Estimates are too low.  Reforms have shifted costs from service delivery areas to head offices. For example, the use of the internet to disseminate information is a head office cost. Videoconference and telemedicine increase central office administrative costs.	Opposed, but if abolished Commission should review fixed costs.

**Table A-1** STATES' POSITIONS ON COMMISSION'S PROPOSALS (continued)

	Retain existing assessment framework	Retain existing estimates of fixed costs	Remove the scale-affected variable cost component
ACT	Broadly. Examples of scale-affected functions include inter-government forums, community forums, and regulatory and training functions.	Estimates should be reviewed and increased.  Increased complexity of government eg accrual accounting, discrimination, microeconomic reform means fixed costs are a higher proportion of total costs.	Qualified supporting depending on how Commission assesses fixed cost component.
NT	NT did not agree to guidelines at the Priority Issues conference. If judgement has to be used so be it, rough justice is better than no justice.	Estimates are understated. Treasury core activities require 130-200 staff, not 80.  Fixed costs include such things as related to Indigenous populations and geography including such things as: Forensic Science Centre, Indigenous education branch; Indigenous health policy and programs; Aboriginal health workers; Aboriginal community police.	Not supported. 'Non-fixed' costs include functions that are additional service demands, such as for Indigenous population. These are specific to jurisdiction.