

**THE AUSTRALIAN FISCAL EQUALISATION  
SYSTEM AND CAPITAL TRANSACTIONS**

**THE FINAL STEP**

by

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**Abstract**

This Paper examines how best to integrate the assessment of recipient governments' relative needs for the funding of capital into an overall assessment of needs for grant distribution aimed at the equalisation of fiscal capacities. It is based on the assessment processes of the Commonwealth Grants Commission in Australia and discusses how those processes might best be extended to include the States' capital funding requirements.

The conclusion is that it is the assessments of States' needs to finance the recurrent impacts of capital transactions, rather than those transactions themselves, that would give a better result.

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# The Australian Fiscal Equalisation System and Capital Transactions — The Final Step<sup>1</sup>

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## Introduction

Vertical fiscal imbalance in Australia is such that the central government, (the Commonwealth) provides the State Governments<sup>3</sup> with nearly 50 per cent of their fiscal capacity through grants.

Over half of that transfer is made as general revenue or untied financial assistance, distributed on the recommendations of the Commonwealth Grants Commission<sup>4</sup>. The principle that has been used by the Commission as the basis of its recommendations for over 60 years, and through a set of detailed assessments for over 20 years, is *fiscal capacity equalisation*. It is that:

State Governments should receive funding from the Commonwealth such that:

?? if each State made the same effort to raise revenue from its own sources; and

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<sup>1</sup> An earlier version of this paper was presented to a workshop titled *Intergovernmental Fiscal Transfers – Australia and Italy in Contrast* organised by the Piemonte Institute of Economic and Social Research (IRES), Torino, Italy, on 21 May 2001.

<sup>2</sup> Bob Searle is the Secretary (Chief Executive Officer) of the Commonwealth Grants Commission in Australia. This paper has been written with the support of the International Centre for Economic Research,, Villa Gualino, Torino; and the Department of Economics of the University of Torino, Italy.

<sup>3</sup> There are six State Governments. There are also two self-governing Territories of the Commonwealth – the Northern Territory and the Australian Capital Territory – that have the same powers and responsibilities to the States and which, for the purposes of this paper, are also covered by the term ‘State’ or ‘States’.

<sup>4</sup> The Commonwealth Grants Commission can only *recommend* the distribution of the untied funding for the States, but its recommendations have never been rejected. It has no role in relation to the quantum of the transfer.

?? operated at the same level of efficiency (in both service provision and revenue collection);

each would have the *capacity* to provide services at the same standard.

In implementing this principle, it had traditionally been assumed (by both the Commission and the States) that the untied funding was being used for recurrent purposes. The Loan Council<sup>5</sup> made decisions about the relative needs of the States to raise loans, and distributed Commonwealth untied capital grants.

The basis of the Commission's analysis of States' needs for untied funding was therefore limited to an examination of recurrent transactions. Very detailed analyses have been done of differences in States' capacities to raise recurrent revenue and in unavoidable differences in costs of providing services, but the Commission's work has been restricted to consideration of recurrent activities. It has taken a very theoretical and principle-driven approach to its work and listed the occasions and circumstances in which the assessments were not based strictly on the fiscal equalisation principle<sup>6</sup>. At least some of those deviations have been initiated by governments rather than the Commission and reflect the political circumstances in which the system of transfers has operated.

In recent years, however, the assumption that untied grants were for recurrent purposes has become less and less supportable as the States have:

1. used consolidated budgets that do not differentiate between recurrent and capital transactions;
2. become much more involved in the leasing rather than the purchase of capital, even to the extent of selling their infrastructure and leasing it back;

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<sup>5</sup> The Loan Council is made up of the Commonwealth and State Treasurers and oversees public sector borrowing under voluntarily agreed arrangements. The present arrangements, introduced in 1993-94, are designed to enhance the role of financial market scrutiny in the public sector. They emphasise transparency of public sector finances and are less concerned than previous arrangements about placing strict borrowing limits on States.

<sup>6</sup> See, for example, the Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1999, Volume 1, Main Report*, p. 8.

3. outsourced the provision of some services to the private sector, which usually also involves the private sector providing the capital necessary for those services to be provided;
4. moved to accrual accounting and thus introduced depreciation expenses into their cost records for the first time; and
5. more frequently applied a policy of not funding capital from loan funds unless the assets would generate revenue sufficient to repay the loan (that is, funding 'social' capital from recurrent revenue sources).

Adding to this, the Commonwealth gradually reduced its untied capital grants to the States through the Loan Council, and then ceased them completely from 1 July 1994.

In February 1999, after nearly 10 years of consideration of the issue of how best to handle capital needs, the Commonwealth Grants Commission introduced assessments of States' relative needs for depreciation into its determinations. By doing this and co-ordinating the assessments with its assessments of States' debt servicing requirements, the Commission believes that it has now included all the recurrent impacts of capital. It has included what might be seen as the final element of States' activities in the assessment of their relative needs.

As a result of the Commission's actions, Australia appears to have been the first nation to expand its equalisation system to include the full recurrent impacts of capital transactions, and one of the few to have attempted a full quantification of capital funding needs (either the quantum or an annualised equivalent of it). A search of the documentation for about 40 nations, including all members of the OECD, indicates that even though most countries have tied capital grants, none takes a systematic needs assessment approach to their distribution between units of sub-national government. Although little information is available, it appears that the usual way of determining the distribution of capital funding, usually given as tied funding, is on a project approval basis. It is also usually approached on a functional basis rather than by attempting to look at overall capital needs.

Further, only two other countries (Japan and the United Kingdom) take any recurrent costs of capital into account when measuring sub-national governments' needs for untied funding. In both Japan and the UK, however, it is only debt charges that are taken into account. There seems no doubt that Australia is alone in including assessments of recipient governments' relative need to cover depreciation costs.

## **PART 1 THE AUSTRALIAN EXPERIENCE TO DATE**

The process of covering the full impacts of capital in the Australian equalisation assessments began in September 1989 when the central government advised the Commonwealth Grants Commission that it was to review, and report in March 1993, on the methods of assessment on which the distribution of untied general revenue (recurrent) funds was based.

The Commission is usually asked to do such a review every five or six years. However, on this occasion, it was asked to look particularly at some aspects of its methodology, including the coverage of expenditure functions in the assessments, before it undertook the review. In the brief inquiry that resulted, several of the States argued for an expansion of the analysis to cover capital transactions. This was the pointer to the next step in the development of the fiscal equalisation assessments used to distribute untied funding to the Australian States.

### **The 1990 Inquiry**

The Commission's 1990 consideration of capital transactions concentrated on what, if anything, should or could be done to bring them into the equalisation processes<sup>7</sup>. It concentrated on two questions.

1. Whether the objective was:
  - ?? to do a separate assessment of States' relative capital needs to distribute a separate pool of funds for capital purposes; or

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<sup>7</sup> See Commonwealth Grants Commission, *Report on Issues in Fiscal Equalisation, Volume I, Main Report*, Australian Government Publishing Service, Canberra, 1990, Chapter 8.

?? to integrate capital assessments into the basis on which untied general revenue funding was distributed?

2. And, if the former, whether the objective of equalisation in a capital sense was:

?? the equalisation of flows of capital expenditure based on relative need; or

?? the equalisation of capital stock based on relative need.

The Commission already had assessments of debt charges and interest earnings in its framework for assessing the relative levels of recurrent need of the States. In this inquiry, it concentrated on looking at what would be necessary to undertake a separate assessment of capital needs.

Some States argued that because the distribution of capital funding at the time was not based on capital needs, however they were defined, changes had to be made to the Commission's assessments because some of the untied Commonwealth funding was being used for capital purposes. Others argued that even if there was no relationship between capital needs and the then current distribution of capital grants, this was not relevant to the Commission's work as the untied funding distributed according to the Commission's recommendations was used for recurrent purposes. They argued that capital needs should not be part of the Commission's considerations.

The Commission concluded that it would not be feasible to introduce assessments of capital transactions *per se* into the 1993 review of methods because of both conceptual and practical difficulties. It expressed the view, however, that improving the assessments of the impacts of capital activities on recurrent transactions, through debt charges, interest earnings and depreciation, might 'ameliorate the methodological difficulties caused by interactions between recurrent and capital transactions, and hence mute the call for assessments of capital transactions'<sup>8</sup>.

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<sup>8</sup> Ibid, p 79.

### **The 1993 Review**

As it turned out, the issue of why and how capital needs might be assessed did not have to be faced in the 1993 review. After the Commonwealth and the States had reached agreement on the issue, the Government's instructions to the Commission for the inquiry (terms of reference) told it not to extend its assessments to cover capital transactions. If it was to do anything to improve and widen its assessments, the Commission could only do so through the debt charges and interest earned categories. The States still operated on cash accounting principles and there was no information on their costs of depreciation.

As a move to including more aspects of capital impact, the Commission decided to expand and improve the assessment it made of States' relative needs to fund debt charges<sup>9</sup>.

### **The 1995 and 1996 Work**

#### **The 1995 Report**

In January 1995, the Commonwealth advised the Commission that it was required to review its methods of assessment again, and to report this time in early 1999. Associated with that review, the Commission was instructed to commence a program of research on some of the more important assessments, after consulting with the Commonwealth and State Treasuries on the priorities for such research.

As it had been in previous reviews, the scope of the Commission's assessment was high on the priority list. On this occasion, the terms of reference did not specifically exclude the assessment of State needs associated with capital transactions, but the Commission took this to be the agreed position of governments. As a result, its 1995 volume of Reports on Research in Progress<sup>10</sup> held no discussion of capital transaction issues, except to say that the Commission would continue as it had in the past and not accept on face value what a State classified in its accounts as being a capital transaction. It would make its own judgements on the issue so as to get greater comparability between the States' budgets.

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<sup>9</sup> See Commonwealth Grants Commission, *Report on General Revenue Grant Relativities, 1993 Review, Volume I – Main Report*, p 28. Australian Government Publishing Service, Canberra, 1993.

<sup>10</sup> Commonwealth Grants Commission, *Reports on Research in Progress, 1995*, Volume 1. Australian Government Publishing Service, Canberra, September 1995, p 17.

### **The 1996 Report**

In 1996, the Commission reported that while the States had all been in agreement when Part 1 of its terms of reference for the 1999 Review had been decided, there were different interpretations of what was possible under those terms of reference. Western Australia was of the opinion that, because the Commission had not been specifically instructed to leave capital transactions out of its calculations, it was free to include them if it wished. Other States agreed with the Commission that it could decide which transactions were capital and which were recurrent, but that it should continue to assume capital assessments were to be excluded.

Western Australia noted the increasingly blurred line between capital and recurrent transactions in States' accounts due to the way capital expenditure (or at least the use of capital equipment) was being funded. It argued that including capital transactions in the assessments would allow the Commission to avoid having to make difficult differentiations.

Western Australia also looked again at the objective of equalisation and argued that capital expenditure is a necessary part of the total resources required for each State to provide the average standard of State-type services. It said that, as a result, the achievement of equalisation implies that disabilities associated with capital transactions (both expenses and revenues) should be assessed and reflected in the distribution of Commonwealth untied assistance.

The Commission, however, confirmed its previous decision and, in its September 1996 volume of Reports on Research in Progress<sup>11</sup>, said that unless it was directed otherwise in amended terms of reference, it would not include assessments of capital transactions in the 1999 review.

### **The 1996 Discussion Paper.**

Debate on the issue continued however and, later in 1996, the Commission distributed a Discussion Paper<sup>12</sup> to try to improve clarity of the issues before the final sections of the terms of reference for the 1999 review were provided.

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<sup>11</sup> Commonwealth Grants Commission, *Reports on Research in Progress, 1996*, Volume 1. Australian Government Publishing Service, Canberra, September 1996, p 37.

<sup>12</sup> Commonwealth Grants Commission Discussion Paper 1996/7, *Future Treatment of Capital Transactions*, November 1996.

The paper briefly summarised the arguments for and against the inclusion of assessments of capital transactions. On the particularly difficult question of roads expenditure, it pointing out the problems of differentiating between capital and recurrent expenditure. It also discussed how the Commonwealth's decision to cease the provision of specific funding for State roadworks was complicating the issue because capital grants for roads had been subsumed into the (recurrent) general revenue grants. This action by the Commonwealth provided more argument than ever in favour of somehow bringing capital transactions into account.

The Commission asked the States to reconsider the issues that had been first raised in 1990 — the purpose of equalisation in the capital sense. It said that developments in public sector accounting and the financing of capital assets again raised the question of whether equalisation would be better served by considering:

?? the relative needs of States for capital expenditures; or

?? the relative capacities of the States to meet the on-going costs of financing and maintaining capital assets.

It suggested that there were few limitations on the ability of States to obtain capital funds, other than the limits on their ability to meet the resulting annual outgoings and, hence, equalising States' capacities to fund those annual expenses is as much as it should do. The Commission also noted that the States had agreed to present their budgets in an accrual format within a few years and that this would allow an assessment of their relative needs to fund depreciation.

Its conclusion was that it thought an improved assessment of the recurrent effects of capital transactions would be the most effective way to proceed, if this was wanted or became necessary.

### **The 1998 Discussion Papers**

#### **A Capital Assessment – Principles and Concepts**<sup>13</sup>

During their discussions with the Commission in late 1997, and in their following written submissions, all the States except one agreed with the proposal to proceed by

assessing the recurrent costs of capital. The Commission was therefore able to confirm that, for the 1999 review, it would work to do something better in relation to the impact of capital transactions on the capacity to provide recurrent services.

To give some structure to the States' considerations of the aspects of capital activities that might be driving differences in their per capita costs, the Commission asked them to reconsider the ultimate objective of bringing needs associated with capital activities into the assessments. It asked whether the objective should be to equalise per capita capacities to:

?? fund annual fixed capital expenditure;

?? fund depreciation;

?? maintain capital stock; or

?? maintain net worth?

The concentration of the paper, however, was in discussing how the assessments of the recurrent impacts of capital (especially the new element of depreciation) might be approached. It looked in great detail at how an assessment of States' relative needs to fund depreciation expenses might be calculated, and reintroduced the thought that 'a critical issue is the extent to which equal starting points can be assumed for capital stock'<sup>14</sup>. The paper benefited from the submissions the Commission had received from the States (especially Western Australia) and proposed a detailed method of assessment.

### **Implementing a Capital Assessment through Depreciation<sup>15</sup>**

As the title indicates, this paper was about how a capital assessment might be done through depreciation. It was designed to give the States as clear a guide as possible on how the Commission was going to do the assessments of depreciation and debt charges.

The paper:

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<sup>13</sup> Commonwealth Grants Commission, 1999 Review Discussion Paper 1998/3 – *A Capital Assessment – Principles and Concepts*, June 1998.

<sup>14</sup> Ibid p viii.

<sup>15</sup> Commonwealth Grants Commission 1999 Review Discussion Paper 1998/4, *Implementing a Capital Assessment through Depreciation*, June 1998, p iv.

1. stated the Commission's objective as being to give the States equal capacity to fund standardised levels of stock at standardised costs of provision, allowing for different rates of depreciation;
2. confirmed the Commission's decision that its approach 'would involve an assessment of depreciation needs which would allow States to fund annual depreciation based on a standardised level of stock at a standardised cost of provision, taking account of factors resulting in different rates of depreciation. It would not be necessary to attempt to equalise State capital programs, future capital requirements, financing capacities or net worth'<sup>16</sup>;
3. stated the Commission's intention to disaggregate the depreciation expenditure, by both function and type of asset, so that different disability factors could be applied where necessary;
4. expressed the Commission's agreement with the States that the depreciation assessment needed to be co-ordinated with other assessments, particularly debt charges;
5. told the States that the period over which asset accumulation would be determined would be from 1961-62; and
6. proposed a list of 20 disability factors that the Commission would apply (or attempt to apply) in the depreciation assessment.

The biggest practical difficulty the Commission saw in assessing States' relative depreciation needs was that the Government Finance Statistics assembled by the Australian Bureau of Statistics were very poor in quality. It had hoped to rely on these data and now had to propose how an artificial standard could be arrived at.

There was considerable discussion about the interaction of the depreciation and debt charges assessments and the Commission concluded that standardised depreciation must be deducted from the States' gross standardised net borrowings. Unless this was done,

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<sup>16</sup> Ibid p iv.

there would be double counting of some of the States' needs for capital related expenses.

The roads function was again raised as requiring special treatment because of the way expenditure data in that field were structured. It was impossible to adequately differentiate between recurrent and capital expenditure (except for newly declared roads), and capital expenditure that would normally be funded from accumulated depreciation (category D expenses) was funded as recurrent. The Commission decided to bring all this expenditure into its functional category of roads, and omit roads from the depreciation assessment.

### **Report on Depreciation Briefing for the States<sup>17</sup>**

Following the release of the Discussion Papers, the States sent representatives to the Commission's offices for a discussion on how the assessments of the recurrent impacts of capital were to be done. The major outcome was the establishment of a Commission and State Treasury Working Party to progress thoughts on how the assessments might best be approached.

#### **The Commission-State Treasury Working Party**

The report of the Working Party was presented to the Commission in November 1998 and later published with the Commission's review report<sup>18</sup>. It limited its discussion to how the assessments might be done and there was little mention of whether 'the recurrent impact of capital' approach was the best way to proceed.

The working party had detailed discussions on whether a stock or a flow based approach was better as the basis for the Depreciation assessment. A stock based approach used concepts and techniques appropriate to the capital stock at a point in time, and aimed to standardise States' stock holdings. A flow based approach used concepts and techniques based on the annual changes in the States' stock holdings, and aimed to standardise capital expenditure streams. It was eventually concluded that, over time, both approaches should give the same result.

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<sup>17</sup> Commonwealth Grants Commission 1999 Review Discussion Paper 1998/6, *Report on Depreciation Briefing*, July 1998.

<sup>18</sup> Commonwealth Grants Commission *Report on General Revenue Grants Relativities, 1999, Volume III – Appendixes and Consultants' Reports*. Commonwealth of Australia, 1999. p 195.

There was also discussion of what disaggregation of stock was necessary to improve the assessment, and it was concluded that some separate identification of assets by type and function would be beneficial. Asset type was seen to influence the rates of depreciation, and the function being performed was seen to influence the levels of demand for assets.

The interaction between the depreciation and debt charges assessments was also discussed in the report and the need for co-ordination between the two assessments was stressed, but no agreement could be reached on how this was best catered for.

In an Attachment to the Working Party report provided by Western Australia, the issue of whether the assessments should be done by looking at economic costs rather than accounting costs was raised, but there was no discussion of that issue.

### **The 1999 Review Report**

In the 1999 review report, the Commission assumed that the best approach to continue to tackle the capital needs assessments was through their recurrent impacts, and assessed States' needs to fund both depreciation and debt charges expenses. It did not discuss the alternative of doing direct assessments of capital needs. This was not surprising after the developments over the previous four years.

### **Since the 1999 Review**

Shortly after the completion of the 1999 review, the States agreed to continue with the working party process to give further consideration to the assessment of depreciation and debt charges expenses. At its first meeting, the working party agreed that its future work should concentrate on a number of broad issues, including the overall approach to the equalisation of capital-related operating expenditure — both the theoretical underpinnings and its practical application.

The terms of reference the Commission has given the working party ask it to 'proceed from the general approaches' applied in the 1999 review. Most States understand this to mean that the working party should accept the general assessment framework currently underlying the assessment of the recurrent expenditure impacts of capital through depreciation and debt charges.

Western Australia, however, believes it means that the working party can put forward any assessment option that:

- ?? recognises the consumption and interest costs associated with capital (this being the ‘general approach’ adopted in the 1999 review) — whether interest costs are recognised through borrowing costs or opportunity costs (debt charges and return on equity) is, in its view, a matter of specific method rather than general approach; and
- ?? allows States to fund standardised levels of depreciation, debt charges and the like, either by equalising operating budgets on an annual basis (that is, through an assessment of borrowing costs) or equalising operating budgets over time in net present value terms (through an assessment of opportunity costs).

It argues that the working party should look at the theoretical underpinnings of the current assessments. It says the rationale for the current debt charges assessment is not specified and the Commission has not demonstrated that its current model, applied over time, will actually allow States to provide equal levels of services. Its view is that the current assessments do not achieve equalisation because needs relating to the costs of capital financed through equity are ignored.

Western Australia suggests that a number of different approaches to the assessment of capital needs should be examined, including a direct assessment — a method also favoured by South Australia.

The Commission has accepted that the working party may wish to re-visit the question of the theoretical approach to the depreciation and debt charges assessments. However, it has re-affirmed its position that it is committed to equalising States’ operating budgets for the effects of capital transactions. It does not see the fiscal equalisation process as relating to State capital needs or State net worth.

In general, the State position papers presented to the working party again indicate that some have a preference for direct assessments of capital needs. Most agree with the

Commission's position that examination of the recurrent impacts of capital is the best way forward, but others seem to be undecided. Queensland does not go quite as far as their consultants, but argue that if equalisation of capital needs based on an operating approach is to be fully achieved, there must be an equalisation of capital stock over time.

Western Australia has again asked whether economic costs rather than accounting costs should be used as the basis of assessment for capital aspects of States' activities. They are suggesting that the opportunity costs of holding capital should be part of the expense for which States are equalised, and argue that 'depreciation should be measured in economic terms so that it reflects the actual reduction in the current value of capital items over the course of the financial year, excluding price changes in the years'<sup>19</sup>. What the Commission needs to consider is what impact such a change would have and whether asset revaluations are relevant to measuring the recurrent use of capital.

### **Comment on Developments to Date**

When it started considering this issue in 1990, the Commission seemed to be somewhat unsure of what it was trying to do. It seemed to be unsure whether the ultimate aim should be to combine a capital needs assessments with its measurement of relative recurrent needs, or to measure relative capital needs so that they could be used in the distribution of a completely separate pool of funds.

The Commission's suggestion in 1990 that one of the options for tackling capital needs might be through a closer examination of the recurrent impacts of capital was a fairly bold initiative. Except for their trading enterprises, the States did not keep financial records based on accrual accounting and there were no data on depreciation expenses. The Commission knew that any depreciation expenses would have to be estimated from data on the value and age of assets, and that such data did not exist in any convenient form or from any comparable source. Its decisions during the 1993 review seem to have been influenced by two things.

1. The Commonwealth's decision to stop providing general revenue capital grants to the States from 1 July 1994. This removed the

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<sup>19</sup> Western Australian Submission on Capital Issues to the Commonwealth Grants Commission's 2004 Review, February 2001, Treasury Department, Western Australia.

question of why capital assessments were being considered — they were not to distribute untied capital grants. It enabled the Commission to concentrate on improving the assessments of the recurrent impacts of capital transactions.

2. Its decision early in the review to include all the recurrent transactions of the States in its calculations and to make a more detailed analysis of why there were differences in States' per capita expenditures and revenues.

These led to a confirmation of 'the recurrent impacts of capital' approach, possibly without sufficient consideration being given to the questions that had been raised in 1990. Why were the impacts of capital transactions being included, what was the objective in doing so, and how was this objective best achieved?

Over 1995 and 1996, the Commission seems to become set in the belief that a better assessment of the recurrent impacts of capital was the way forward. It raised the wider issues again in a brief paper in November 1996, but quickly nullified any discussion by giving its opinion that an assessment of the recurrent impacts of capital transactions was preferred.

What the Commission also did over this period was to advise the States that there would be changes made in the 1999 calculations and that, if possible, an assessment of relative needs for depreciation expenses would be included. The States now had to get serious about making a contribution to the thinking on the issue. The early evidence of this thinking was received in late 1997 when the States attended a Conference with the Commission, and then provided written submissions on the subject.

From the Commission's point of view, the focus then changed. The wider questions were forgotten and the concentration was on what could be done to better assess the States' relative fiscal needs in relation to the recurrent impacts of capital.

In 1998, the Commission started to use the term 'capital needs (depreciation) assessments'. After very little discussion, its conclusion was that 'depreciation and debt

charges together provided a reasonable coverage of a capital expenditure budget<sup>20</sup> and it confirmed its decision to look at such expenses rather than more directly at capital needs. Its stated aim was to assess depreciation as the consumption of assets in the provision of recurrent services, not as a proxy for present capital needs.

There was no discussion at all of the extent to which capital needs were already being met through recurrent expenditure, and thus no discussion of how an extension of the assessment of the recurrent impacts of capital fitted into the overall model, the objective or the fiscal equalisation principle. It was simply assumed that any extension to the breadth of assessments was going to be beneficial to the result. This may have been so, but the conceptual underpinnings of the decision were not provided.

The 1999 review report provided details of how the assessments were done, but held no discussion of the conceptual basis or principles behind the decisions taken.

## **PART 2 A BROADER PERSPECTIVE**

### **Equalisation and the Use of Capital – What is the Objective?**

Over the last decade, we have had much debate about the objective of including capital assessments in the determination of recurrent untied grants. Among the many suggestions have been that the fiscal capacity equalisation objective should be extended to cover the equalisation of:

1. flows of capital expenditure;
2. capital stock;
3. States' capacities to fund depreciation;
4. States' capacities to maintain capital stock;
5. States' capacities to maintain net worth; and

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<sup>20</sup> Commonwealth Grants Commission, 1999 Review Discussion Paper 1998/3 – *A Capital Assessment – Principles and Concepts*, June 1998. p.3.

6. States' capacities to fund a standardised level of stock at standardised cost of provision, allowing for different rates of depreciation.

I suspect that none of these objectives goes close enough to linking the general fiscal equalisation principle with the inclusion of capital needs assessments. Clearly, untied general purpose funding can be used for capital as well as recurrent spending, and we know that this has been happening. The stated objective should therefore link capital need assessments much closer to:

- ?? how the States' are funding their access to and use of capital;
- ?? the principle of fiscal capacity equalisation; and
- ?? the provision of services.

As stated earlier, the general principle is that State Governments should receive funding from the Commonwealth so 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 same capacity to provide services. The emphasis in this statement is very much on giving the State governments the capacity to do what they were established for — to provide services.

As an extension of this, the objective of including the assessment of relative capital needs in the determination of how untied funding should be distributed, should be:

to ensure that the States have equal fiscal capacity to *access and use* capital in the provision of services, assuming:

- ?? they each *use* capital in the provision of services with the same level of efficiency; and
- ?? they each make the same effort to raise revenue from the assets they *own or use*.

The term *access and use* has been used to allow for the fact that Governments have several ways of ensuring that they have access to adequate capital from which to

provide services. Traditionally, State ownership of the capital was assumed but now, States:

1. *own and use their own capital* (in such cases, the cost of capital is not always accounted for, even in notional terms, and is not always attached to a specific function of government);
2. *lease capital from the private sector and use it* (in such cases, the expenditure is usually functionalised and is a large proportion of the lease payment, but is not usually separated from recurrent costs associated with the lease, such as security, cleaning and power); or
3. *have the private sector own and use the capital to provide government services under contract* (in such cases, capital costs are usually functionalised because contracts are usually single function agreements, but capital costs are not separated from recurrent costs which can generally be assumed to be the major costs under the contract).

In the general government element of the public sector, each of these three methods has a direct impact on the operating budget, with ownership also having major indirect impacts through depreciation and debt charges.

There may also be a hidden impact of capital in the funding of Government Business Enterprises through community service obligation payments from the general government sector, on which total spending by the Australian States is about \$175 per capita. Any such impact has, for the purposes of this discussion, been omitted from consideration. This will become a more important issue and need consideration if the funding of State activity in the Urban Transit area (which would involve a further \$80 per capita) is moved to a Concessions and Other Payments assessment. It is something that needs to be thought about for the 2004 review.

At present, it is impossible to quantify the relative size of the three methods of funding capital listed above, and it is unlikely that it will ever be possible to do so. States are

unlikely to go to the considerable data collection effort and cost that would be involved, and there will always be problems of data confidentiality.

What can be said is that the second and third options are being used more frequently and for increasingly bigger items of capital expenditure. Victoria, for example, now operates from very modern prisons that are privately owned and operated under contract. It also has some hospitals that are privately owned but leased and operated by the State. Some States now own very little of the public transport infrastructure in their jurisdiction, having sold what they owned and leased it back from the private sector, or sold it to contracted service operators.

It is also clear that once the second and third options are chosen, the recurrent costs shown by the States are based on different cost structures. It cannot be assumed that the costs of financing the use of capital are the same no matter what means are used to gain that use. In relation to depreciation for example, the income tax legislation applicable in the private sector allows assets to be depreciated much faster than would normally be the case, and these higher costs can be assumed to be a determinant in the lease and contract costs. The opportunity costs associated with State owned land is not included in public sector accounts. Are these costs being included in lease and contract prices?

The private sector will also have a profit element built into its cost of providing capital assets for government use. How this influences total costs will depend on the comparative level of efficiency between the public and private sector in providing services. It may simply be that any relative inefficiency in the public sector is being swapped for a profit element in the private sector.

The term *access and use* also means that the equalisation of net worth cannot be seen as the objective of including the recurrent impacts of capital in the assessments. The objective must be linked to the provision of services, not just the ownership of assets. One State might, for example, decide to have much more active leasing and contracting policies. If the equalisation of net worth was seen as the objective, overall equalisation of capacity to access and use capital in the provision of services would not be achieved. Net worth covers only the 'ownership' method of giving access to capital.

The term *own or use* has been used when considering revenue raising capacity because States can use both owned or leased assets as sources of revenue. Owned assets can be

sold, or leased (on either a short term or long term basis) when not in use. Leased assets can be sub-leased.

Knowing that we do not have to equalise the efficiency with which assets are used to generate revenue (because this is assumed in the objective), we can limit any discussion of efficiency to that associated with the *use* of the assets in the provision of services. Here, future work may be much more specific than that associated with the provision of recurrent services because, if data become available, research should be able to relate the value of assets used to the number of services and the standardised cost per unit of service, and thus measure the relative efficiency with which States use capital.

### **Direct or Indirect Assessment of Capital Needs**

The direct assessment of capital needs involves decisions about the relative levels of absolute need for capital creation or replacement in each State, so that they can each be funded to provide the same level of access and use of capital. The process might be:

1. to take an inventory of the infrastructure in each jurisdiction;
2. to do an assessment of the condition of the infrastructure and the level of services being provided from it; and
3. estimate the costs of building, upgrading or restoring facilities so as to provide standard levels of services.

The need in each jurisdiction is then the difference between the estimated requirement and the jurisdiction's capacity to fund capital works.

This approach results in a concentration of thought on the State-owned assets and to equalise only one method by which States access capital. It suggests that leasing and contracts are unimportant and can be ignored.

The indirect assessment involves decisions about the relative levels of need to fund debt charges, depreciation and other recurrent expenses associated with capital, including leases and contracts, so that States can be assured of having equal fiscal capacity to provide themselves with access and use of capital. It also requires an examination of the revenue capacities associated with the ownership or control of capital assets. The indirect approach seems to take more account of the wider environment in which States

provide themselves with *access and use* of capital, and the implications of that provision. It is more likely to lead to an examination of all methods of such provision.

The direct approach is closely related to a cash-based approach to decision taking, while the indirect approach is more closely related to accrual costing. State Governments use both costing approaches. While service provision costs are now more frequently measured in terms of accrual-based data, large capital projects and financing decisions still have a substantial element of cash flow data in the supporting information base. The Commission's usual approach when setting financial and policy standards is to try to match what States actually do. This criteria is not definitive but would tend to support the indirect 'accruals' approach.

With a direct assessment approach, needs can vary substantially from year to year and result in much greater instability than is usually appreciated in an annual distribution of funding. Stability is something that recipient look for in any fiscal transfer system. The indirect approach should therefore be favoured on these grounds. It also has benefits associated with the concepts of equity over time, and of intergenerational equity. The direct approach seems to attach costs to now and the current groups of users. The more appropriate way to look at who should fund capital is to look into the future and ensure that future users share in the costs of the capital they will be using. The indirect approach does this much better by looking at the recurrent costs associated with the access and use of capital.

On the other hand, the direct approach is probably easier for the general community to understand — it is simpler and more transparent. I doubt, however, that this is sufficient reason to use it in a system aimed at a distribution of untied funding that equalises capacity to provide services.

It is possible that the direct approach would be more appropriately applied to a capital grants distribution. This is because, when dealing with capital funding, there are more important criteria than the even flow of grant funding. In these circumstances, there is also a minimum realistic amount that each government should receive. There is little benefit in giving a government a nice even flow of capital grants if the annual grant is so small as to be useless for capital works. In some circumstances, governments may

prefer a more uneven flow of funding but be able to use the grant more readily for the intended purpose when they do receive a grant (say once every 5 years).

### **Economic Cost or Accounting Cost**

As stated earlier, Western Australia has raised the issue of whether economic costs are a more appropriate base for the assessment of States' relative needs for funding associated with capital stock. It suggested that the use of economic costs would ensure that all the costs associated with owned capital are brought into the assessments and that all capital costs are covered. There is something in this argument, but such a concept can only be applied to the costs associated with assets that are owned by a government — again, this is only one of the three ways in which they provide themselves with access and use of capital.

With the growing tendency for governments to provide themselves with access and use of capital by other means, I think it is inappropriate for economic costs to be used for the 'ownership' element of capital costs while other costs associated with the same provision are in accrual accounting terms. Also, if this paper's proposed objective for including capital assessments in the Commission's determinations is accepted, we should not isolate one method of providing access and use of capital from the others and treat it differently. We must see the three methods as combining to produce the full level of access and use of capital required by the States to provide services.

In terms of the Commission's standard budget, it would be inappropriate to have part of the cost of access and use of capital based on accounting cost concepts (and there is no alternative for the lease and contract elements) and the other based on economic cost concepts.

Effectively, the argument to use economic costs is that assets owned and used in the provision of government services can be divided into: those owned by the private sector and used through leases or contracts; those being purchased by the government through loans; and those fully owned by the government and to which loans no longer apply. Unless the economic costs are considered, the last group of assets is left out of considerations except for its impact on depreciation.

The argument here is about how States give themselves access to capital. Access costs that we could include on a purely accounting approach would cover lease costs, contract costs and debt charges costs. It is true that we would have no equivalent economic type costs associated with the capital not purchased through debt, but this is not an insurmountable problem. These costs have no impact on the budgets of the States and it is budget capacity that the Commission is trying to equalise. If States' capacities to provide themselves with *access* to capital stock through loans, leases and contracts are equalised, the Commission will have achieved its objective. The cost of *using* capital that is either owned or being purchased (and thus on the governments' assets registers) can then be assessed through a depreciation assessment

There is one related technical issue that should also be discussed. It has been claimed by Queensland and South Australia that States do not fund their depreciation expense in the general government sector and, as a result, the Commission should not include this expense in its calculation of the standard budget result. In effect, they are saying that while they agree that the standard budget should be based on accruals data, the standard budget result (the 'B' in the Commission's equalisation equation  $(G = E + B - R - O)$ )<sup>21</sup> should continue to be calculated on a cash basis.

To do what is proposed would create an imbalance within the equalisation equation unless the depreciation expense was also taken out of the 'E' element. It would mean there would be a gap between the assessed needs for funding and the amount of funding that had been available in the assessment years. The technical issues associated with the existence and then closing of such a gap have been discussed in a recent Commission document and do not need to be covered in this paper<sup>22</sup>.

But if States are not funding depreciation, there must be some doubt about whether the Commission should be including it in the standard budget. It always attempts to base its assessments on what States do.

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<sup>21</sup> For complete exposition of the Commission's model, see *Commonwealth Grants Commission, State Revenue Sharing Relativities, 2001 Update, Supporting Information. Attachment D The Distribution Model: A Mathematical Presentation*, p. 375.

<sup>22</sup> Where the fiscal transfer system is not bound by externalities, there should be no gap and no need for factoring back. An interesting discussion of how a gap might come into existence, and then how it might be closed, is to be found in the Working Papers for the Commission's *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, June 2001, Chap 14, pp 136.

Depreciation has been brought into the assessments at least partly on the assumption that it was to be funded: there was an assumption that it was what States would be doing under accrual accounting. The ultimate objective of equalisation is to enable equal levels of service provision. Should this question be considered a little more from a 'cash' perspective and depreciation omitted from the standard budget? If this approach were taken, the Commission could argue that depreciation differed from superannuation, the other category where accrual accounting has a substantial impact, because superannuation has to be funded sometime in the future, depreciation does not. This is an important issue that needs to be considered further by the Commission.

For the moment, let it suffice to say that economic costs should not be considered in the equalisation system, and the standard budget result should continue to be based on all transactions within the standard budget, including depreciation.

### **Types of Assets, Expenses and Capital Receipts**

Before clarifying the impact of capital on the recurrent transactions of government, we might beneficially discuss what types of capital assets governments access and use, what types of expenses attach to each of these asset types, and what types of capital receipts governments receive.

#### **Assets and Expenses**

The first necessity is to arrive at some agreed approach to the definition of an asset, and what we might see as capital stock. In an accounting sense, the value limit given to an asset is sometimes much smaller than the type of capital items that seem to have been in mind when bringing the recurrent impacts of capital into the assessments of States' relative needs. A new computer, for example, might be capitalised and depreciated if its purchase price is more than \$3000. Should such equipment be brought into the concept of capital for the purpose of discussion in this paper? Can we use one concept of capital for purposes of calculating depreciation expenses, knowing that a different concept of capital (maybe something closer to what might be termed infrastructure) is being used when we come to consider debt servicing requirements?

The costs of minor equipment purchases, if they are funded from recurrent budgets, are being included in the Commission's standard budgets as functionalised costs and are having recurrent demand and cost disabilities applied to them. But the value of these

assets may will be being included in the depreciation calculations if they are ion the asset registers. Over time, therefore, there is some double counting of the value of these assets. The disabilities being applied to the purchase price as recurrent expenditure are undoubtedly the wrong ones, and such expenditure would need to be removed from the functional standards if the Commission were to be pure in its approach. However, the degree of inaccuracy in the assessments caused by this difficulty would not be significant and can probably be overlooked.

Minor repairs and maintenance of government owned assets is probably also included as recurrent expenditure. The extent to which major maintenance can be split between functions depends on the type of asset, the management and control arrangements under which it is used, and whether or not it is a joint-use facility. In most cases, however, major maintenance will be capitalised because it will result in a revaluation of the asset. We are probably left with: minor maintenance being functionalised; and major maintenance being capitalised and influencing the recurrent budget through greater depreciation and, possibly, debt charges costs.

Looking at the assets included in the States' assets registers, and thus depreciated irrespective of how they have been financed, it appears that we should split them between land, buildings, and plant and equipment. Each of these asset types influences recurrent costs differently. Different functions of government require different mixes of asset type and different asset types have different expenses attached to them. There is no depreciation associated with land but there is for all other assets. Education is much more intensive per employee than police in the use of land and building, but the police function uses much more plant and equipment per employee than education. The rate of depreciation clearly differs between buildings and plant and equipment, and different items of plant and equipment also have different expected lives. Debt charges can attach to land as well as non-land assets. Land appreciates with inflation and demand. Buildings and some other assets appreciate for the same reasons, (or we would not have revaluations) but also depreciate. Should these differences have any impact on the assessments?

The expenditure associated with assets that are accessed and used through leases or contracts is initially accounted for (and shown in the Commission's standard budget) as recurrent functional expenditure. It is shown as an education, health, welfare cost etc.

In this respect. Where leases are in use, most of the cost under the lease will be the equivalent of government capital related expenditure, with a small element possibly being for non capital type expenditures such as security and cleaning. In contracts for the supply of services through privately owned capital, most of the contract price will be the equivalent of recurrent expenditures for salaries etc, with probably a small part only relating to what would be a substitutes for government capital related costs.

If we are unable to take capital related costs out of leases and contract payments, it supports the argument that we should functionalise the costs associated with major State owned assets so that the complete assessment of, say, primary education or hospitals, is in the one place. To do so would be more in the spirit of accrual accounting and a more complete standardised cost of providing each service would be achieved.

Two problems mitigate against such an approach. First, the problem of joint use facilities, especially for administrative functions, will make it most unlikely that depreciation could ever be fully functionalised. Second, States' methods of funding capital through general purpose and rollover loans will continue to make the functionalisation of debt charges impossible. Jointly, these data difficulties will probably always prevent any accurate functionalisation of costs associated with State-owned capital.

As the basis of future assessments, we are left with a mixture of functionalised expenditure for the minor equipment purchases and the use of non-owned assets, and non-functionalised expenses for major owned assets.

### **Capital Receipts**

On the revenue side, the Commission can and should differentiate between:

- ?? receipts resulting from interest on short term cash balances;
- ?? receipts from the sale of assets;
- ?? receipts of grants for capital purposes; and
- ?? receipts resulting from the use of assets by others.

Data should not be a difficulty in relation to the first three sources of capital receipts as they can be expected to be separately accounted for, probably at a central level in the State accounts, although in relation to the sale of assets this might depend on the value of the asset and where it is held in the State's asset register. In all cases, it is likely that the revenue from the sale of minor (obsolete) assets such as old computers, whether still on the asset register or not, will be a functionalised receipt.

The last group of receipts, however, those resulting from the use of assets by others, may cause difficulties. Here, it is more likely that the receipts are accounted for at a functional level and, depending on the degree of autonomy given to individual institutions, the receipt may be in the institutional accounts rather than in departmental or State accounts. An example of this will be schools in States that have school based management and budgeting. Any receipts from the use of school facilities by the community are likely to be limited to the accounts of the school.

We are probably left with having good data on three aspects of capital related receipts, and having to forget about trying to collect comparable State data for receipts relating to the use of capital by others.

## **Assessing the Operating Impacts of Capital Use**

### **Expenditure Assessments**

On the expenditure side, the Commission should aim to have the capital related assessments done by looking at the three ways in which governments provide themselves with access and use of capital. It should aim to equalise the extent to which States have the fiscal capacity to finance their access and use of capital through:

1. ownership; *plus*
2. leasing; *plus*
3. contracts for the provision of services.

The task then is to see how the expenses associated with each of these three different ways of financing access and use of capital can be brought into the standard budget, and then measurements of States' relative need for funding undertaken.

Ownership of capital is still the dominant method by which governments provide themselves with access to capital. The present assessments in fact pay little attention to methods 2 and 3 and assume the recurrent disability factors applied to the equivalent of capital related costs are appropriate. This is currently not done as a result of any conscious decision and will need to be tested as the degree to which access and use of capital through these methods increases.

*Asset ownership issues.* As implied earlier, costs associated with the State ownership of assets can be divided for assessment purposes into depreciation costs, debt servicing costs, and repairs and maintenance costs.

In relation to depreciation, the objective should be to identify and quantify the States' different fiscal needs for depreciation expenses if they are each to fund the same level of access and use of capital through ownership. This will necessitate an examination of those influences that cause differences in required levels of stock, and differences in rates of use of stock, as between the States. Before this can be done, there is a need to understand the structure of assets owned and used by governments, and the normal expected life of each type of asset used in each function of government. In reality, to build differences in asset type mix between functions into the assessments, the Commission needs to start with two matrixes. One should show the proportional composition of capital (land, buildings, and plant and equipment at a minimum) by function (up to about 40 functions under the Commission's current budget structure). The other should show depreciation rates by asset type for each function.

For debt charges, the objective of the equalisation assessment must be limited to the annual charges associated with debt necessary for each State to fund the standard provision to access and use of capital through loans. Clearly, the costs should not include the repayment of capital as to do so would double count costs covered by depreciation. Most debt will relate to the purchase of assets, although some will relate to accumulated recurrent deficits. Once repayment of capital is excluded from total debt related costs, it will be necessary to consider whether debt charges associated with capital purchases should be separated from those associated with funding recurrent deficits. This will be necessary if it is believed that different disabilities attach to the different reasons for loans having been arranged — probably unlikely.

Minor repairs and maintenance costs can probably continue to be seen as recurrent costs and isolated from the capital impact issue. They are generally accounted for as recurrent costs when assets are owned by the government, and the costs are therefore accounted for in the same way (as recurrent costs) whether the government owns the assets or not. The only difference is whether they are paid by the government directly or through an arrangement with the private sector.

The Commission's current assumption is that repairs and maintenance costs are already being functionalised. In three categories (roads, housing and education), there are special disability factors to account for repairs and maintenance cost differences. The possibility of double counting is compensated for in relation to roads by deleting roads assets from the depreciation assessment. It is unlikely that the types of maintenance allowed for in education (that necessitated by vandalism) will be causing any revaluation of the assets held, but the relationship between the maintenance of housing and the asset valuations (and therefore depreciation) will need to be examined more closely. In other categories, repairs and maintenance is probably a small proportion of the administration component and is having an administrative scale disability factor applied to it. There is a question of whether it would be better treated as a small addition to the accommodation element of the input costs assessment, where more appropriate disability factors might be applied.

In this regard, South Australia has presented evidence that the average age of States' assets varies from 8 per cent below the national average to 10 per cent above that average, and that this difference must be having some influence on repairs and maintenance costs. The difficulty for the Commission will be to isolate policy influences on these average age data, and then decide how average age influences asset values (taking refurbishments and revaluations into account) and deciding whether the extent to which stock are older as a result of disabilities is itself a disability.

***Issues associated with Leasing of Capital.*** In most cases, the full cost of leases by the State is probably being shown as an administration cost. It would include the impact of all costs faced by the private supplier in providing the asset — depreciation, debt servicing costs, and repairs and maintenance.

Some functions are more likely to operate through leased assets than others. It may be that the proportions of expenditure being assumed for accommodation in the input costs disability factor is adequately taking account of functional differences in propensities to lease, but the Commission may need more detail about the pattern of State use of leased assets to see whether the differences between functions are being adequately taken into account in the assessments. If nothing else, it will need to look at how its assumed accommodation percentages of total expenditure in each function were arrived at. They should include lease (and part of contract) costs and exclude any economic costs such as asset use charges on owned capital imposed by a central agency and being shown in departmental accounts.

The Commission will also need to look at how the accommodation input cost disability factors have been arrived at and ensure that they take adequate account of the hidden debt charges and depreciation cost differences.

The issue of repairs and maintenance is similar to that described above for State owned assets.

***Issues associated with Contracts.*** No separation can be expected within contract payments to differentiate between recurrent type costs and capital related expenses. Even if the data were provided to the State as a party to the contract, confidentiality would probably prevent it being supplied to the Commission. In the current assessment procedure, the value of the contracts is probably being split into components within a function in accordance with what is happening in the other States.

The issues are similar to those described above for access and use of capital through leases.

***A Capital Expenditure Assessment Framework.*** In summary then, what we have at present in the expenditure assessments, and what the Commission is likely to be forced to stay with because of data limitations, is shown in Table 1. It illustrates that it must concentrate on the separate assessments for depreciation and debt charges. It also shows why it would be best to look upon repairs and maintenance, and capital type costs hidden in leases and contracts, as normal recurrent costs and assess them in the functional categories such as education, health etc. The depreciation and debt charges assessments will be discussed further in a later section.

**Table 1 Recurrent Impacts of Capital – An Expenditure Assessment Framework**

Source of access and use of Capital	Assessment Category			
	Depreciation	Debt Charges	Repairs and Maintenance	
			Minor	Major
State Ownership	A separate category	A separate category	Functionalised, and covered either in input costs or admin. costs assessment	Not Recurrent. Increasing the value of assets being depreciated
Lease	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment
Contract	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment	Equivalent costs are being functionalised and covered in the input costs assessment

### Revenue Assessments

On the revenue side, the Commission should aim to do the capital related assessments by looking separately at each of the ways capital transactions can influence the revenue States' raise and use to provide services – either by the direct or indirect funding of services, or by funding the access and use of capital. It should quantify what revenues each State would raise if it made the average effort to raise revenue through the use of the capital it owns or uses in the provision of services.

States can raise revenue through their capital by:

1. selling assets;

2. interest receipts on short term investments of cash balances; and
3. charging others for the use of the assets they own or lease.

From the Commission's perspective, revenue from the sale of assets is the most contentious of these three, possibly because it is the largest potential source of revenue and is truly a capital transaction rather than a recurrent impact of a capital transaction. It is also a revenue source that has, to date, been omitted from the Commission's assessments because of its capital nature.

***Sale of Assets.*** Asset sales are obviously capital transactions. The difficulty is in deciding what the recurrent impacts of these capital transactions are. The answer differs depending on the type and value of the asset sold, and the purpose to which the funds are put. If a low value, fully depreciated or obsolete piece of equipment is sold, for example, the revenue is small and is sometimes even accounted for as a recurrent receipt. Much of this kind of asset sale revenue is already included in the Commission's standard budget. It is either hidden as user charge revenue and functionalised as an expenditure offset, or included in the miscellaneous revenue category.

If the State sells a large piece of land, a trading enterprise (which will hold intangible assets of goodwill etc) or a major constructed asset, and uses the funds received to reduce debt or cover recurrent costs, the receipt of the funds is a capital transaction, but the expenditure has direct recurrent impacts. However, some receipts from major sales of capital assets are used to fund capital replacement or expansion. These are clearly capital transactions, but they have an indirect impact on the level of debt the States holds, and therefore an indirect recurrent impact on the States' capacities to provide services.

All State assets (land and non-land, tangible and intangible) could be sold, even if many of them would need to be leased back if service provision by the government were to continue (the alternative being to contract for the services). Governments have sold all kinds of assets, and both methods of service provision after divesting property have been used. They both have recurrent expenditure impacts.

The difficulty for the Commission is in deciding whether the sale of assets is relevant to States' capacity to fund services or the access and use of capital associated with service provision. If it is, what assumptions should be built into the assessments about what assets governments can (and do) sell to finance their normal recurrent services and capital provision? Should the assessment differentiate between:

- ?? assets that were being used and assets that were not being used;
- ?? types of assets, such as land, buildings, and plant and equipment;
- ?? tangible assets and intangible assets;
- ?? assets that have been depreciating and assets that have appreciated over time; or
- ?? assets that are at the end of their useful lives, and those that are not?

Could we really expect governments to have or provide these data? Is it necessary anyhow? Eventually, the revenue raised from all assets sold has an impact on States' service provision capacity (either directly or by changing the mix of how access and use of capital is provided) and the revenue should therefore be assessed. How an assessment might be approached is discussed in a later section.

***Interest Receipts.*** These receipts are the interest on cash balances, from whatever source and however invested, and do not necessarily relate to assets being used to provide services. Thus, although they result from assets being invested, they may be best seen as recurrent receipts and kept out of the consideration of capital impacts.

The Commission's current assessment is that the States all have the same per capita capacity to raise revenue from this source. This may be a result that the Commission and the States can live with for simplicity reasons, but whether it is real might need further consideration. Is there, for example, a diseconomy of scale that means the less populous States have to hold a higher per capita amount for their day-to-day cash management requirements than the larger States? If they do, they have a small advantage in raising revenue from this source.

There have been suggestions that these receipts should be netted off interest payments. I do not think this is an appropriate treatment as they:

- ?? do not negate debt charges paid on accumulated past deficits;
- ?? do not relate conceptually to the assets being used to provide services (to which most of debt charges relates); and
- ?? will have different disability factors applied to them.

***Leases and Other Receipts.*** To the extent that they can be identified (that is they are not hidden in the accounts of institutions or departments), receipts resulting from the use of government owned or controlled assets by other organisations should be seen as capital receipts. They result from the use of assets that are either leased or sub-leased from the government during periods when they are not required (for either short term or longer term periods) for government service provision.

Minor amounts are probably already included in the Commission's standard budget as recurrent revenues (again hidden in user charges or expenditure offsets). Data availability will dictate what can be done to clarify the assessments in this area.

***A Capital Receipts Assessment Framework.*** In summary, what the Commission has at present in the revenue assessments is somewhat deficient. The only explicit assessment being done is of interest earned. What it should have, I think, is summarised in Table 2. It illustrates that it has not yet included the major area of asset sales. It is also possible that it may have understated the revenues capacities from the recurrent use of assets by others. The asset sales assessment is discussed further in a later section.

### **The Issue of Capital Grant Receipts**

Capital grant receipts must be considered in determining the States' needs for untied funding if those grants are used by States to provide themselves with the capital they need to provide normal services. The question is whether they should be seen as available to reduce States' total financial assistance requirement (in the same way as recurrent grants treated by the inclusion approach), or as reducing States' needs to borrow.

**Table 2 The Recurrent Impacts of Capital -- A Revenue Assessment Framework**

Type of or access to capital	Assessment categories			
	Sale of assets		Interest receipts	Lease and other receipts
	Minor assets	Major assets (a)		
State assets - cash	na	na	Interest received category	na
State assets - other	Currently functionalised and probably recorded as expenditure offsets	Not currently included in the assessments	Na	Currently functionalised and probably recorded as expenditure offsets
Leased assets	na	na	Na	Currently functionalised and probably recorded as expenditure offsets
Contracted assets	na	na	Na	na

(a) These may need to be split between tangible and intangible assets.

na not applicable.

The Commission's general approach to bringing capital needs into the assessments is through the recurrent impacts of capital transactions. The receipt of a capital grant is a capital transaction so bringing it in as an ordinary specific purpose payment and treating it by what the Commission terms 'the inclusion approach' would be inconsistent with the general approach. The Commission should look for the recurrent impacts of these transactions.

The use of a capital grant will inevitably have an impact on the level or type of assets held by the State, and therefore on the depreciation that will be shown as an annual expense. The real question is what impact the use of a capital grant might have on the level of debt a State needs to carry, and therefore on the debt charges assessment.

There are two questions that are relevant to this issue, and they must be considered from both a theoretical and a practical perspective. They are:

1. Would the States have undertaken the capital expenditure even if they had not received the grants?
2. If the States would have undertaken the capital expenditure, would they have funded it from loan funds, or from other sources?

**The theory.** If *the States would not have undertaken the capital expenditure*, (their capital works program may not have included the works funded by the grants) the receipt of the grants and its expenditure on the capital items specified in the grant arrangements would have had an impact on the standard budget only through the level of expense on depreciation. There would be no impact on debt charges as there would have been no equivalent debt entered into if the grants had not been received, and no recurrent revenue would have been ‘freed up’ as a result of the grant receipt. The correct treatment of the capital grants in these circumstances would be exclusion from any consideration of debt charges.

If it is determined that *the States would have undertaken the capital expenditure* even if they had not received the grants, *and would have taken out loans to do so*, the recurrent impact of the grants (as well as increasing depreciation) is to reduce debt and therefore debt charges. This would be so even if the debt was to arise simply as a result of a larger deficit. The correct treatment of the grant in these circumstances would be to reduce the standardised level of debt each State is expected to carry by the actual grant it has received. This reduces the levels of debt it is assumed each of the States would need to carry to provide themselves with the standardised level of owned assets.

If it is determined that *the States would have undertaken the capital expenditure* even if they had not received the grant, and that they *would have funded the capital expansion by non-debt means*, another question arises.

3. Would the capital expansion have been funded from asset sales, accumulated (and funded) depreciation reserves, or from recurrent revenue sources?

If the capital expansion would have been *funded from asset sales*, the impact on the standard budget would be shown only in the depreciation category. The correct treatment of the grant would be by the exclusion approach.

If the capital expansion would have been *funded from accumulated depreciation reserves*, the impact is somewhat similar to what it is for funding through the sale of assets. We will see a reallocation of assets on the balance sheet and an increase in depreciable assets, but no impact on debt charges. Exclusion would again be the appropriate approach.

If the capital expansion would have been *funded from recurrent revenues* (that is, a decision to fund it from current year revenues without influencing the budget result), the impact will already be shown in the standard budget, either as lower revenues, higher expenditure or a mixture of both. In any case, there will be no need to bring the capital grant into the debt charges assessment. Again, it should be treated by exclusion.

In summary, this theoretical framework can be expressed as in Figure 1.

**Figure 1 Theoretical Treatment of Capital Grants**

Would the States have undertaken the capital expenditure even if they had not received the grants?	
<i>No</i>	exclusion
<i>Yes</i>	
Would they have funded it from loan funds?	
<i>Yes</i>	inclusion as a reduction in debt
<i>No</i>	
Would they have funded it from asset sales, funded depreciation reserves or current year revenues?	
<i>Asset sales</i>	exclusion
<i>Funded depreciation reserves</i>	exclusion
<i>Recurrent revenues</i>	exclusion

**The Practice.** The discussion above is based on an assumption that the Commission is able to conclude, after the event, what the States as a group would have done if they had not received the capital grants. Clearly this is not possible without information from the

States, and to ask them for such information would be to introduce a grant design inefficiency into the process. They would have incentives (which would differ between States) to influence the result of the assessments by answering the questions one way rather than another. The Commission would also be left with making its decisions, at least initially, on a State-by-State basis and then combining them into an average decision. It would eventually be making either a State-weighted or a population-weighted decision to get an answer to its questions.

The Commission must look for a way to make its decisions without asking the States for *ex poste* judgement based information, and arrive at decisions that can be assumed to apply to all States.

We know there are ongoing demands for capital expansion or replacement in all States, and that all States have active capital works programs. Based on an assumption that the assessments of States' capital need undertaken by themselves and the Commonwealth would be the same, it would seem acceptable to assume that the standard answer to the first question would be 'yes' — the States would have undertaken equivalent capital expenditure, even if they had not been given the grants.

However, looking for a standard way in which States might have funded the capital works, we know that, increasingly, they are using non-loan funds to pay for non-income generating or 'social' capital expansion or replacement. The tendency should therefore be to exclude capital grants from the assessments completely, but this would probably be going too far. The States are not using accumulated depreciation reserves to fund this capital expansion, and are taking out loans.

It should be possible, by examining State accounts, to arrive at an average extent to which the States are financing social capital from loan funds. This could then be used as the extent to which each State's actual receipts of capital grants should be treated as reductions to the standardised debt the State would carry if it were to provide itself with all State owned assets through loans.

### **PART 3 THE MAIN ASSESSMENTS**

There are three assessments that need to be discussed in more detail. Some further consideration also needs to be given to the interaction between the Depreciation and

Debt Charges assessments, and the concepts of flow and stock approaches that might be relevant to those assessments..

### The Depreciation Assessment

In the 1999 review depreciation assessment, the Commission took a stock approach and looked at the stock each State would need to hold to provide the standard level of services through ownership of capital. On an assumption that differentiation between functions was necessary because of different patterns of use of different types of assets, it differentiated between urban transit, housing, education, health, law and order, and all other services. On an asset type basis, it differentiated between buildings, other constructed assets, and plant and equipment. The composition of the assessment is set out below in Table 3. The isolation component does not relate to the ownership of assets directly but accounts for the different costs States experience because of their distance from one another due to communication and other costs not taken into account elsewhere.

**Table 3 Components of the 1999 Depreciation Assessment (%)**

Function	Type of asset			Percentage of total expense
	Buildings	Other Construction	Plant and Equipment	
Urban Transit	(a)	7.430	7.780	15.210
Housing	9.430	(a)	(a)	9.430
Education	8.525	(a)	4.522	13.047
Health	5.115	(a)	2.714	7.829
Law and Order	3.410	(a)	1.809	5.219
All other services	17.050	22.790	9.045	48.885
Isolation component	nil	nil	nil	0.380
<b>TOTAL</b>	<b>43.530</b>	<b>30.220</b>	<b>25.870</b>	<b>100.000</b>

(a) Included in 'all other services'.

The assessment for each of the components of total depreciation (except isolation) was made by taking:

*standard per capita depreciation expense*      and *multiplying* it by  
*quantity of stock* disabilities;

*cost of stock* disabilities; and

*asset life* disabilities.

***The Standard Expense.*** Because the data on depreciation expenses from States' accounts were of very poor quality, the Commission was forced to estimate the standard expense. It did this by using Australian Bureau of Statistics data, commencing in 1961-62, on:

1. reported capital expenditure and receipts by year (dissected by State, function, government purpose code and asset type);
2. capital price indexes (dissected by function and asset type); and
3. mean asset lives (dissected by function and asset type).

Estimated disposal values were assumed to be a percentage of acquisition expenditure and all assets in a class were assumed to have the same mean asset life.

On the assumption that useable data will become available from State accounts, this paper does not need to discuss how standards will be compiled for future years — they will be derived from actual State data. For the past years for which data are of poor quality, the estimates already made should be used unless future data enables them to be estimated more accurately.

***The Disability Factors.*** The quantity of stock disabilities are designed to make allowances for differences in the per capita stocks necessary for all States to provide the standard level of access and use of capital through ownership. They include service delivery scale, population composition and other impacts that result in differences in the per capita number of units of physical stock required. The cost of stock disabilities, such as construction cost differences, are designed to make allowances for the differences in the average prices States face in purchasing each unit of stock. Asset life disabilities are designed to make allowances for interstate differences in the rates of depreciation for like assets, because of differences in physical environment and other such disabilities.

The disabilities currently applied in the assessment are summarised in Table 4, together with the percentage of expenditure to which each is applied. Because disability factors often, in practice, cover more than one of the types of disabilities mentioned above, there has been no attempt to classify them as either quantity, cost or life disabilities.

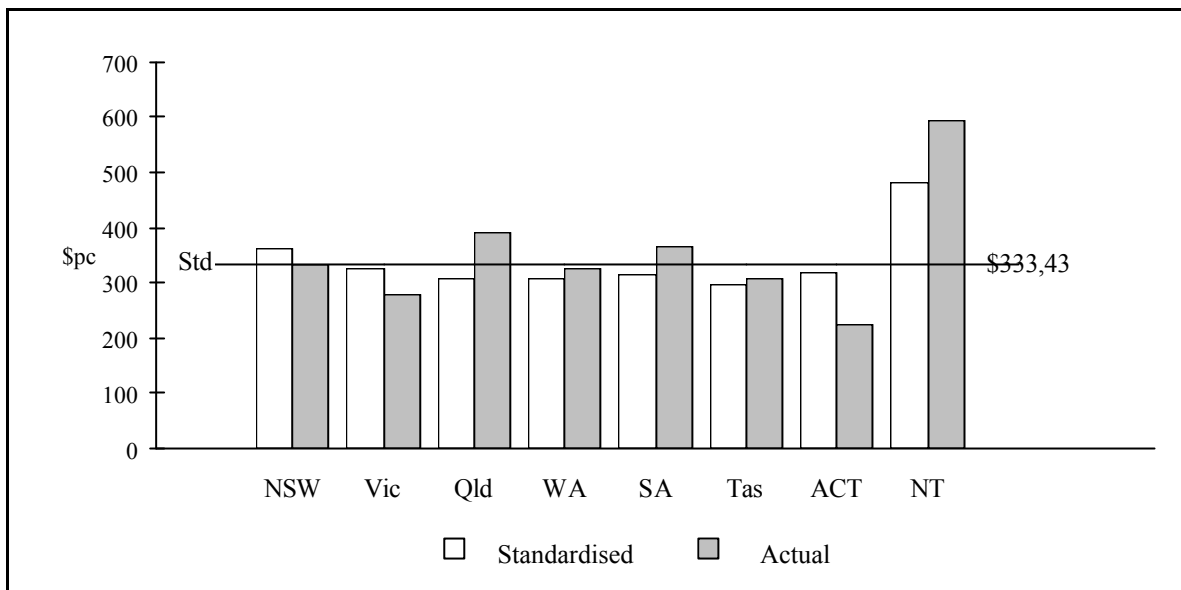
**Table 4 Disability Factors applied in the 1999 Depreciation Assessment**

Disability Factors Applied	Depreciation relating to					
	Urban Transit		Housing Building	Other Building	Other Construction	Other Plant and Equipment
	Construction	Plant and Equipment				
	7.43 %	7.78 %	9.43 %	34.10 %	22.79 %	18.09 %
Socio-demographic Composition.			X	X		X
Construction Costs	X		X	X	X	
Urbanisation (a)				X	X	X
Service Delivery Scale (a)				X	X	X
Administrative Scale (a)				X		
Dispersion						X
Physical Environment			X			
Capital Requirements	X	X				
Asset Life	X	X		X	X	X

(a) Assessed as a combined 'population concentration' factor.

The results of the assessments for 1999-2000, based on the above method (done for the 2001 Update) are shown in Figure 2. It can be seen that the Australian average depreciation expense was \$333.43 per capita, that the expense in New South Wales, Victoria and the Australian Capital Territory was lower than what it would have been if average policies had been applied (the standardised expenditure), and that all other States had a higher than assessed level of expense (particularly Queensland and the Northern Territory).

**Figure 2 Depreciation – Gross Expenditure Per Capita – Standardised, Actual and Standard, 1999-2000**



Without looking at how each of the disability factors has been calculated, there are several questions that arise from the matrix in Table 4. Why do some factors apply to some components and not others? Has the Commission got the same conceptual coverage of disabilities for each component, and are there legitimate reasons for the differences? Some of the specific questions are therefore as follows.

1. Why has the Commission not increased transparency by splitting the influences of urbanisation, service delivery scale and administrative scale within the population concentration factor?
2. Why has the demand aspect of the Urban Transit assessment been approached differently to the same type of disability in the 'other' components?
3. Why has a socio-demographic composition factor not been applied to the Other Construction component?
4. Does the housing component really need both a construction cost and a physical environment factor, but have no demand aspects other than socio-demographic differences?
5. Do the factors applied to the Housing component really obviate the need for an asset life factor?

6. Why do we have an administrative scale factor in Other Buildings but not in Other Construction?

It is possible that the calculation methods or logic within the assessment (that is, the assumed coverage of each of the components and the disability factors) adequately answer these questions but, as at least Western Australia has suggested, this does need to be re-examined.

In their submissions to the Commission since the 1999 review, the States have concentrated on what disability factors should be assessed, and how they should be assessed. They have also looked at the interaction between factors and the relationship between the depreciation assessment and the debt charges assessment. These are all issues that will need to be considered by the Commission again before 2004.

Other major issues raised — whether the assessment should be combined with Debt Charges; whether a stock or a flow approach should be applied; the interaction between the Depreciation and Debt Charges assessments; and whether there is any double counting of disabilities — are discussed later in the paper.

### **The Debt Charges Assessment**

The category of debt charges differs in concept to all others in the standard budget, and the approach taken to its assessment therefore also differs. Unlike any other, the debt charges assessment necessarily relies on other assessments or the data used in and approaches taken in other assessments. The task of the debt charges assessment is to quantify what each State would spend on debt charges if it:

1. had the standard mix of ways of providing itself with access to and use of capital over a long past period (the Commission assumes 30 years) — that is ownership, leases and contracts;
2. had the standard mix of ways of funding its ownership of capital over that period — that is loans, asset sales, funded depreciation and recurrent sources; and
3. had the standard budget result each year over that period.

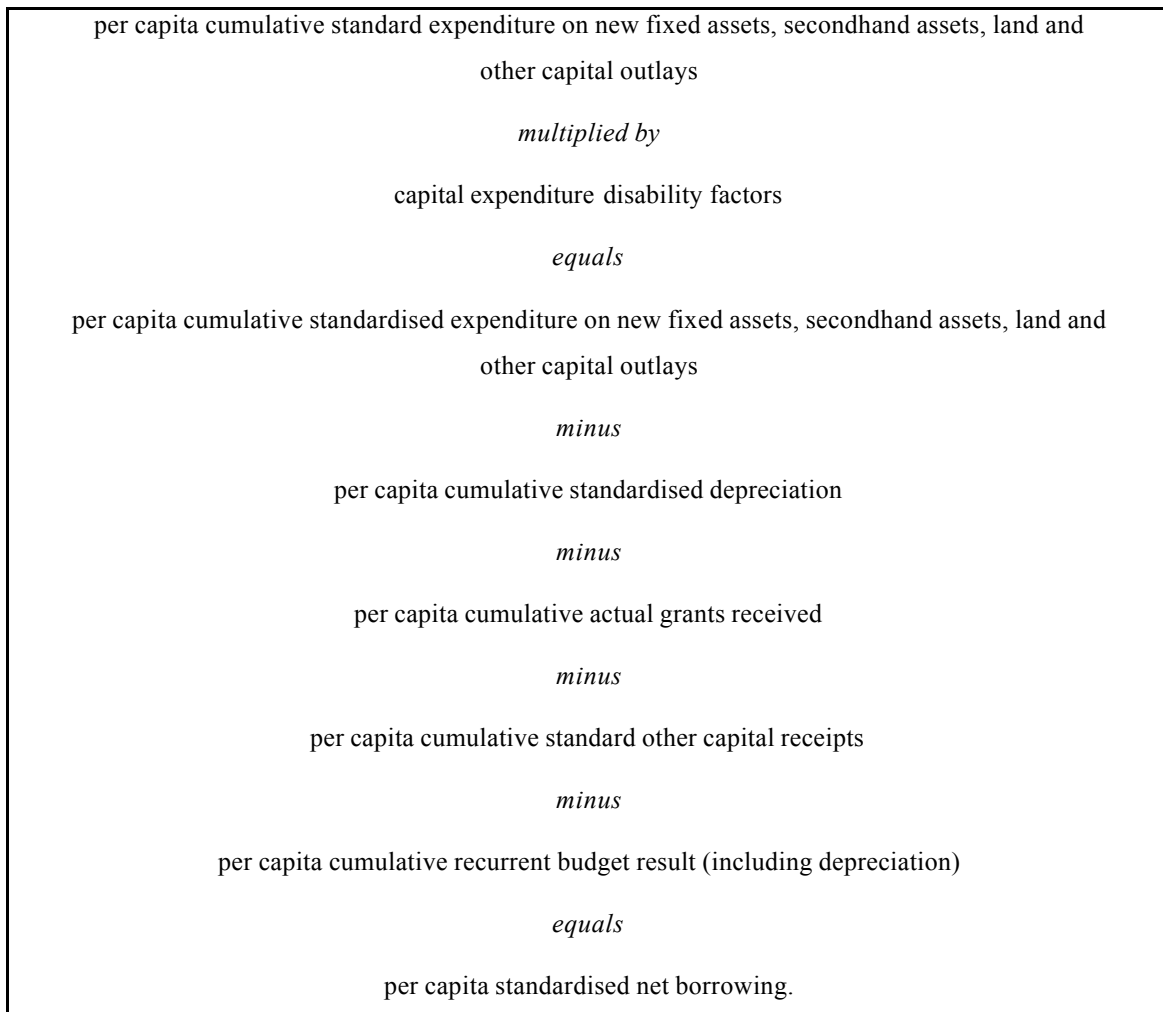
The first two of these clearly rely on capital stock data similar to that used in the depreciation assessment, but stretching back for a much longer period. The last relies on all the assessments undertaken, again over a much longer period than any one inquiry which covers five years. No other category is reliant on other Commission decisions in this way for its conceptual foundation.

The Commission's assessment approach has effectively combined two components. One for the debt charges resulting from capital purchases and the other for the debt charges resulting from accumulated past budget deficits. For the second component, the States have been assessed to have equal per capita needs. There is a question of how this fits logically with the application of a borrowing cost disability factor to the other component of the category. Transparency might be increased if there was a division of the assessment into its two components.

In the 1999 review, the Commission took a flow approach to the debt charges assessment because it saw debt as being determined not by the current value of stock (or the current value of stock purchased through loan borrowings) in the assessment years, but by the value of stock purchased through loans, at its time of purchase. The assessment was done by taking:

*standard per capita debt charges expenditure* and *multiplying* it by  
*cost disabilities*; and  
*demand disabilities*.

The cost (or interest rate) disability factors were arrived at by judgement after consideration of differences States had faced in long term bond rates and the influence of their policy differences on those rates. The demand (or quantity of borrowing) disability factors were calculated according to the framework shown in Figure 3.

**Figure 3 Framework for the 1999 Debt Charges Assessment**

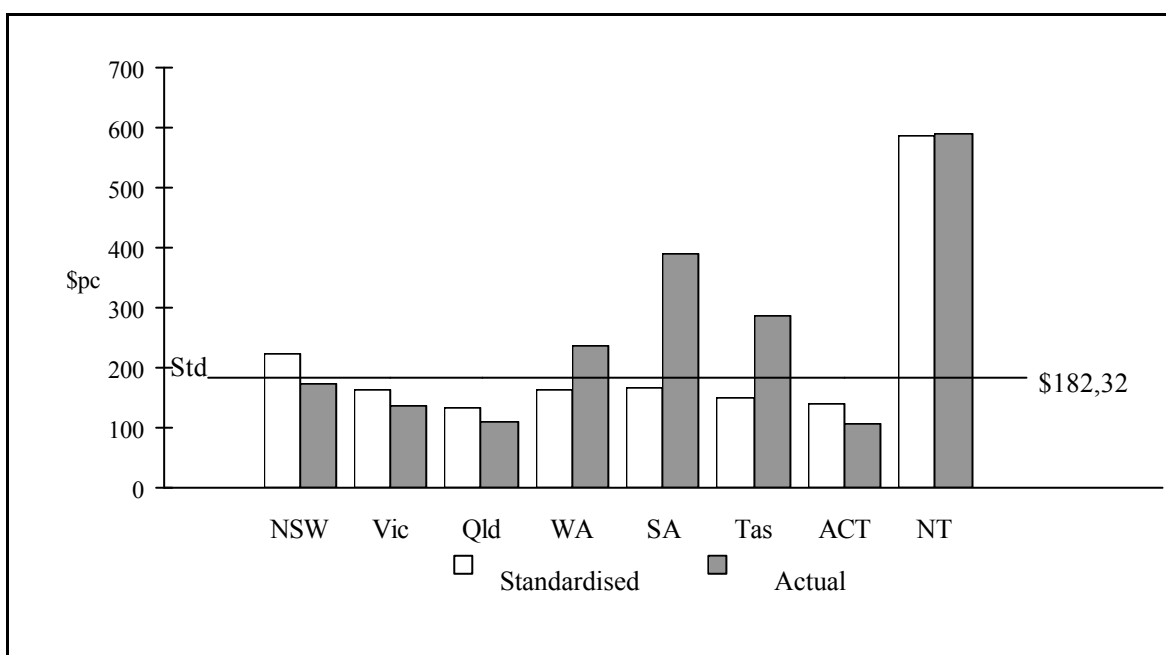
To match the data used in the depreciation assessment, the accumulations to measure States' asset holdings were done over the period since 1961-62 using Australian Bureau of Statistics data on fixed asset purchases by the States. There must, however, be a question of whether this was too long a period and that a more appropriate relationship between asset age and the existence of debt would be between 15 and 30 years.

The capital expenditure disability factors were a blend of the overall disability weights derived in the depreciation assessment (75 per cent) and the overall disability weights derived in the assessments of recurrent expenditures (25 per cent). There was no implicit element in the calculation to cover the land assets that differentiate the asset base here from that used in the depreciation assessment. The assumption was that disabilities applying to the value of land are the same as the mix of 75 per cent depreciation and 25 per cent other recurrent expenditure functions. This could be

reconsidered and some assumed component of the States' standard asset base be varied according to data we hold on the per capita value of commercial and industrial land in each State.

Using this method, the results for 1999-2000 are shown in Figure 4. It can be seen that, against an Australian average expenditure of \$182.32 per capita, the Northern Territory spends nearly \$600 and is assessed as having a need to spend close to that amount (the standardised expenditure). Three States, Western Australia, South Australia and Tasmania spend considerably more than they are assessed to need to spend to provide the average level of services, and the other States are assessed to spend less than what would be needed.

**Figure 4 Debt Charges – Gross Expenditure Per Capita – Standardised, Actual and Standard, 1999-2000**



The States have claimed many faults with this assessment and the Commission has expressed concerns about the extent of the implied policy differences that are resulting in the differences between the actual and standardised levels of per capita expenditure in the States.

The Commission's basic approach to the assessment has been to try to estimate the amount of debt each State would be carrying if, over a past asset accumulation period, each had applied the standard policies of providing assets through ownership, and had

had standard ways of funding asset accumulation. The Commission commenced with an estimate of the total fixed assets that had been purchased (assuming those to which debt might still apply had been purchased since 1961-62), then reduced this amount by the standardised amounts from three sources of funding which it assumed had been available to fund the capital purchases. They were depreciation, capital grants received and other capital receipts.

There appear to be three main difficulties with this approach. The first relates to the fact that depreciation was not funded (or even calculated) for much of the period over which it is assumed to have been available as a source of funds to finance capital expenditure. The standardised amount of debt a State faces in 1999-2000 can be influenced by the capital expenditure undertaken in 1989-90, but it cannot be influenced by the extent to which depreciation funded that expenditure, because there was no funding from depreciation provisions. Depreciation should not be deducted from the capital expenditure until it can be assumed to have been funded and used for that purpose.

The second is that a source of funding that has been used over the full accumulation period has been omitted from the calculation: recurrent revenues. The importance of this omission will depend on what type of assets are included in the data on new fixed assets, secondhand assets and other capital outlays on which the calculation is based. If it covers all depreciable assets, including minor plant and equipment, it is likely that, even in the early years, this omission will be of importance. In more recent years, because of States' policies to fund social infrastructure from recurrent resources, the omission becomes much more important. Any assessment of the extent to which States have been able to fund capital expansion from recurrent revenues would be a standard proportion (based on their experience) of total standardised recurrent revenue.

The third is that there is no assumption being made about a standard rate at which debt is being paid off. The assumption is that no capital has been paid off since 1961-62, and if the States had different rates of standardised capital accumulation during the early part of the period in particular, this should be differentially influencing the standardised net borrowings figures being calculated. Applying an assumed rate of repayment of capital would also link logically to the asset life assumptions made in the depreciation

assessment, as it could be considered standard policy to repay debt over a maximum period equal to the expected life of the asset.

There must also be a question, as South Australia has suggested, of when in the process the capital expenditure disabilities are applied. Clearly, it must be before the cumulative recurrent budget result is subtracted, but whether it is before any, or all, of the three assumed sources of funds are subtracted is worth more consideration. Subtracting them after the standardisation of the capital asset holdings allows the extent to which grants and depreciation provisions are not needs-based to be adjusted for in the assessments (in the same way as the inclusion approach does for SPPs). It is interesting to note in this regard that the impact of the standardised distribution of depreciation is being decreased by the extent to which the recurrent expenditure based factors used (weighted by 25 per cent) in determining the capital expenditure disability factors differ from the depreciation needs factors. The correct procedure for these two sources of funds is probably to deduct them after standardisation — this is what is currently done.

For other capital receipts, whether they should be deducted before or after standardisation depends on what assumptions are to be made about the assessment of States' abilities to raise revenues from this source. The present approach attaches the capital expenditure disabilities to expenditure funded from this source of revenue. To subtract the standard revenue before applying the capital disability factors would be to assume States had an equal per capita capacity to raise these revenues. Probably, neither approach is correct.

There are also likely to be many ways in which the calculations of the individual adjustments (disability factors) to the base data can be improved, and in how the capital grants and other capital receipts can be more appropriately handled. The States' recent submissions have concentrated on these aspects rather than the general structure and have made many suggestions for future research. The concentration in their submissions has understandably been the capital expenditure disability factors as these drive the results to a large degree. They certainly need close consideration.

### **Interactions between Depreciation and Debt Charges**

The Commission and all the States are concerned about the interaction between the Depreciation and Debt Charges assessments, and the possibility that there may be

double counting of disabilities. Queensland (and its consultant) and Western Australia see the difficulties as being best overcome if the assessments are combined.

There is no doubt that the two functions are linked because, in practice, most debt is entered into for the purchase of assets that then become depreciable. In principle, however, the two expenses can still be seen as quite distinct functions of government. Depreciation is the cost to government of it providing itself with capital to be used in the provision of services. This expense exists no matter how the provision of the asset has been funded, and may or may not have cash implications.

Debt Charges, on the other hand, is related to but not reliant on the holding of assets through which services are provided. Debt Charges expenditure (which is a cash outlay) results simply from a method of funding. In reality, the debt charges category could be split into two components, one relating to the use of loans to fund capital purchases, the other (presumably much smaller) relating to the use of loans to fund recurrent deficits. Would the provision of, say teaching services, have any different relationship to the second component of debt charges than the provision of the schoolroom might have to the first?

For simplicity and transparency, and because they are different expenditure functions of government, it is better to keep the two functions as separate as possible. There is nothing wrong in principle, however, with applying the factors derived from standard levels of State asset holdings used in the depreciation assessment to the debt charges assessment, if those disabilities are believed to be representative measures of the differences in States' needs to hold assets. That is not double counting or implying the depreciation disabilities apply. It is saying no more than that the same calculation can be used to indicate disabilities in two categories. This approach is common in the administrative scale disability factor, for example, where the Commission weights the basic line of relative disabilities differently for different categories.

We have seen above that a legitimate question arises as to how to treat depreciation funded capital in the debt charges assessment. At least to the extent that the depreciation expense is funded, it should be seen as a source of funds available for capital purchasing and thus used to reduce future debt charges. In this sense, however,

depreciation is a source of revenue, not an expense, and this is what the limit of formal interaction between the two expenditure assessments should be.

If the two assessments use the same base data on capital accumulations, it obviously needs to be from the same source and be used in a compatible way, but that is no different to the many assessments that use, say, population age and sex data. It also must be used consistently and be obtained from a consistent source.

### **Stock or Flow Approaches**

After several years debate of whether the assessments of depreciation and debt charges should be based on a stock or a flow approach, and whether the assessments have to be handled the same way in this regard, there is still some confusion as to how the terms should be used in the discussions. Western Australia believes that ‘flow factors are disability factors which apply to changes in the quantity of stock over time’<sup>23</sup>: that is, the variation between years. Others think of flow factors as a set of factors that are based, one for each year, on data relevant to the stock at a series of points in time, then averaged (and weighted if necessary) to apply to the more recent points in time for which the assessment is being undertaken.

The latter approach seems to look at disabilities associated with the actual levels of stock (and debt charges) needed at points in time, rather than disabilities that cause differences in stock (and debt charges) needed between points in time.

I don’t think there is any question as to flow or stock approaches when describing the depreciation and debt charges assessments for a year, or for a period of five years. They must be conceptually the same for both categories — they are what the States would have spent in each year if they had all been applying the same policies in that year with the same level of efficiency. They are a stock concept.

The difference comes about when consideration is given to what cost disabilities drive differences in the States’ expenses in a year, and what data should be used in quantifying those cost disabilities. If the data on which disabilities are based relates to the year of assessment, then we might say a stock approach is being taken to the

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<sup>23</sup> *Western Australia’s Submission to the Commonwealth Grants Commission’s 2004 Review*, February 2001, Treasury Department, p 13.

assessment, the same way we might say the relevant population calculation in many other categories is a stock assessment.

If the expense in the year results from a series of past events, and we need to look at the accumulation of those past events when quantifying the disability, we might say a flow approach is necessary to determine the disabilities that apply in the year, and that a flow approach is being taken to the assessment. The use of a flow or a stock approach to assessing disabilities must be taken on a case-by-case basis and can (and should) differ between functions.

If depreciation and debt charges are seen as two separate functions of government, there is no reason why the same approach needs to be taken in their assessments. Depreciation is an expense that is determined by the value of stock at the start of the assessment year, plus revaluations, purchases and sales of stock during that year. It is basically a stock based concept and should be assessed that way.

The level of the States' debt charges expenditure in any year has been determined by their actions over many years (the Commission assumes 30 years) prior to the year of assessment, as well as decisions taken during the year of assessment. It has resulted from a flow of decisions and the quantification of the disabilities States suffer should therefore be approached from a flow related perspective. The debt charges assessment is different to other expenditure assessments in this regard.

There is no reason in principle why the depreciation and debt charges assessments should be made on the same basis. There is a need, however, to ensure that the interaction between the two assessments (discussed earlier) is on a consistent basis where it needs to be. If depreciation is seen as a method of financing capital expenditure, and thus reducing the need for debt, then a depreciation assessment must be done for each of the flow of years on which the debt charges assessment is based.

### **An Asset Sales Assessment**

Revenue from asset sales can be used for many purposes. Some of the more obvious ones are:

1. to fund recurrent deficits;
2. to fund capital expenditures;
3. to repay debt;
4. to increase cash holdings; and
5. to fund provisions (such as for Depreciation).

Each of these purposes has either direct or indirect impacts on the operating accounts of the States, and influences their capacity to provide services to their citizens, the equalisation of which is the objective of the Commission's procedures.

In the current determination of relativities, there is no assessment of States' capacities to raise revenue from this source, but it has been argued earlier in the paper that such an assessment is necessary. The logical revenue base would be the total value of assets, and the logical standard extent to which this revenue base was used would be the value (sale price) of the assets sold in a year. On this basis, it is likely that a very small standard 'rate of effort' would be applied to a very large per capita revenue base. Much of the revenue from minor asset sales is probably already included as recurrent revenue or expenditure offsets so, to be correct, the value of this type of asset should be removed from any revenue bases used in this assessment.

The assessment framework probably should also differentiate between intangibles and other assets if States have a different tendency to sell different types of assets. It would also rely on the collection of what might be classified as commercial-in-confidence data — asset sale prices. Whether it would be possible to get the relevant data must be doubtful. It is possible that there are no complete registers of government land, or valuations made of that land, even if a register is kept. The problem of defining, identifying and then valuing intangible assets will be even greater.

In principle, however, an assessment should be done and we know what data are necessary to do that assessment.

## PART 4 CONCLUSIONS

The Commonwealth Grants Commission did not seem to give sufficient thought to the way it was proceeding when it started to favour the recurrent impact of capital approach over the direct assessment approach in 1990. Its confirmation of that approach seems to have been taken on a pragmatic basis.

Notwithstanding these limitations in its processes, however, it does seem to have made the correct choice. For its purposes, it is better to approach the assessment of States' relative capital funding needs by looking at the recurrent impacts of capital.

There are, however, two major issues to which the Commission needs to give further consideration.

1. Should it include an assessment of States' capacities to raise revenue from the sale of assets, at least to the extent that this source of revenue is being used to fund services or the access and use of capital necessary for the provision of those services?
2. Should it change its method of treating capital grant receipts so as only to include those that States would have been used in such a way as to impact on the recurrent debt charges figures?

There are also many issues relating to the assessment of individual disability factors that need to be debated fully in the Working Party of Commission and Treasury officers that has been established for that purpose.

Clarifying these questions may well be *the final steps* by the Commonwealth Grants Commission in establishing the theory of fiscal equalisation through an untied grants system. Whether the results of such a 'pure' theoretical model will be practical, or politically and culturally acceptable is another question.

Every fiscal transfer system, whether based on equalisation or some other criteria, must complement the cultural, social and political environment of the country for which it is designed. It is at least possible that Australia may find it necessary, over time, to move away from the largely theoretical model it currently uses and become a little more

pragmatic. If that occurs, it will at least have done the theoretical work and know why it has moved away from 'full equalisation'.