



Group of Eight

POSITION PAPER ON THE INDEXATION OF UNIVERSITY GRANTS –

*Prepared in response to the review of indexation required by
the Higher Education Support Act 2003 (Cth).*

GROUP OF EIGHT UNIVERSITIES

The Group of Eight is a coalition of Australia's leading universities. Membership comprises The University of Adelaide, The Australian National University, The University of Melbourne, Monash University, The University of New South Wales, The University of Queensland, The University of Sydney and The University of Western Australia.

Executive Summary

The way that Commonwealth grants to universities are adjusted or indexed each year is a critical issue for the Group of Eight and Australian universities more generally.

For close to a decade Commonwealth grants to Australia's public universities have been indexed according to a method that bears little relationship to changes in costs. As a result, the rate of growth in university operating grants has fallen seriously behind increases in average weekly earnings and Commonwealth grants to schools.

On one estimate discussed in this position paper, if the wage component of university grants alone had been adjusted according to increases in average weekly wages, rather than the wages of Australia's lowest paid workers, then between 1997 and 2003 Australian universities would have received almost \$3 billion in additional Commonwealth funding.

This paper seeks to focus attention on the key issues that need to be taken into account by the government in its review of indexation. The paper:

- Provides historical background on the current mechanism for the indexation of university grants and highlights the fact that when originally introduced, the present method of indexation was always intended to be reviewed and replaced, if necessary, with a method that better reflects actual changes in costs.
- Compares the index used to adjust university grants with a range of other comparable measures of price changes. In particular, the indexation arrangements for universities are contrasted with the significantly more generous method the Commonwealth uses to adjust its funding to schools.
- Demonstrates the impact of inadequate indexation on Australian universities in terms of the decline in academic salaries relative to the wider community and increases in student-to-staff ratios.
- Questions the purpose behind the indexation of Commonwealth grants to universities and argues that this needs to be clearly articulated.
- Calls on the government to develop, through the Australian Bureau of Statistics, a *Higher Education Input Cost Index*, to accurately measure changes in university operating costs over time.
- Concludes that a measure based on the Wage Cost Index (Education) and the Consumer Price Index, represents as good an approximation of the changes in costs in the higher education sector as is currently available.
- Recommends that in the absence of an index which properly reflects increases in costs across the sector, the current method of indexation should be replaced by a model based on 75 per cent Wage Cost Index (Education) and 25 per cent Consumer Price Index.

Without adequate indexation, the capacities of Australia's universities to maintain the quality of their buildings, libraries, laboratories, teaching and research services are at risk, as are their abilities to remain competitive in an increasing international higher education environment.

If the Commonwealth is serious about Australia having a world class higher education system, then as a starting point it is essential that the way university grants are adjusted from year-to-year properly reflects actual increases in the costs that universities face.

Introduction

In December 2003, the Minister for Education, Science and Training, the Hon. Dr Brendan Nelson MP, committed the government to undertake a review of the current indexation mechanisms for the Commonwealth funding of universities.¹ The review, which must be completed by February 2005, is being undertaken internally by the Department of Education Science and Training, in consultation with the departments of Prime Minister and Cabinet, Finance and Administration and Treasury. This position paper represents the Group of Eight's formal contribution to the review. The paper seeks to provide a context for the review and to focus attention on the key issues supporting the case for change in the way that Commonwealth grants to universities are indexed.

The importance of indexation for the Australian higher education sector

The way Commonwealth grants to universities are indexed is a critical issue for Australia's higher education sector because if the rate of indexation is less than the real rate of the cost increases universities face, then there is an effective cut in resources. If this happens over a long period of time, as it has in Australia, the financial impact is substantial and the capacity of universities to provide quality services is jeopardised. For example, as a result of the different indexation mechanism applied to university operating grants, as opposed to schools, between 1997 and 2002, grants to universities increased by less than 10 per cent compared to more than a 30 per cent rise over the same period in the index used to adjust recurrent Commonwealth funding for schools.² On one estimate discussed in this paper, if the wage component of university grant indexation had been linked to increases in average weekly wages, rather than the wages of the lowest paid workers in Australia, then between 1997 and 2003 Australian universities would have received close to \$3 billion in additional Commonwealth funding.

Background to the current mechanism for the indexation of university grants

1974 to 1995

In 1974 when the Whitlam Labor government abolished university fees it agreed to index grants to account for the changes in costs universities would experience over time. The method of indexation then adopted was sustained from 1974 to 1995. The Tertiary Education Commission maintained several indexes, compiled by suitably weighting the component items of each. The indexes were the *Academic salaries index*, *General salaries index*, *Non-salary costs index*, *Equipment grant index* and a *Building cost index*.³

¹ The legislated terms of reference for the review are included in **Appendix A**.

² G Burke and P White, *Price measures in education and training; opening a discussion*, December 2003, p.1.

³ The Tertiary Education Commission described the method in 1979 (TEC 1979 Appendix 14).

Academic salaries index, based on movements in salary rates set for each category of staff distinguished by the (since abolished) Academic Salaries Tribunal. Allowance was made for salary related changes such as payroll tax and leave loading.

General salaries index, based on movements in wages and salaries in the Australian Public Service for positions similar to those of university general staff.

Non-salary costs index, for costs of non-salary items including consumables, books and periodicals, stationery, post, utilities, travel and maintenance. This was based on a variety of data sources including the ABS.

Equipment grant index, designed to measure the prices of equipment including computers. This was based on ABS estimates for private capital expenditure excluding housing and other building and construction costs.

Building cost index, based on ABS data on building costs.

Universities' recurrent grants were adjusted by an index which was the weighted average of the indexes for academic salaries, general salaries and non-salary costs. The weights were set according to the relative size of each of the components of recurrent expenditure, not the patterns of individual universities. Equipment grants were adjusted by the equipment grant index. Approved grants for capital purposes were adjusted by the Building Costs Index. The precise timing of adjustments was carefully specified with some adjustments being allowed for quarterly changes in costs and others only on an annual basis.

1996 to the present

In the 1995-96 budget the then Keating Labor government announced a major change in the ways by which Commonwealth grants for a wide range of activities were to be adjusted for price increases. The reasons for the change were the replacement of award rates of pay by pay based on enterprise bargaining and the intention of the government not to fully fund cost increases. As stated in Commonwealth Budget Paper No.1 (Commonwealth 1995, page 3-18):

The previous arrangements were largely based on two types of measures of change in labour costs both of which are no longer appropriate. On the one hand, measures of total wage growth include pay increases which are meant to be offset by higher productivity, but on the other hand award wage indexes are increasingly irrelevant in the enterprise bargaining environment. New arrangements have now been developed which will be more appropriate, simpler and fairer.

*The new indexation arrangements comprise two components. Indexation for wage costs will be based on the Industrial Relations Commission's Safety Net Adjustment as a proportion of Average Weekly Earnings. Indexation for other non-wage costs will be based on the Treasury Measure of Underlying Inflation. These two measures will be combined in 'cocktail' indexes with four different weightings of wage costs (40%, 60% 75% and 90%). The particular cocktail applied to each affected program will be determined by the proportion of its funding spent on labour costs. The wage measure in the new indexation arrangement will be reviewed once the ABS has developed a new Labour Cost Index to replace the outdated award wage indexes. ...The new arrangements will affect all programs with substantial wage costs across the whole of government.*⁴

The new method of indexation was designed to deal with two problems. The first was that 'award wage indexes are increasingly irrelevant in the enterprise bargaining environment'. The second was that 'measures of total wage growth include pay increases which are meant to be offset by higher productivity.' The then government's solution to these two issues was to ignore costs in any of the sectors it funded and opt for the adjustment in which the main component was the Safety Net Adjustment (SNA). This is the annual dollar adjustment for the lowest paid workers in Australia. The 'cocktail' adopted for the higher education sector was a 75 per cent weighting for wage costs and a 25 per cent weighting for non-wage costs. This index became known as the Cost Adjustment Factor or (CAF).

⁴ It is worth noting that the 1995 Budget Paper No.1 also stated 'Social security payments and other types of income support will not be affected. In the case of recurrent funding for government and non-government schools the Government reaffirmed the use of the Australian Government School Recurrent Cost (AGSRC) index. The AGSRC was implemented in 1993, as part of the Government's commitment to maintain: the quality of education in non-government schools relative to those in government schools; freedom of choice for parents between education institutions; and the relative levels of Commonwealth and State funding to government schools.... (pages 3-18,19).

From 1996, the notional salary component of university operating grants (75 per cent) has been indexed annually on the basis of the SNA as determined by the Industrial Relations Commission. Until 2001 the notional non-salary component of operating grants (25 per cent) was indexed annually on the basis of the Treasury Measure of Underlying Inflation (TMUI). From 2001 onwards the non-salary component has been based on the Consumer Price Index (CPI). The combination of these two measures (75 per cent SNA and 25 per cent CPI) results in an annual Cost Adjustment Factor (CAF). Figures for the CPI and SNA are provided by the Department of Finance and Administration in June each year, shortly following the Federal Budget. The resulting CAF applies to the whole of the following calendar year and indexation starts from the first payment of that year.

Simpler?

The new arrangements were said to be ‘*more appropriate, simpler and fairer*’. There is no doubt they are simpler: they involve no collection of data on prices and costs in any of the areas funded and the same indexes for the wage and non-wage elements are used for most areas of Commonwealth funding, with the notable exceptions of recurrent grants to government and non-government schools, social security payments which are largely adjusted to the CPI, and MPs’ salaries which are indexed to reflect current market trends.

More appropriate and fairer?

It is difficult to see that the arrangements are more appropriate or fairer. The selection of the SNA as the wage measure appears to have been chosen as a mechanism that will yield a wage adjustment considerably less than the average increase in earnings in any sector. Its use automatically builds in some inexact but substantial amount of ‘efficiency’ or ‘productivity’ reduction in the funding per unit of output. To be convinced that the measure is more appropriate and fairer requires more transparency in its application and documentation of the size of its effect compared with maintaining real funding per unit of output.

Since the shift to the CAF from the start of 1996 the government has not indexed its grants to reflect actual increases in costs. The government acknowledges this fact annually through the Triennium reports released by the Department of Education, Science and Training which consistently contained statements along the following lines:

*The Higher Education Cost Adjustment Factor (CAF) is an index reflecting the **contribution the Commonwealth makes towards increases** in the operating costs of higher education institutions. **The CAF does not measure actual price rises** but the Commonwealth’s contribution towards annual increases in salary and non-salary costs.⁵*

In other words, the government recognises that the CAF provides only a partial contribution towards the real additional costs faced by universities. Yet unlike private firms or some government funded schools, Australian universities face arbitrary restrictions on their capacities to pass on cost increases to their main customers—undergraduate domestic students. While increases in allowable HECS charges introduced in 1997 and 2005 have given some flexibility in this regard, without proper indexation, pressure will grow inexorably for universities to seek fee increases over-and-above those currently permitted.

⁵ Department of Education Science and Training, *Higher Education Report for the 2003 to 2005 Triennium*, 2003, p.120.

Development of a Labour Cost Index

Commonwealth Budget Paper No.1 of 1995 also indicated that the '*wage measure in the new indexation arrangement will be reviewed once the ABS has developed a new Labour Cost Index to replace the outdated award wage indexes*'. The Australian Bureau of Statistics has produced a Wage Cost Index (WCI) since September 1997, but it has not been used by the Department of Finance and Administration in any of its cost adjustment measures. The WCI covers changes in wage and salary cost of a representative 'basket of jobs' over time, unaffected by changes in the quality and quantity of work performed.

The ABS also intends to produce a Labour Cost Index (LCI) in the near future. The LCI would include the wage and salary measure of the WCI and also measures of non-wage items including paid leave, employer funded superannuation, payroll tax, workers' compensation, fringe benefits and fringe benefits tax.

As shown in Table 1 below, the WCI for the education industry or for professional occupations has increased far faster than the SNA measure. If the LCI had been available for recent years, incorporating superannuation changes, it is likely that it would have risen even faster than the WCI.

Price data

The variation among a range of price indexes over a five year period is illustrated in Table 1 below. The largest increase is in average weekly earnings for all full-time adult employees (AWE), which grew 25 per cent or nearly 5 per cent per annum. The smallest is the measure of wage costs devised by the Department of Finance based on the wage changes of the lowest paid workers and expressed as a percentage of average weekly earnings. This measure, which rose only 8 per cent over the five years, represents 75 per cent of the CAF applied to university grants.

The national accounts provide measures of compensation per hour of employees. The measure for all employees rose almost as much as average earnings. The measure for employees in the education industry rose by 21 per cent. The Wage Cost Index (WCI) which measures the wage changes for a given 'basket' of occupations increased by 19 per cent from 1997 to 2002. The WCI may, however, have understated total labour costs in that it excludes costs such as employer contributions to superannuation, which grew relative to wages over this period. The major measure of consumer prices, the CPI, increased by 15 per cent whereas the measure of prices for the whole Gross Domestic Product increased 12 per cent only. It should be noted, however, that productivity improvements help restrain general price increases below the general level of wage increases.

Table 1. Selected cost measures, Australia, percentage increases 1997 to 2002

	%
Average Weekly Earnings, AWE, Full time adult ordinary time earnings	25
National Accounts Compensation per hour – All employees	23
National Accounts Compensation per employee per hour - Education	21
Wage Cost Index WCI (Education industry)	19
Wage Cost Index WCI (Professional occupations)	19
Wage Cost Index WCI (All occupations)	17
Consumer price index CPI	15
GDP deflator	12
Non-farm GDP deflator	11
Safety Net Adjustment SNA Factor	8

Source and notes: ABS and the Department of Finance and Administration. WCI is for total hourly rates of pay excluding bonuses. A base rate for the WCI for 1997 has been estimated based on the September 1997 value.

Table 2 below lists several measures which combine wage and non-wage indexes. The lowest increase is in the CAF, which combines the SNA and (since 2001) the CPI. It grew by less than 10 per cent over the five years.⁶ The highest is in an index with the wage element measured by the change in average compensation of all employees in the community. The increase in this index is nearly 21 per cent, or 11 per cent more than the CAF over the five year period. For reference the table also includes the AGSRC which is the measure used to adjust Commonwealth general recurrent grants to government and non-government schools. It increased by over 30 per cent over the five years, far faster than any other adjustment measure.

The Commonwealth has made some adjustments to university grants over and above that arising from the CAF since 1996 and further adjustments are planned for the period 2005 to 2007.⁷ These, will, however, have very little impact on the relative reduction that has occurred since 1995.

⁶ More detail on the CAF is provided in **Appendix B**.

⁷ An additional 1.5 per cent of operating grants was paid to universities which complied with the requirements of the Workplace Reform Program:

http://www.dest.gov.au/highered/programmes/workplace_reform/default.htm

The Commonwealth will increase its contribution per student place by 2.5 per cent from 2005, building to a 7.5 per cent increase by 2007 on the condition that universities adhere to the National Governance Protocols and the Commonwealth's Workplace Relations Policies.

Table 2. Alternative adjustment indexes, size of increase Australia, percentage increase 1997 to 2002

	%
CAF (75% SNA + 25% CPI)	9.7
75% WCI Education +25% CPI	18.0
Professional WCI (75% WCI Professionals+25% CPI)	18.0
Compensation per hour per employee education (CPEE) (75% CPEE+25% CPI)	19.5
Compensation per hour employee all industries (CPAI) (75% CPAI+25% CPI)	20.6
Average Government School Recurrent Cost (AGSRC)	32.7

Source: ABS and DEST.

Note: CAF is the cost adjustment factor used by DEST for operating grants in higher education; is the adjustment measure used for Commonwealth General Recurrent Grants for government and non-government schools. It is based on the recurrent expenditure from government funds in government schools. AGSRC estimate is the average of primary and secondary school values.

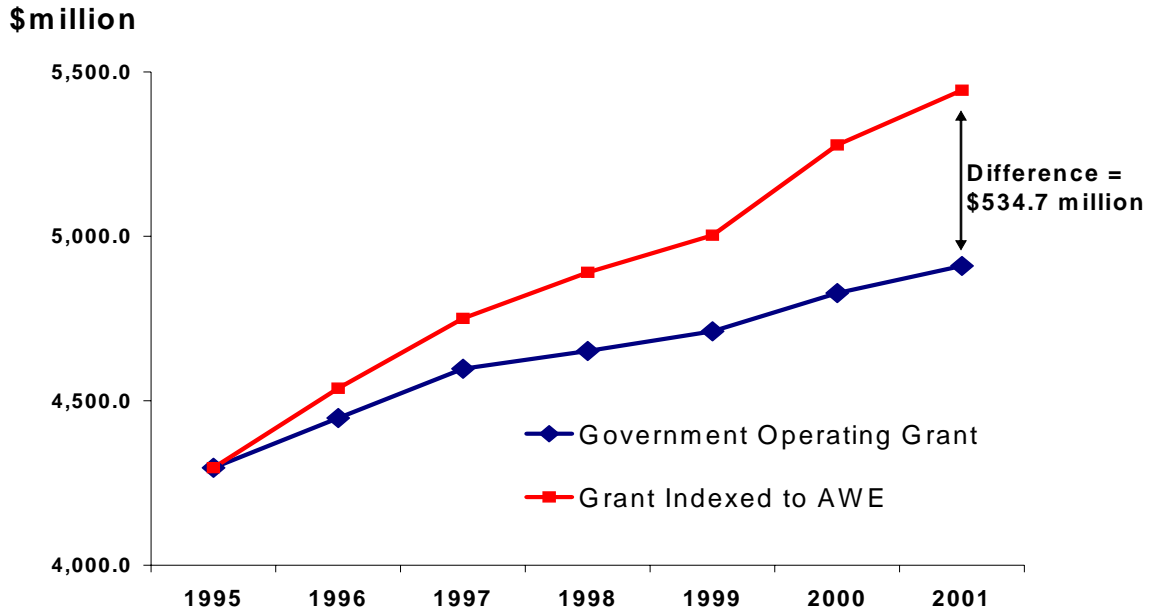
The extent of the funding gap

Various recent studies have measured the extent of under-funding the higher education sector has experienced since 1996 as a result of CAF indexation. According to one study, if the notional salary component of university operating grants had been indexed in line with changes in Average Weekly Earnings, rather than the Safety Net Adjustment, then by 2001 the sector would have received \$535 million per annum more than it did through CAF indexation.⁸ Another study estimates that substituting AWEs for the 75 per cent SNA component of the CAF since 1997 would have resulted in an extra \$845 million in operating grants across the sector in 2003 alone and found that if the salary component of university grants had been indexed in line with AWEs between 1997 and 2003 then an additional \$2.97 billion would have flowed to the sector.⁹ Charts 1 and 2 below show the growing gap due to the use of the CAF as opposed to other measures of changes in wages and other operating costs.

⁸ *ibid.*, p.2.

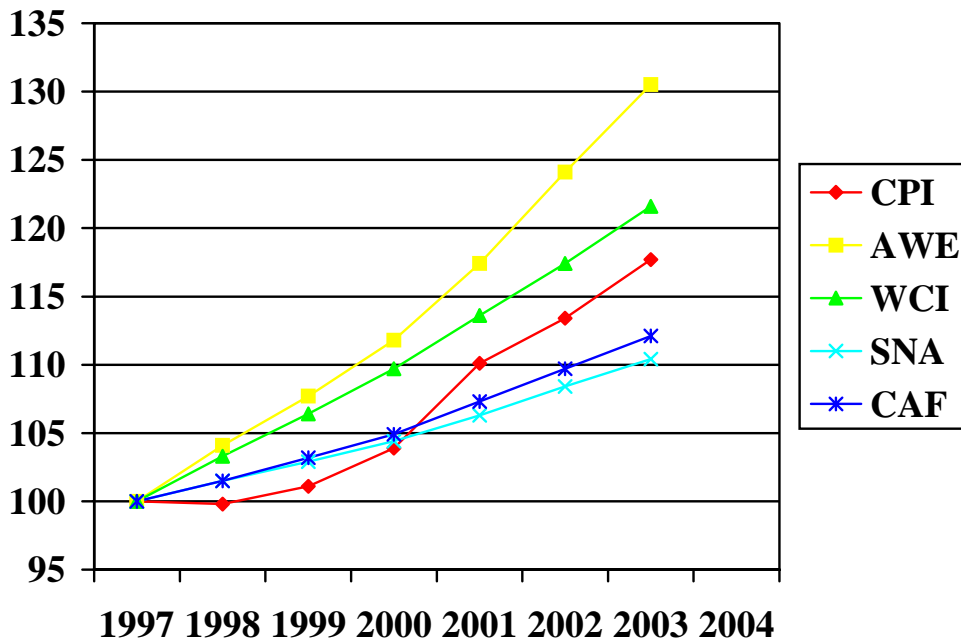
⁹ M. Gallagher & J. Mitton, *A Comparison of Different Index Values of the Salary Component for Higher Education Funding*, November 2003.

Chart 1
University Base Operating Grants:
Actual Funding Compared to an Average Weekly Earnings Index



Source, Burke and Phillips, 2001.

Chart 2
Cost Indicators indexed, 1997 =100.

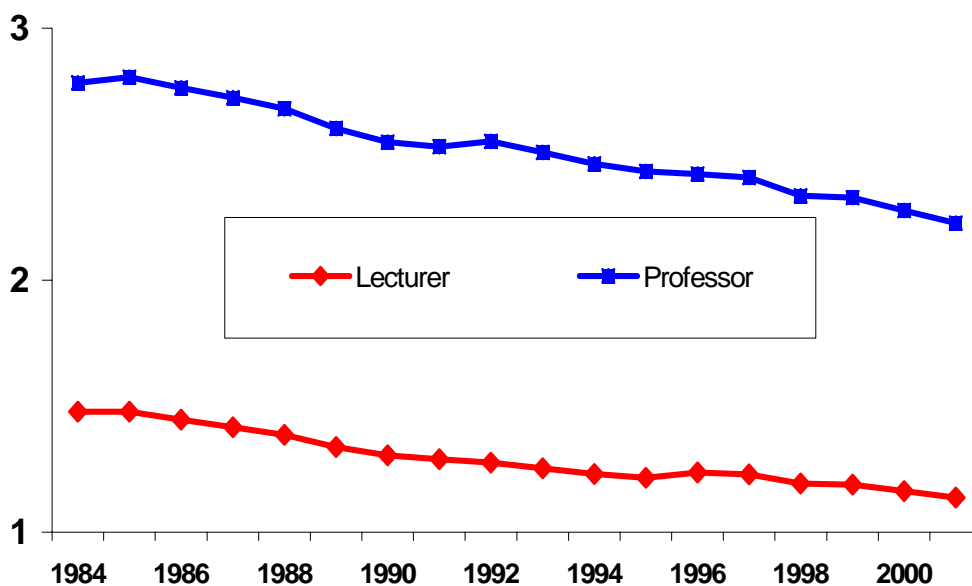


Source, Gallagher & Mitton 2003.

The impact of the funding shortfall

The impact of funding pressures on Australia's universities has been highlighted by tracking academic salary levels and student-staff ratios.¹⁰ The chart below shows the long-term decline in the remuneration of academics compared to average weekly (ordinary-time) earnings.

Chart 3
Academic Salaries as a Proportion of Average Weekly Ordinary Time Earnings



Source: Chapman 2001. Figures calculated from Academic Salaries Tribunal data (to 1996), ANU academic salaries data and ABS AWE series, 6202.0.

In 2001 a study estimated that the relative decline in academic salaries since the early 1980s was in the order of 25 per cent and argued that this was: *'of consequence for the higher education sector because it means that for a long time there have been increasing difficulties in attracting the highest quality staff, and this must have implications for the delivery of higher education services.'*¹¹

According to Burke & Phillips, if it was: *'accepted that salary increases greater than the SNA and roughly equal to the increases in average earnings in the community are inevitable (and arguably desirable) for university staff, then the main remaining element to balance the funding equation is the number of staff employed. The shortfall between income and expenditure must be met substantially by constraining or cutting staff numbers. This in turn contributes to increased student-staff ratios.'*¹²

The relative decrease in public sector funding since 1995 has contributed to increases in student-staff ratios – from around 15 in 1995 to 21 in 2003¹³. While factors such as improved technology

¹⁰ B. Chapman, *The Higher Education Funding Debate: Returns to Educational Investments, Current Pressures and Some Suggestion for Reform*, 2001.

¹¹ *ibid.*, p.4.

¹² G. Burke and D. Phillips, "The Implications of Recent Adjustment of Government Funding Approaches to Higher Education", mimeo, Monash University, 2001, p.3.

¹³ Chapman, *op.cit.*, and Australian Vice-Chancellors Committee Statistics Collection:

http://www.avcc.edu.au/documents/publications/stats/Ssr_03_full_year.xls

and efficiency may have partly contributed to the increase in student-staff ratios, studies have concluded that the funding shortfall due to inadequate indexation has been a major contributing factor.¹⁴

In assessing the impact of inadequate indexation of university grants two other factors, though outside the terms of reference of this review, should also be noted. The first is that under the purchaser-provider model being used in 2005 the government pays set amounts per student in each of the ten funding clusters and two national priority disciplines. Whether these are appropriate starting points for indexation is not being examined. For some disciplines, an inadequate level of base funding may be as important an issue as the method of indexation. Another factor is that at the time the current method of indexation was adopted the sector also experienced significant cuts in Commonwealth funding as a result of the government's 1996-7 budget. In that budget operating grants were cut by 1 per cent for 1997, 3 per cent for 1998, and a further 1 per cent for each of 1999 and 2000.¹⁵ Inadequate indexation is part of a larger set of funding problems and issues.

Conclusion

The key question to be addressed in the current review of indexation arrangements for the higher education sector is what is the purpose of the indexation? This has never been clearly articulated by the present government, or its predecessor. If the purpose is to maintain a particular standard of service and facilities, then funding needs to be adjusted by the cost of maintaining these standards. This is the policy approach the government has applied, for example, to the Commonwealth funding of schools.

If, on the other hand, the purpose of indexing Commonwealth grants to universities is to force productivity and efficiency improvements on the sector then this needs to be explicitly stated and a mechanism put in place to measure the 'efficiency' dividend the government is extracting from the sector each year through inadequate indexation. As discussed above, the CAF comprising 75 per cent SNA and 25 per cent CPI is not a measure of costs in the university sector. It is an arbitrary measure chosen to yield a wage adjustment considerably less than the average increase in earnings in any sector. This is acknowledged every year by DEST in its Triennium reports.

In the interest of transparency, there is a need to develop an index which accurately measures increases in university operating costs over time. The maintenance of such an index, which could be called, for example, the *Higher Education Input Cost Index*, would provide important information for examining resourcing and productivity changes in the sector. Such information would be valuable independent of any use it might have in adjusting government funding levels. Ideally, the production of such an index should be handled by an independent agency such as the Australian Bureau of Statistics, free of interests in the outcomes of the estimates.

Failing the development and introduction of an indexation measure which properly reflects costs increases across the sector, the Group of Eight considers the measure (75 per cent WCI (Education) and 25 per cent CPI) as good an approximation to the changes in costs in higher education as is currently available. The failure to introduce more realistic indexation of university grants will further damage the quality of research and teaching in Australia's universities with far-reaching consequences for the economy.

¹⁴ Chapman, *op.cit.*

¹⁵ R. Bell, and K. Jackson, *Higher Education Funding Amendment Bill 1998 (Cth) Bills Digest*, Parliamentary Library, 1998, p.4.

References

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- Tertiary Education Commission Papers, 1979.

Appendix A: The government's review of indexation

The terms of reference for the review of indexation the Government has committed to are contained in the *Higher Education Support Act 2003 (Cth)* as follows:

Section 198-25 Review of indexation

(1) The Minister will initiate and undertake a review of the cost adjustment factor indexation mechanism for the Commonwealth funding of universities from 2007/08.

*(2) The review must be completed by **February 2005** and the Government must respond to the **review by April 2005** and give effect to its response when introducing the annual Higher Education Support Amendment Bill in the 2005 May sittings of the Parliament.*

(3) Without limiting the scope of the review, the reviewers must, among other things, consider the following:

*(a) the alternative indices to use for **wage costs**—for example, the relative merits of **average weekly earnings**, the **Commonwealth's education wage cost index**, **baskets of domestic professional wage rates** and **purchasing power parity** adjusted indices for academic labour;*

*(b) the **alternative indices for non-wage costs**, noting the high reliance of universities on advanced equipment, information technology, research infrastructure and international book and periodical stocks;*

*(c) the application of any agreed index or indices to the **actual Commonwealth-funded staffing and financial profile** of each university rather than the application of an assumed uniform profile.*

Appendix B: The Higher Education Cost Adjustment Factor (CAF)

(from Australian Government, 2004, *Higher Education Report for the 2004 TO 2006 Triennium* page 116.)

The Higher Education Cost Adjustment Factor (CAF) is an index reflecting the contribution the Commonwealth makes towards increases in the operating costs of higher education institutions. The CAF does not measure actual price rises but the Commonwealth's contribution towards annual increases in salary and non-salary costs. Salary costs notionally constitute 75 per cent of grants. This component of the CAF is based on the Safety Net Adjustment (SNA) as determined by the Australian Industrial Relations Commission.

Non-salary costs notionally constitute 25 per cent of grants and are indexed using the Consumer Price Index (CPI). Before 2001 the Treasury Measure of Underlying Inflation was used instead of the CPI.

Figures for the CPI and SNA are provided by the Department of Finance and Administration in June of the preceding year, around 6 weeks after the Federal Budget. The resulting CAF applies to the whole of the following calendar year and indexation starts from the first payment each year.

In this Report all figures for 2003 are actual amounts (unless stated otherwise). All amounts for 2004 are estimates using the current legislated 2004 CAF (i.e. 1.188354) - SNA 2.1 per cent and CPI 3.0 per cent. Figures for 2004 have not been adjusted for anticipated movements in the CAF. It is likely that the 2004 preliminary will be the 2004 actual.

The Cost Adjustment Factor index is shown in Table B1.

Table B1: Cost Adjustment Factor Index, 1995 to 2004

1995	1.000000
1996	1.015750
1997	1.033823
1998	1.050122
1999	1.066707
2000	1.085211
2001	1.108650
2002	1.134358
2003 (preliminary)	1.158914
2003 (final)	1.161183
2004 (preliminary)	1.188354