
Administrative Scale

Proposed approach to estimating administrative scale costs for the 2020 Review (CGC 2017-06-S)

NSW Treasury comments

Key points:

- The current administrative scale assessment results in implausible outcomes for small jurisdictions.
- Diseconomies of small scale may be offset by adoption by different technological models for head office functions, and this is evidenced by data for the NSW local government sector. Failing to take these different technological models into account will overstate the administrative scale disability.
- The calculated staff to total cost gross up factor in the Staff Research Paper suffers from substantial data issues and understates staff costs as a share of total costs making its use highly problematic.
- An asymmetric assessment of the higher per capita fixed costs incurred through diseconomies of small scale, without taking into account the cost disadvantages of undertaking large scale activities, will bias the final distribution outcome in a manner inconsistent with the principle of horizontal fiscal equalisation.

Background

In the 2015 Review the Commonwealth Grants Commission (CGC) defined administrative scale as

'...an assessment of fixed cost which does not vary with service populations (the minimum cost). It includes costs associated with:

- *core head office functions of departments such as corporate services, policy and planning functions, but not all staffing and other resources delivering them*
- *services that are provided for the whole of the State including the legislature, the judiciary, the Treasury, the revenue office, and a State museum, but not all staffing and other resources delivering them.'*¹

CGC Staff Research Paper proposes using the same definition of administrative scale costs for the 2020 Review, which has been tentatively accepted by the Commission, subject to state and territory views.

The conceptual case

NSW Treasury considers that a conceptual case can be made for the existence of some government-wide costs that are independent of population size.

However, we are concerned that the current and proposed administrative scale assessment overstates the cost of states and territories operating a basic administrative structure to provide a national average standard of services to their populations.

The highly abstract nature of the conceptual case supporting the assessment presents difficulties for the CGC to develop a methodology that is a reliable indicator of what the administrative scale assessment is attempting to measure. The inability to test the integrity of the current and proposed methodology undermines the credibility of the assessment, and the ability of the CGC to achieve the broader objectives of horizontal fiscal equalisation (HFE).

This lack of credibility and reliability is evidenced by the size of the administrative scale assessment relative to the assessed expenditure in each category. Naturally, the fixed-cost component of any expenditure category will be a larger share of total expenditure for smaller states. However, when these shares are calculated based on the Commission's administrative scale estimates, they appear implausible for some of the smaller states and territories. This is shown in the following table.

For example, it is not plausible that 26.8 per cent of the costs of housing activities in the Australian Capital Territory in 2014-15 were fixed and unrelated to any scale of operations. Similarly, the plausibility of administrative scale cost representing over 20 per cent of expenses in the services to industry category in Tasmania, the ACT and Northern Territory is questionable. These examples give a clear indication that the current methodology used by

¹ CGC, *2015 Review Final Report*, Volume 2, p. 508

the CGC to estimate administrative scale costs is unreliable and overestimates administrative scale costs for small jurisdictions.

Table 1: Assessed Administrative Scale as a Proportion of Total Assessed Expenditure – 2014-15

	Tasmania %	ACT %	NT %
Schools education	1.6	2.3	2.2
Post-secondary education	8.3	10.4	15.0
Health	1.7	2.8	2.5
Housing	12.2	26.8	10.0
Welfare	2.1	4.8	2.6
Services to communities	2.7	3.7	0.9
Justice	6.3	10.2	4.4
Roads	3.3	6.2	2.6
Transport	3.4	2.1	7.5
Services to industry	20.9	23.1	27.2
Other expenses	15.9	16.5	20.5
Total	5.0	7.5	5.8

Source: CGC 2016 Update, Supporting Documentation, the Assessed Budget, Summary Tables, Table 7; Staff Research Paper (CGC 2017-06-S), p. 3

The following section outlines specific concerns with the CGC's proposed methodology.

Methodological issues

Efficiencies and costs can vary with size

In conducting the administrative scale assessment, the CGC assumes that all states and territories have a similar technological model for their administrative structure. The proposed 'bottom-up' approach ignores the potential for differences between jurisdictions that may negate the impact of small scale operations.

In practice, small-scale operations can have coordination and agility advantages that can offset diseconomies suffered by the smaller states and territories. Smaller states and territories can also organise their structure in a way that offsets diseconomies of small scale by combining agencies into larger, more economic units. The one-size-fits-all methodology proposed by the CGC for the administrative scale assessment does not take these advantages into account.

Outsourcing of corporate functions can also be used to offset diseconomies of small scale and has become more prevalent in recent years, but is not reflected in the proposed methodology. For example, NSW has outsourced core administration functions for central agencies through the 'GovConnect' service, where certain HR and IT administration services are provided to the state on a 'fee for service' basis.

Large organisations can suffer from the need to invest more resources into internal coordination to offset communication diseconomies as organisations get larger. In fact, the Staff Discussion Paper appears to acknowledge this factor.

*'We have not derived the number of functional areas on the basis of arithmetic averages because the number of functional areas in a head office tends to increase with the State's population size.'*²

No allowance has been made for this within the hypothetical administrative staffing structures proposed by the CGC.

The more complex nature of larger organisations also sees the need to employ more highly graded staff. This has again been acknowledged in the Staff Discussion Paper and is not picked up as part of the Commission's wage costs disability factor.

*'Larger States tend to have higher classifications for similar positions. For example, New South Wales and Victoria's organisational structures show their staff tend to be a level higher in seniority than the smaller States for similar positions.'*³

Finally, policy issues generally come to prominence earlier in the larger states, where policy responses need to be developed which in turn benefit all jurisdictions.

Box 1.1 Examples of policy responses developed in larger states

Countering violent extremism

As part of the broader COAG initiative to counter violent extremism (CVE), NSW developed a pre-charge detention scheme for those suspected of terrorism offenses, permitting detention of terrorism suspects without charge for a period of up to 14 days. The NSW pre-detention model was agreed in-principle by COAG to form the basis of a nationally consistent pre-charge detention scheme, which has been adopted in various forms by smaller states.

Professional Teaching Standards

From 2003-2005, the NSW Institute of Teachers developed the NSW Professional Teaching Standards, the first Australian jurisdiction to undertake a project of this kind. The standards covered four teacher levels at graduate, proficient, high accomplished and lead teacher.

In 2010, the Australian Government established the Australian Institute for Teaching and School Leadership (AITSL) and commissioned the development of national teaching standards. AITSL adapted the four levels of the NSW teaching standards, and the standards were adopted in all jurisdictions (through a National Partnership Agreement) for use when approving initial teacher education courses and to underpin teacher registration/ accreditation processes.

Accreditation of teachers at highly accomplished and lead teacher levels

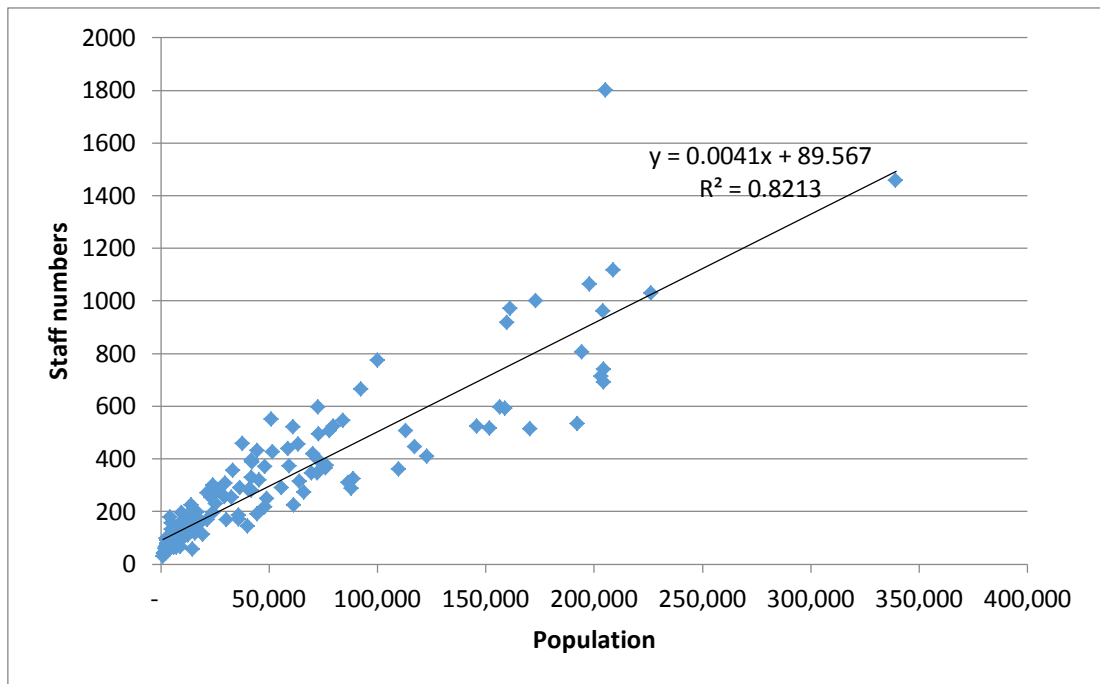
In 2010-11, AITSL developed a national certification process for highly accomplished and lead teachers. As part of this process, the NSW Institute of Teachers provided AITSL with support through access to existing NSW policy and processes for highly accomplished and lead teacher certification and the NSW online readiness assessment module used by teachers to self-assess readiness for higher level accreditation.

To assist the Commission in determining any level of administrative scale assessments, we have analysed the relationship between full-time equivalent staff numbers and the population of individual local government areas in New South Wales as shown in Chart 1.

² Staff Research Paper CGC 2017-06-S, Paragraph 30.

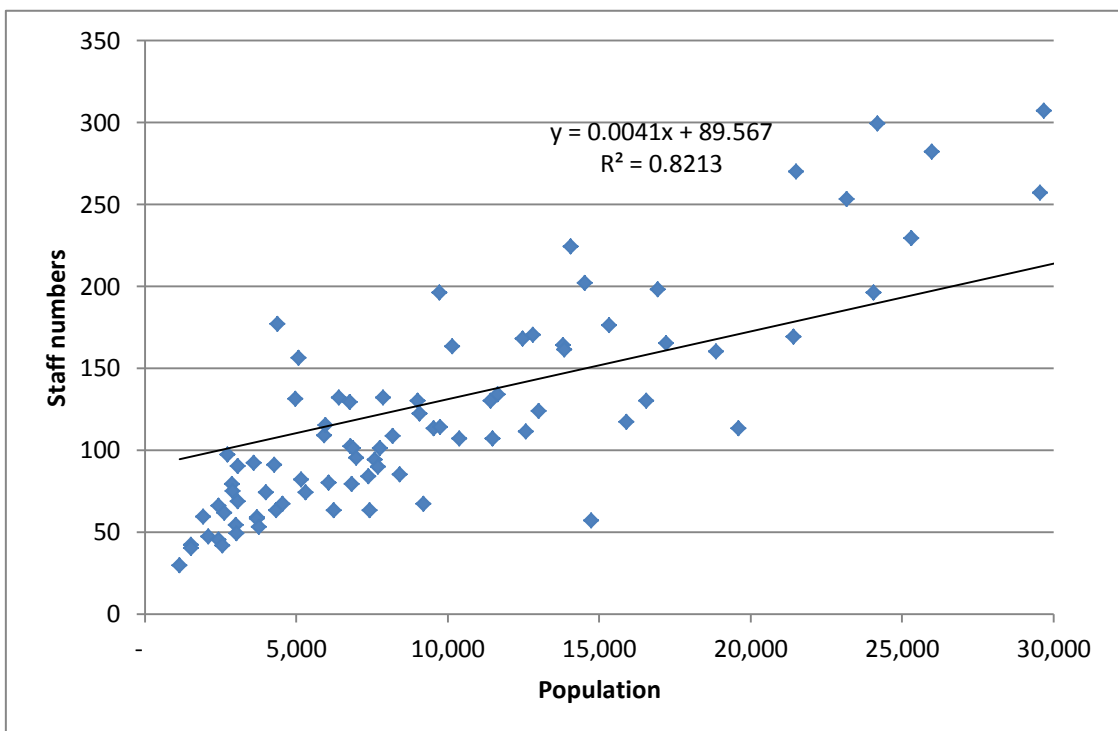
³ Staff Research Paper CGC 2017-06-S, Paragraph 42.

Chart 1: Staff Numbers (FTE) versus Population for 2015-16 – All Councils



At face value Chart 1, supports the existence of diseconomies of small scale as the line of best fit contains a statistically significant, positive constant. However a closer inspection of the data for very small councils (see Chart 2) reveals that these councils are predominately below the line of best fit. This appears to indicate that they adopt a different service delivery model which enables them to operate with lower levels of staff than would be indicated by a regression of the full data set.

Chart 2: Staff Numbers (FTE) versus Population for 2015-16 – Small Councils



NSW submits that similar circumstances arise for jurisdictions claiming to suffer from diseconomies of small scale.

Negation of incentives

The assessment of administrative scale may also negate the incentive for smaller jurisdictions to find more efficient and cost-effective operating models and business processes. As mentioned above, smaller states and territories may, as demonstrated by the local government sector in New South Wales, be able to organise their departments and functions in such a way that negates at least some of the disadvantages of their small scale.

However, if small states and territories are aware that any improvement in their departmental and organisational structure will result in a lower share of GST, the incentive to reform to take advantage of these efficiencies is removed.

NSW Treasury does not agree with discounting for uncertainty. We consider that if assessments are sufficiently uncertain as to require discounts, the assessments should not be made. However if discounting continues to occur, it should be applied to the administrative scale assessment to account for this incentive as well as due to the lack of robust data supporting the estimates of administrative scale.

Staff costs to Non-Staff Costs

Considerable further investigation is required of the ratio between staff and non-staff costs in the out-of-school education category shown in Table 7 of the CGC's Staff Research Paper (CGC 2017-06-S).

The data sourced from the Productivity Commission is clearly not comparable, with individual jurisdictions seeming to adopt vastly different allocation methodologies. For example, it is implausible for other operating costs to represent 16 per cent of staff costs in New South Wales and 116 per cent in Victoria. Similar implausible variations occur for other components of costs (see Table 2).

Table 2: Out of School Costs in 2013-14

	NSW	Vic.	Qld.	WA	SA	Tas.	ACT	NT	Aust.
Expenditures (\$m)									
Employee-related	264	111	275	148	138	23	20	34	1,014
Other operating	43	129	296	56	66	7	16	25	637
User cost of capital	10	9	3	2	6	0	3	–	32
Depreciation	4	17	4	1	1	1	1	0	29
Total	322	266	578	206	210	31	39	59	1,712
% of Employee Related Costs									
Other operating	16%	116%	108%	37%	48%	30%	80%	72%	63%
User cost of capital	4%	8%	1%	1%	4%	0%	15%	0%	3%
Depreciation	2%	15%	1%	0%	1%	5%	7%	1%	3%

Source: Productivity Commission, Report on Government Services 2016, School Education, Attachment Tables, Tables 4A.1 and 4A.10 (Out of School Costs)

Furthermore, the calculated gross-up factor derived in Table 7 of the Staff Research Paper is for the schools sector only, but has also been applied to the post-secondary education sector in deriving CGC's estimates of administrative scale for its hypothetical education department. There is no evidence the ratio of staff to non-staff costs is constant across different areas of government.

Data provided by Commonwealth agencies is also unlikely to be representative of the ratio of staff to non-staff costs of state activities. For example as shown in Table 3 below, in 2014-15 depreciation represented 11.8 per cent of employee-related expenses for the Commonwealth Department of Health and the Therapeutic Goods Administration (TGA) and 13.0 per cent for the Commonwealth Department of Education and Training. This compares with only 2.5 per cent for the head office of the NSW Ministry of Health.

The functions that agencies perform centrally can vary between the Commonwealth and states and territories. For example, the NSW Ministry of Health is responsible for drug and blood purchasing centrally, while other jurisdictions distribute these functions differently. Grossing up staff calculated costs based on a 60/40 split of employee/non-employee expenses is therefore extremely problematic.

We are also concerned that the proposed grossing up of staff costs to estimate total costs may result in a double count of depreciation disabilities with the existing infrastructure assessment.

Table 3: Selected Agency Head Office Costs in 2014-15

	Department of Health and TGA (Cth.) %	Department of Education and Training (Cth) %	Ministry of Health (NSW) %
Percentage of employee-related expenses			
Consultants	10.6	4.8	1.2
Information technology	14.4	7.4	10.6
Lease payments and rentals	19.1	19.4	5.7
Depreciation	11.8	13.0	2.5
Sub-Total	55.8	44.7	20.0
Other	27.3	18.9	NA
Total	83.1	63.6	NA
Employee-related share of total expenses			
	54.6	61.1	NA

Source: Department of Health (Cth.) Annual Report 2014-15, Pages 159, 202 and 229; Department of Education and Training (Cth.) Annual Report 2014-15, Pages 4 and 27; NSW Health Annual Report 2014-15, Pages 119 and 142-143

Attempting to estimate an appropriate ratio of staff on non-staff costs will be challenging. We believe that any case studies used by the Commission should be state rather than Commonwealth based and involve agencies of primarily a policy nature to avoid contamination from services delivery costs. We present the following data for the Commission's consideration which indicates an employee-related share of total cost of 75-77 per cent rather than the 60 per cent put forward in the Staff Discussion Paper.

Table 4: Staff Cost Shares for Selected NSW Agencies in 2015-16

NSW Government Agency	Raw Employee Share %	Adjusted Employee Share⁽¹⁾ %	Adjusted Employee Share⁽¹⁾ excluding Depreciation %
Audit Office	75	75	78
Crime Commission	70	70	76
Crown Solicitor's Office	78	78	79
Director of Public Prosecution	78	80	82
Health Care Complaints Commission	66	66	67
Independent Pricing and Regulatory Tribunal	68	68	70
Independent Transport Safety and Reliability Regulator	82	82	82
Information and Privacy Commissioner	71	71	73
Judicial Commission	75	75	76
Mental Health Commission	43	72	74
Multicultural NSW	64	77	78
Ombudsman	83	83	85
Parliamentary Counsel	79	79	81
Police Integrity Commission	75	75	80
Average	72	75	77

(1) Adjusted to remove witness protection payments and grants to community groups.

An alternative approach

NSW Treasury does not believe a methodology exists to provide an accurate assessment of the administrative scale disability. However If an assessment is pursued, NSW Treasury believes that the proposed methodology should be significantly improved and provided to states and territories for further comment.

NSW Treasury invites the CGC to consider approaches to the administrative scale assessment through the top-down approach. A top-down approach would present similar methodological difficulties and challenges as a bottom-down approach. However NSW Treasury considers that a top-down approach would provide a more reliable and transparent result based on empirical data and minimal judgement.

This might include a regression-based approach that analyses the relationship between service delivery costs and population size (or service population for particular services) using data from other countries such as the United States and Canada. The unexplained portion of the regression (the 'y-intercept') may provide some indication of state costs that are not affected by scale.

However if a bottom-up approach is to be pursued, NSW Treasury would invite the CGC to take into account the conceptual case for diseconomies of large scale. An asymmetric assessment of the higher per capita fixed costs incurred through diseconomies of small scale, without taking into account the cost disadvantages of undertaking large scale activities, will bias the final distribution outcome in a manner inconsistent with the principle of horizontal fiscal equalisation.

Alternatively, given the methodological issues and uncertainty outlined in this paper (particularly the data issues and the failure of the proposed approach to consider potential efficiencies that vary with size), it would be prudent for the CGC to consider applying a discount to the existing administrative scale assessment.