



COMMONWEALTH GRANTS COMMISSION

DISCUSSION PAPER CGC 2002/2

CONTEMPORANEITY AND EQUALISATION OVER TIME

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INTRODUCTION

1. Several State submissions raised issues related to the questions of ‘how up-to-date are the relativities’ or ‘are the relativities a good indication of the relative needs of States for assistance in the year they are applied’.

2. These issues arise because the relativities the Commission calculates are based on State revenues and expenditures, and demographic and economic data, for a past period but are used to allocate untied assistance¹ in a future year.

3. The main issues raised were:

- (i) the length of the assessment period (the number of historical years for which data are used in assessing the relativities);
- (ii) the implications of differences between the assessed requirements for untied assistance and the assistance actually received;
- (iii) whether the relativities calculated in annual updates fully reflect the circumstances of the assessment years; and
- (iv) the effect of the rate of growth in the amount of assistance available for allocation.

4. This paper examines those issues. It provides an outline of existing processes, the issues raised by the States and the possible implications of those issues for future assessment methods.

THE CURRENT PROCEDURES

5. In essence, equalisation involves:

- (i) the Commission calculating per capita relativities that reflect the untied assistance each State would require if it were to have the financial capacity to provide the average standard of services (assuming it also made the average effort to raise revenue from its own sources and operated at the average level of efficiency); and
- (ii) the Commonwealth allocating the available untied assistance among the States on the basis of relativity-adjusted State shares of the Australian population^{2,3}.

¹ In this paper untied assistance means the revenue from the goods and services tax and the health care grants.

6. The calculations on which the relativities are based require large amounts of data on State revenues and expenditures and on the demographic, geographic and economic characteristics of each State. Since these calculations are done for years for which adequate data are available, there is a lag between those years and the year in which the relativities are applied. In addition, to smooth out the effects of short term events and to minimise the effects of data deficiencies, calculations are done separately for five years and the results averaged.

7. There is typically a minimum lag of two years between the most recent available data and the year in which the relativities are used. (For example, the most recent data that could be used in the 2002 Update were data for 2000-01 and the relativities were used to allocate untied assistance in 2002-03.) Averaging the results of calculations for more than one year implies that the lag is even greater. (For example, the relativities recommended for 2002-03 were based on data for the period 1996-97 to 2000-01, implying an average lag of 4.5 years.)

8. The length of the lag is also affected by the practical reality that the most comprehensive and accurate source of some detailed data is the population census, which is conducted at five yearly intervals. Since data from the 2001 Census were not available, some aspects of the assessments for 2000-01 in the 2002 Update were based on 1996 data.

9. All this raises the likelihood that the average demographic and economic conditions reflected in the relativities to be applied in a year will not be the same as those actually existing in that year. Hence the untied assistance received on the basis of the relativities may not be what each State would require to achieve equalisation.

10. Many of these issues have been discussed previously, including in a special report by the Commission in 1989⁴ and in the 1993 and 1999 Reviews. Some of the issues are summarised in Attachment A.

11. In the 1999 Review Report, the Commission said that:

- (i) the current process of calculating relativities based on historical data for five years would not deliver grants in a future year that would fully equalize the States in each future year;
- (ii) deriving reliable estimates of relativities based on projections of the economic and demographic circumstances of the States for the future year when the relativities would be applied is not feasible;
- (iii) the current processes achieve equalisation over the long run;

² A State's relativity-adjusted share of the Australian population is equal to its share of the population multiplied by its relativity.

³ This is a simplified description of the allocation process. In particular, it ignores the transitional arrangements under the Inter-Governmental Agreement (IGA), whereby the Commonwealth guaranteed that each State would receive a guaranteed minimum amount for a transitional period.

⁴ Report on Updates of Relativities 1989.

- (iv) a three year assessment period would also achieve equalisation over the long run and would produce relativities that are a little more up-to-date than the five year review period, but at the cost of less year to year stability;
- (v) frequent changes in the length of the assessment period would not produce equalisation over the long run; and
- (vi) the guidelines covering what can be amended in annual updates have been too restrictive and prevented the relativities determined in updates being as relevant to the application year as they might have been and should be revised to provide greater flexibility to make changes in future updates.

12. Governments decided to retain the five year assessment period for the 2000 and subsequent updates and, through their Heads of Treasury, decided that the update guidelines should not be revised to provide increased flexibility.

THE LENGTH OF THE ASSESSMENT PERIOD

13. In its submission, **Tasmania** argued that the relativities derived in any one year would not reasonably reflect each State's relative need for untied assistance in the year they are applied, especially in the existing circumstances where there is a consistent trend of diverging State economic capacities. As a result, the slower growing economies would never receive a level of grants sufficient for them to provide levels of service comparable with other States. Tasmania suggested that shortening the assessment period to three years would help to narrow the gap and make the relativities more consistent with current needs.

14. The charts in Attachment B illustrate some of the issues raised by Tasmania. The charts compare relativities that would have been applied in each of the years 1988-89 to 2002-03 if they were based on:

- (i) a five year assessment period (relativities applied in 2000-01 would be based on the average of data for 1994-95 to 1998-99);
- (ii) a three year assessment period (relativities applied in 2000-01 would be based on the average of data for 1996-97 to 1998-99); and
- (iii) the data for that year⁵ (relativities applied in 2000-01 would be based on data for 2000-01).

15. The charts suggest that the following conclusions may be drawn.

⁵ The analysis uses the relativities for the year when they were first included in an inquiry, for example, it uses the 1999-2000 yearly relativity in the 2001 Update (and not the 1999-2000 relativity in the 2002 Update).

- (i) During 1988-89 to 2000-01, the yearly relativities are less stable than the three or five year average relativities.
- (ii) A State with a continuous downward trend in its relativity (its assessed requirement for assistance is falling), has average relativities above its yearly relativity. That is, the averaging processes and the time lag in the assessment process mean that the relativities do not fully reflect the State's improving economic performance. Western Australia has been in these circumstances since 1991-92.
- (iii) A State with a continuous upward trend in its relativity (its assessed requirement for assistance is rising), has average relativities below its yearly relativity. That is, the averaging processes and the time lag in the assessment process mean that the assessed relativities do not catch up with the declining relative economic circumstances of that State. Tasmania and the ACT are in this situation.
- (iv) States which have cycles in their economic performance relative to other States may be placed in positions of fiscal equalization, over the long term. There are, however, times when their grants rise (implying declining relative economic circumstances) but their actual economic circumstances are improving (for example Victoria in 1996-97) or vice versa (Victoria in 1997-98).

16. Neither a three nor a five year assessment period would produce relativities that fully match States' requirements for assistance in the year they are applied. However, a three year assessment period would produce relativities that are more up-to-date, especially if States experience long term trends in their relative economic capacity. But a five year assessment period would better smooth out the effects of data errors or transient events. These are similar observations to those that have been made in the past.

17. The terms of reference for the 2004 Review leave it open for us to revise the length of the assessment period if we conclude it would improve the appropriateness of the relativities to be applied after 2003-04. At this stage, we are inclined to a similar view to that held by the previous Commission during the 1999 Review — that either a three year or a five year assessment period would achieve equalisation in the longer term, but changes in the length of the assessment period would reduce the level of equalisation over time because the experiences of some years would receive a different weight in the processes over the long run. We therefore see the issue as involving a choice between:

- (i) retaining the existing five year assessment period; or
- (ii) a permanent change to a three year period.

18. We seek advice on whether there is a clear preference among the States for a permanent move to a three year assessment period. If there were, we would adopt it. In the absence of any preference from the States or the receipt of new arguments, we are currently inclined to retain the five year assessment period.

DIFFERENCES BETWEEN THE ASSESSED REQUIREMENTS FOR UNTIED ASSISTANCE AND THE ASSISTANCE ACTUALLY RECEIVED

19. In its submission, **South Australia** also argued that the present procedures were not achieving full equalisation. It reached that conclusion after observing that there were differences between the untied assistance actually received by each State in each year of the 2002 Update assessment period and the Commission's assessed requirements for untied assistance for those years. South Australia's comparisons are shown in Table 1.

20. Like Tasmania, South Australia concluded that States with long term growing needs are at a consistent disadvantage because the five year average relativities are not up-to-date. South Australia suggested that this deficiency might be overcome by an annual adjustment to the relativities based on the average differences it identified over the assessment period. It said that in this way, the stability of the five-year average would be retained and contemporaneity would be achieved.

21. It is not clear to us exactly how the process envisaged by South Australia might be applied, but it appears the process would be as follows. We would:

- (i) calculate each State's assessed requirement for untied assistance in each year of the assessment period⁶ using our usual processes — in the 2002 Update this would have produced the second block of figures in Table 1;
- (ii) calculate, for each assessment year, the difference between each State's assessed requirement for untied assistance and the untied assistance it actually received — the third block of figures in Table 1;
- (iii) calculate the five yearly average of the differences in step (ii) — the last row of Table 1;
- (iv) adjust each State's assessed requirement for untied assistance in each year of the assessment period by the amount of the State's average difference calculated in step (iii);
- (v) calculate each State's relativity for each assessment year (by dividing its adjusted assessed per capita requirement for untied assistance (step(iv)) by the Australian average per capita total amount of untied assistance available for distribution in the assessment year; and
- (vi) calculate each State's average relativity as the average of the relativities assessed for each assessment year.

⁶ Each State's per capita requirement for untied assistance in each year of the assessment period would be equal to its standardised expenditure per capita plus the standard budget result per capita less its standardised revenue per capita less its per capita revenue from SPPs treated by inclusion. This is equivalent to an equal per capita share of the untied assistance available in that year plus the State's per capita expenditure, revenue and SPP needs.

Table 1 ACTUAL GENERAL REVENUE ASSISTANCE AND ADJUSTED FINANCIAL ASSISTANCE REQUIREMENTS 2002 UPDATE

| | NSW | Vic | Qld | WA | SA | Tas | ACT | NT |
|--|------|------|------|------|------|------|------|------|
| | \$m | \$m | \$m | \$m | \$m | \$m | \$m | \$m |
| Actual untied assistance received | | | | | | | | |
| 1996-97 | 6221 | 4622 | 3982 | 2077 | 2026 | 826 | 338 | 1029 |
| 1997-98 | 6343 | 4690 | 4035 | 2093 | 2057 | 829 | 332 | 1057 |
| 1998-99 | 6638 | 4899 | 4249 | 2185 | 2144 | 865 | 361 | 1104 |
| 1999-2000 | 7018 | 4942 | 4310 | 2148 | 2183 | 914 | 424 | 1138 |
| 2000-01 | 7327 | 5173 | 4574 | 2204 | 2329 | 961 | 460 | 1199 |
| Assessed untied assistance required^(a) | | | | | | | | |
| 1996-97 | 6550 | 4434 | 3785 | 1963 | 2107 | 879 | 424 | 979 |
| 1997-98 | 6273 | 4668 | 4059 | 1865 | 2182 | 905 | 434 | 1050 |
| 1998-99 | 6438 | 4622 | 4272 | 2089 | 2336 | 1009 | 428 | 1250 |
| 1999-2000 | 6473 | 4604 | 4663 | 2183 | 2358 | 1042 | 448 | 1306 |
| 2000-01 | 6894 | 4961 | 4854 | 2065 | 2479 | 1096 | 495 | 1382 |
| Untied assistance received minus assessed requirement | | | | | | | | |
| 1996-97 | -329 | 188 | 197 | 114 | -81 | -53 | -86 | 50 |
| 1997-98 | 70 | 22 | -24 | 228 | -125 | -76 | -102 | 7 |
| 1998-99 | 199 | 276 | -23 | 96 | -192 | -144 | -67 | -146 |
| 1999-2000 | 545 | 338 | -353 | -35 | -175 | -128 | -23 | -168 |
| 2000-01 | 433 | 212 | -281 | 139 | -150 | -135 | -35 | -183 |
| 5-year average | 184 | 207 | -97 | 109 | -145 | -107 | -63 | -88 |

(a) Requirements assessed for each year as part of the 2002 Update calculations. The assessed requirements are the standardised deficits, which equal standardised expenditure per capita plus standard budget result per capita less standardised revenue per capita less per capita SPPs treated by inclusion.

Source: South Australia Submission to 2004 Review of General Revenue Grants Relativities, April 2002.

22. An alternative approach might be for us to calculate per capita relativities using our usual processes. The Commonwealth Treasury could then:

- (i) apply the relativities to calculate each State's untied assistance in the application year; and
- (ii) adjust that amount by the average difference between the assessed untied assistance requirement in each assessment year and the actual untied assistance in each of those years.

23. If our interpretations of South Australia's proposals are correct, they would introduce some retrospective adjustments into our processes. South Australia argued such adjustments would be justified because in the years it examined States whose relativities consistently increased received lower untied assistance than subsequent calculations of the amount required for each of those years (based on actual data for those years).

24. South Australia acknowledged that the differences it observed between the assessed requirement for untied assistance in each year and the untied assistance received could reflect more than just the lags in the equalisation process. They might also reflect revisions to the data, changes in the assistance available for distribution and the backcasting of changes in Commonwealth-State financial arrangements. However, it also asked whether the differences attributable to influences other than backcasting should be included in any adjustment.

25. The approach suggested by South Australia could go some way towards removing the effects of consistent trends in State financial capacities from the allocation of untied assistance. However, it would add some complexity and a retrospective aspect to the equalisation processes.

26. We welcome further comment on this suggestion.

ISSUES IN UPDATING RELATIVITIES

State Submissions

27. **Victoria** argued that outdated data were often used in the assessments. For example, it argued that:

- (i) the heavy reliance on Census data (updated every five years) to measure disabilities resulted in a static picture of the effects of socio-demographic composition in updates following each review; and
- (ii) the use of fixed proportions to dissect expenditure categories into components in each update since the 1999 Review ignored the reality that government expenditure patterns varied over time and did not reflect the true impact of some disabilities, such as administrative scale.

28. Victoria submitted that data should be updated more regularly. It also said that some of its concerns might be reduced if the design of the 2004 assessment methods was forward looking so that future calculations could accommodate developments in service delivery methods and other circumstances as and when they occur.

29. **Queensland** made similar points when it argued that the reliance on Census data meant that annual updates did not reflect the impact on its relative costs of providing services arising from developments such as:

- (i) the steady decline in the population of many parts of western Queensland; and

- (ii) the changing population profile of those areas because it was predominantly the young and working age people who migrated to other States or to Queensland coastal centres.

30. The **Northern Territory** submitted that its Indigenous population was moving further away from regional centres and service centres towards homelands at an increasing rate. This required an expansion of uneconomic and mobile services, particularly education, health and essential services, which must be largely met by government providers.

31. Finally, **South Australia** suggested that in future updates the Commission should have the ability to respond to new information and revise its judgements instead of the current practice of holding most judgements constant until the next review. It argued that amending the update guidelines to provide this extra flexibility could lead to relativities that were more up-to-date.

32. We acknowledge that, for reasons of practicality, relativities assessed for each year of the assessment period may not fully reflect each State's relative needs for those years because:

- (i) assessment methods are determined in the five yearly reviews and are generally not revised in subsequent annual updates unless terms of reference request it; and
- (ii) not all the data required to measure the demographic and economic circumstances of the States and to provide some of the finer details of State expenses and revenues are updated on an annual basis.

Assessment Methods

33. The five yearly cycle of reviews with the use of fixed methods for annual updates represents a trade-off determined by the parties between:

- (i) the ability to ensure that assessment methods reflect the latest developments in service delivery and States' circumstances; and
- (ii) the desire for stability in relativities and for minimising the resource costs arising from more frequent reviews of methods.

34. In the 1999 Review Report, the Commission said it was not convinced that there were net advantages in conducting reviews of methods more frequently than every five years. It thought that having reviews completed immediately after the data from the latest Census become available placed both the methods and the results on a firmer basis. It also noted that State health funding agreements were on a five-year cycle and that there were benefits in being able to complete reviews in full knowledge of the health agreements that would apply over a similar period.

35. During the 1999 Review, neither the Commission nor most States saw net benefits in reviewing specified aspects of methods in annual updates. Most were concerned

that such a process could reduce the level of equalisation achieved because it was too difficult to ensure that reviewing some assessments before others would not unduly benefit one State at the expense of another.

36. In the 1999 Review Report, however, the Commission did suggest that the update guidelines (see Attachment D), which outline the changes that could be made in updates, should be made more flexible. It sought the capacity to make minor changes to the assessments to reflect the effects of changes in the circumstances surrounding service provision or sources of revenue so that the relativities would be as relevant to the application year as possible.

37. In the event, governments through the terms of reference for subsequent updates, indicated that methods should not generally be varied in updates⁷ and Heads of Treasury decided that the update guidelines should not be changed.

Updating the Data

38. At the time of the five yearly reviews, all the data used to measure the financial circumstances of the States and their demographic and wider economic circumstances are as up-to-date as possible. This is because the timing of reviews is aligned with the release of data from the most recent Census and the Commission undertakes large data collections to obtain the data required to measure service use and provide a basis for its judgements.

39. During updates following the 1999 Review, the Commission has incorporated the latest available data for the assessment years. It included all major changes in Commonwealth-State arrangements, data on State expenses and revenues for the most recently completed financial year, the most recent data on all State revenue bases and the most recent annually available demographic, service use and other data used to measure expenditure disabilities.

40. However, as noted by Victoria, it did not generally update:

- (i) those aspects of expenditure disabilities that were based on judgement, that use data that were not available annually (especially Census data), or data used in conjunction with data that could not be updated annually; or
- (ii) the proportions (or weights) of each functional category allocated to each assessment component — for example, the proportion of expenses that were considered to be subject to administrative scale disabilities remained constant during updates.

41. Thus, reasons relating to data unavailability, a desire by the parties and the Commission to minimise the resource implications of updates and a desire to preserve the

⁷ The terms of reference for the 2001 Update did however ask the Commission to review the methods used in the assessment of Superannuation expenses.

internal consistency of the assessments, meant the Commission generally did not update the administrative scale, service delivery scale, dispersion and urbanisation disabilities. Some aspects of socio-demographic composition disabilities were also not updated.

42. Consequently, the 2003 Update, the last update before the 2004 Review, could use:

- (i) financial standards, revenue raising capacities and some expenditure disabilities that are between one and six years behind the commencement of the application year; and
- (ii) data that are over six years old to measure some of the more important expenditure disabilities.

43. The implications of these limitations on updating include:

- (i) some demographic trends that are primarily revealed in Census data, such as population movement towards urban areas or the proportion of the population who acknowledge Indigenous descent, would not be reflected in the assessments;
- (ii) some changes in the use pattern of services might not be reflected in the assessments if the assessment methods combine the use data with Census data — the inclusion of updated hospital use data in the 2001 Update indicated this may have material effects⁸;
- (iii) the assessments may not reflect changes in State expenditure patterns at the more detailed level — it is possible that the assumption that a constant proportion of costs in each category is affected by administrative scale disabilities may overstate the impact of that disability if expenses in a category grow rapidly; and
- (iv) relativities have been more stable and more predictable between updates, but there may be larger changes in the Review.

44. Most of these implications will not affect the 2004 Review because it will use the most up-to-date data available, including 2001 Census data. What happens in subsequent updates will depend on the terms of reference for those updates, the willingness of the parties to provide the Commission with the increased flexibility to take action to ensure its assessments reflect the most recent circumstances, the willingness of the parties to provide additional data and the Commission's capacity to make any necessary estimates.

45. Putting those issues aside for the moment, and acknowledging that we cannot commit future Commissions to specific courses of action, actions that might be attempted to ensure future updates reflect the most up-to-date circumstances include:

⁸ In this case, the Commission attempted to maintain the alignment between the hospital use data and the detailed census-based demographic data used in the calculations by making its own estimates of the updated demographic data.

- (i) designing assessment methods in the 2004 Review that use data that are available on an annual basis — but some of the resulting improvements in the ‘updateability’ of the assessments might come at the cost of less accurate assessments in the 2004 Review;
- (ii) undertaking intercensal projections of data — but some of the improvements in up-to-dateness would come at the expense of increased complexity, and possibly reduced accuracy, in the updates;
- (iii) amending judgements or the apportionment of expenses in each functional category into the finer category components used in the assessments if readily available data indicates there have been material changes — this should make the assessments more up-to-date; and
- (iv) undertaking more regular collections of data used to inform judgements and expenditure proportions — this should make the assessments more up-to-date but would increase the cost and complexity of updates.

46. Comments would be appreciated on which, if any, of these possibilities might be acceptable to the parties and on whether the update guidelines should be reviewed to give future Commissions more flexibility in updates.

Allowing for Future Developments

47. In their submissions, Victoria and Queensland said that the assessment methods designed in the 2004 Review should be mindful of expected future developments in service delivery (such as the increasing role of technology) and of the circumstances of the States (such as the effects of climate change). They argued that the assessment methods should allow the effects of such developments to be taken into account as they arise.

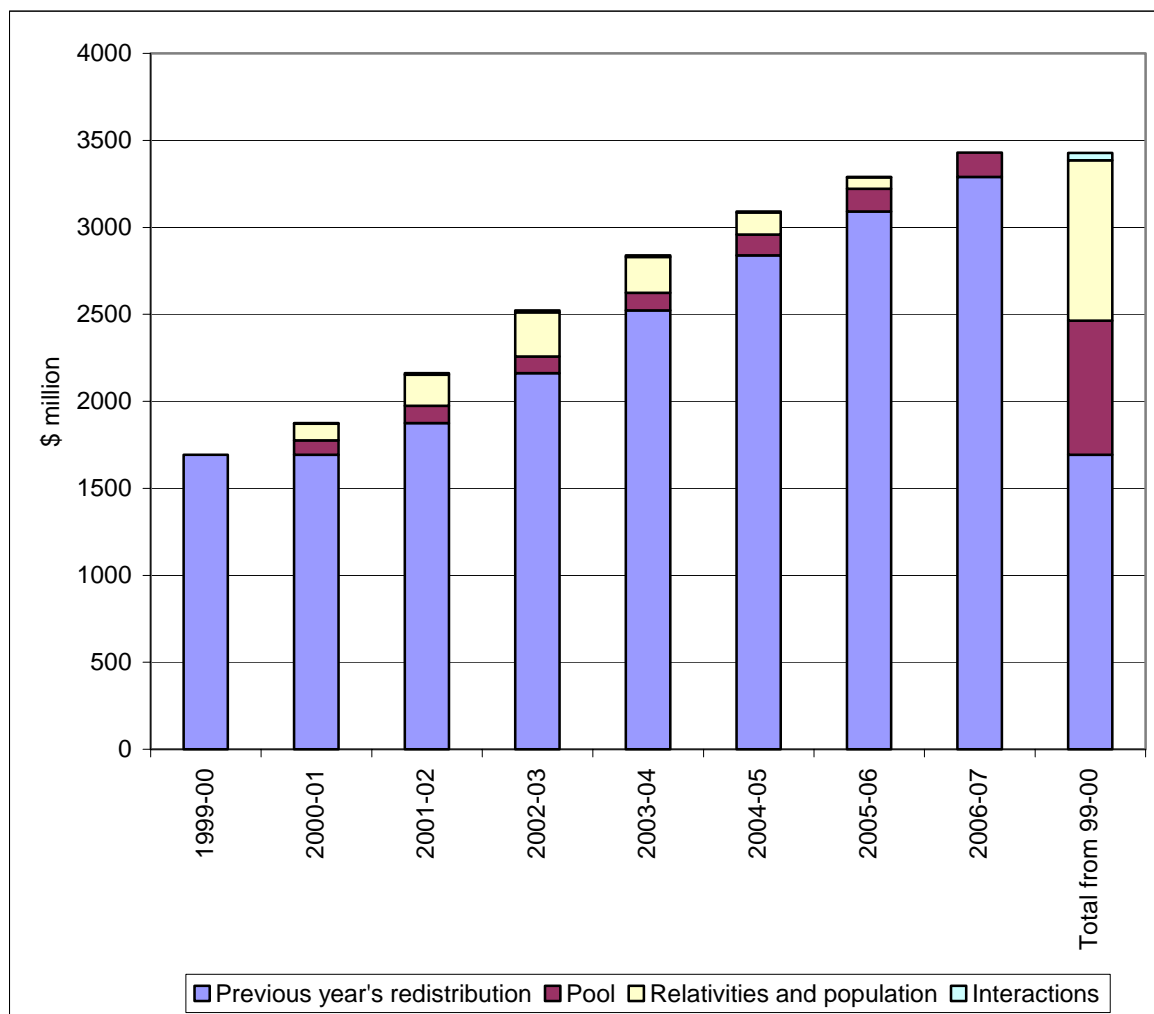
48. In the 1999 Review, the Commission attempted to do just that. For example, its assessments in the Concessions and Other Payments categories were intended to reflect the changes that had taken place as a result of the National Competition Policy and micro-economic reforms and to remain relevant to further changes arising from those policies. We envisage adopting similar approaches when they are appropriate in the 2004 Review.

THE IMPACT OF THE AMOUNT OF ASSISTANCE AVAILABLE FOR DISTRIBUTION

49. *Discussion Paper 2002/1, The Size of Equalisation Redistributions*, demonstrated that a large part of the projected growth in the absolute amount redistributed among the States by the equalisation processes (compared with an equal per capita distribution) was attributable to growth in the amount of assistance available for distribution. Figure 1 identifies the causes of the projected growth in the absolute amount redistributed over the period 1999-2000 to 2006-07. It shows that over that period

1999-2000 to 2006-07, \$771 million (or 44 per cent) of the projected \$1735 million increase in the amount redistributed arose because of the increase in the size of the pool, and \$922 million (53 per cent) was due to changes in relativities since the 1999 Review and the assumption used in projecting future growth — that assumption was that by 2006-07, the relativities and State population shares would be the same as those the Commission assessed for 2000-01 in the 2002 Update.

Figure 1 CONTRIBUTIONS OF CHANGES IN POOL AND RELATIVITIES TO PROJECTED REDISTRIBUTION, 1999-2000 to 2006-07



50. However, it may also be the case that rapid growth in the level of assistance available for distribution between the years used to assess the relativities and the year in which they are applied could affect the appropriateness of the relativities.

51. Attachment C demonstrates that, under the current equalisation procedures, the assistance a State receives can be thought of as:

- (i) an equal per capita share of the amount available for distribution in the application year; plus
- (ii) the needs assessed for it in the assessment years, escalated by the growth in the amount available between the assessment years and the application year.

52. The current equalisation procedures reflect the fact that the needs the Commission calculates for each assessment year are relative needs⁹ which are used to determine per capita relativities. The procedures then assume that those relativities will apply in the future, regardless of the amount of assistance available. That is, needs are proportional to the available assistance.

53. This process is simple and aligns well with reality in circumstances where the growth in available assistance approximately maintains its value in real terms, such as happened with the financial assistance grants. In these circumstances it is not unreasonable to assume that the dollar value of State recurrent expenses or revenues and, as a consequence, needs would change at a rate similar to the assistance available (they would be maintained in real terms).

54. However, these assumptions may not hold if there were to be a high real rate of growth in the assistance available. If high levels of real growth in the assistance available were considered likely, it may be necessary to ask whether that real growth should be distributed using the relativities or some other basis — for example on an equal per capita basis or by some combination of relativities and equal per capita¹⁰.

55. In this context, we note that after the initial years, the growth rate of GST revenue and health care grants is projected to be about 5.8 per cent a year, compared with the projected growth of notional financial assistance and health care grants of about 4.2 per cent. It is not clear that differences of this magnitude would have a material effect on the revenue sharing processes¹¹.

56. When there has been a sufficient length of experience with GST based relativities, comparisons similar to those done by South Australia (see Table 1) and those in Attachment B may indicate whether the issue is material. Comments on this issue would be appreciated.

⁹ Each State's needs are assessed relative to the Australian average revenues and expenditures, using disability factors that are also measured as proportions of the average position.

¹⁰ A State's relativity is calculated as its assessed per capita requirement for assistance in an assessment year divided by the total per capita amount of assistance available for distribution. Consequently, if all other things are equal, the larger the amount of assistance available the closer relativities will be to one. (This outcome can be verified by comparing the FAG and GST relativities assessed in the 2002 Update.) This implies that if, over time, needs grow at a slower (faster) rate than the assistance available, the relativities would converge to (diverge from) one. Thus if there were to be a large growth in assistance available between the assessment years and the application year, relativities based on data for the assessment years may not be fully appropriate for use in the application year. However, further work is required to determine what rate of real growth is required for these effects to be material.

¹¹ In the initial years, the effect of the larger amount of GST revenue relative to the financial assistance grants was reflected in the GST relativities which were all closer to one than the FAG relativities.

SUMMARY AND PRELIMINARY CONCLUSIONS

57. The equalisation processes involve determining relativities on the basis of five past years and using them to allocate untied assistance among the States in a future year. On average, there is a lag of about four and a half years between the circumstances reflected in the data used to derive the relativities and the year when they are applied. This can mean that the untied assistance States receive may not fully equalise them given the circumstances of the year in which the assistance is received. Nevertheless, equalisation would be achieved over the longer term, especially when there are cycles in the relative economic performance of the States.

58. However, the data indicate that some States have been subject to long term trends in their financial capacities. This appears to result in the assistance they receive, even in the long term, being less than (or more than) the amounts required to achieve equalisation.

59. There have been suggestions that these circumstances might be addressed in part by reducing the length of the assessment period to three years. We are currently inclined to a view similar to that expressed by the previous Commission — that either a three year or a five year assessment period would achieve equalisation in the longer term but changes in the length of the assessment period would reduce the level of equalisation over the long run. We therefore see the issue as a choice between:

- (i) retaining the existing five year assessment period; or
- (ii) a permanent change to a three year period.

60. We seek advice on whether there is a clear preference among the States for a permanent move to a three year assessment period. If there were, we would adopt it. In the absence of any preference from the States or the receipt of new arguments, we are inclined to retain the five year assessment period.

61. South Australia suggested the issues might be better addressed by retrospective adjustments to the relativities. Such adjustments seem to have some merit in cases where there are long term trends in State financial capacities, but they could make the equalisation process more complex. We seek further comments on this issue.

62. Victoria, Queensland and South Australia have argued that in the annual updates following reviews, the assessments may not accurately measure each State's relative needs because assessment methods may not reflect the current circumstances and all the data used to measure the demographic and economic circumstances of the States are not updated. These arguments highlight some of the practical constraints facing the equalisation processes as a result of past decisions of the Commission and the parties, and limitations on data availability.

63. Annual updates have included the latest available data on State expenses and revenues, the most recent data on State revenue bases and the most recent annually available demographic, service use and other data used to measure expenditure disabilities.

However, some of the major expenditure disabilities have not been updated or have been only partly updated. This was generally because they relied on Census or other data that were only collected in each Review and updating them would have required estimation.

64. We will endeavour to reflect all the most up-to-date data in the 2004 Review. However, what happens in subsequent updates will depend on the terms of reference. It will also depend on the willingness of the parties to review the update guidelines to allow the Commission greater flexibility to amend its assessments to reflect the current circumstances and their willingness to provide the necessary data.

65. We note that the amount of assistance available for distribution among the States has an impact on the assessed relativities. We also note that rapid real growth in the level of assistance might raise a conceptual question about the appropriateness of using the relativities to distribute the real growth component of the untied assistance. Further consideration of these issues is required.

ISSUES RAISED PREVIOUSLY ABOUT UP-TO-DATENESS

1. The Commission first looked at the issue of up-to-dateness in a special report in 1989¹² and then again in the 1993 and 1999 Reviews.

2. Prior to the 1989 Report, the relativities were the average of the assessments for three years (that is the assessment period was three years). In the 1989 Report, the Commission expressed a preference for the retention of the three-year review period although it did not object a five-year assessment period in principle. It noted that a longer review period reduced the impact on relativities of an isolated event affecting the fiscal capacities of the States, and it also delayed the impact of the full consequences of a sustained change in fiscal capacities.

3. Nevertheless, Governments decided to implement a five year review period, primarily because it reduced the year to year fluctuations in grant shares. The five year review period has been used ever since.

4. Each time up-to-dateness has been considered, similar (often overlapping) issues have been raised, including:

- (i) the relativities are not sensitive enough to recent developments;
- (ii) the relativities are too sensitive to one-off or short term events;
- (iii) changes in grants resulting from changes in relativities can reinforce the effects on State budgets of changes in economic conditions (that is, grants can increase when tax revenue is rising and vice versa);
- (iv) a longer review period would better match State economic cycles, implying the highs and lows would be averaged out;
- (v) States in sustained economic declines (or improvements) are not fully 'compensated' (are 'over compensated');
- (vi) stability of grant shares is a desirable outcome in itself;
- (vii) predictability of grant shares is a desirable outcome; and
- (viii) the length of the review period can effect the workload of the Commission and the States.

¹² The Commission's Report on Updates of Relativities 1989.

5. The range of remedies for these problems has also been fairly constant, including:

- (i) increase the length of the review period to five years;
- (ii) reduce the length of the review period to three years;
- (iii) reduce the length of the review period to one year;
- (iv) put greater weight on the assessments for the more recent assessment years (rather than giving all years the same weight);
- (v) make the assessments more up-to-date by supplementing assessments based on, say, the last three completed financial years with calculations based on State budget estimates for the most recent year and projections for the year in which the relativities are applied;
- (vi) introduce a two part grant system in which an initial assessment is based on estimated data and is 'acquitted' when final data are available; and
- (vii) introduce specific allowances for temporary factors.

6. The current South Australian suggestion of an adjustment to the relativities based on the differences between actual general revenue grants in a year and the assessed requirement for that year has some similarities to previous two part systems.

COMPARISONS OF RELATIVITIES

Chart 1 New South Wales

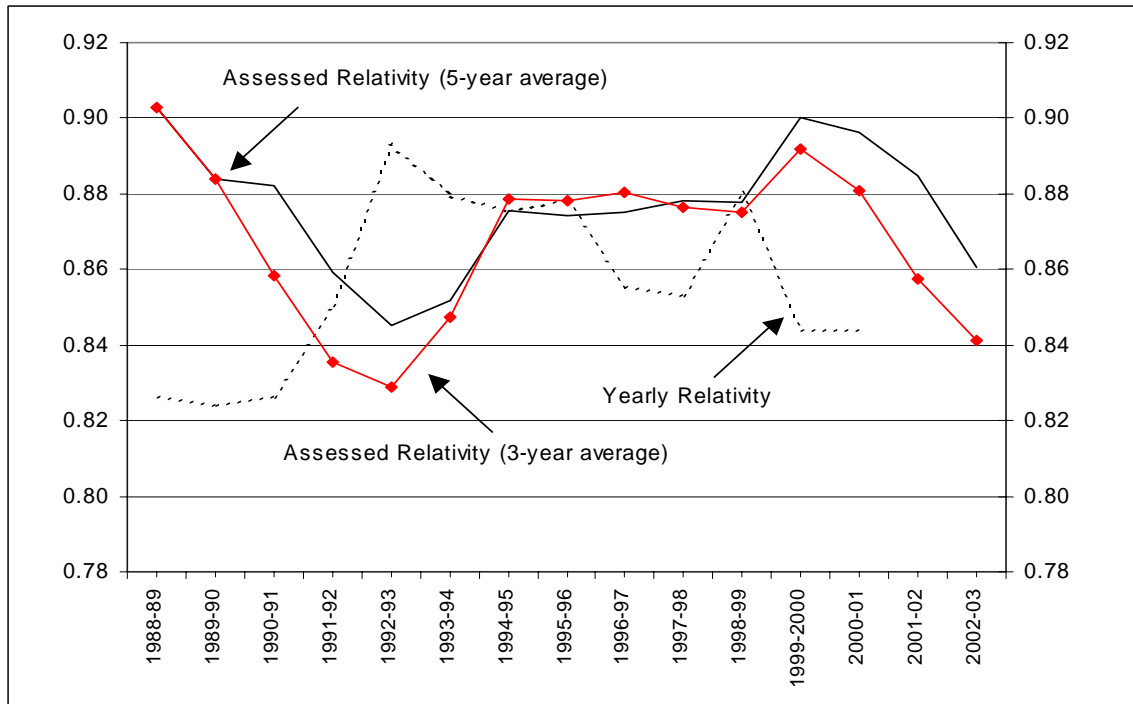


Chart 2 Victoria

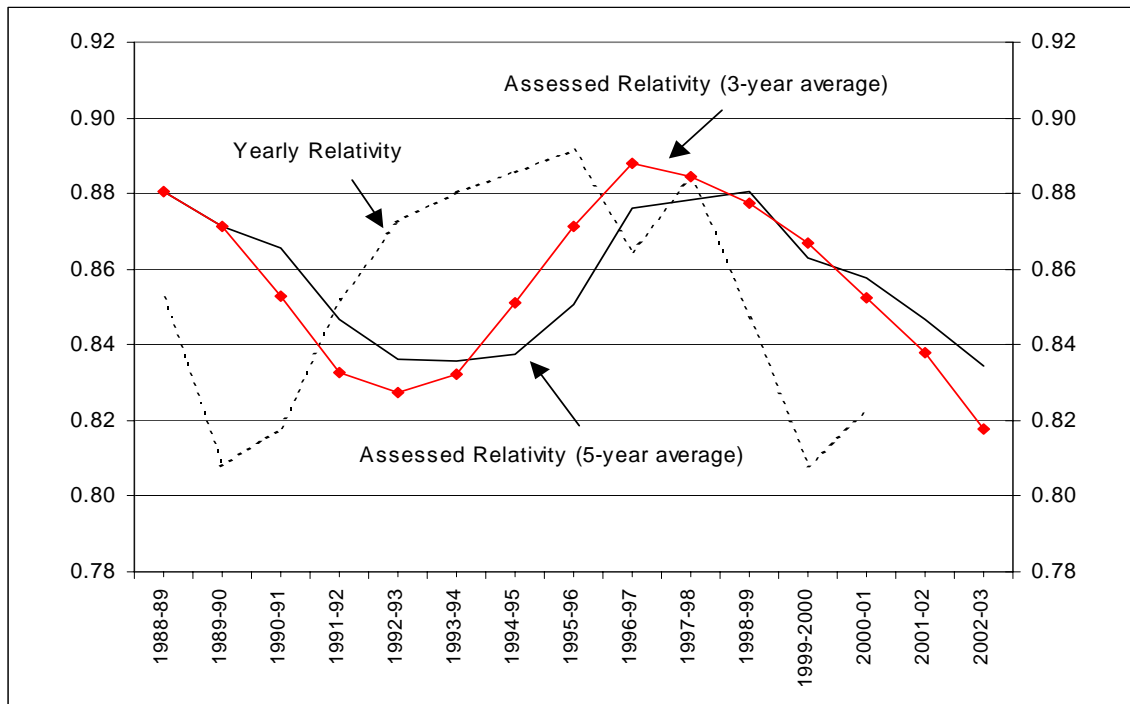


Chart 3 Queensland

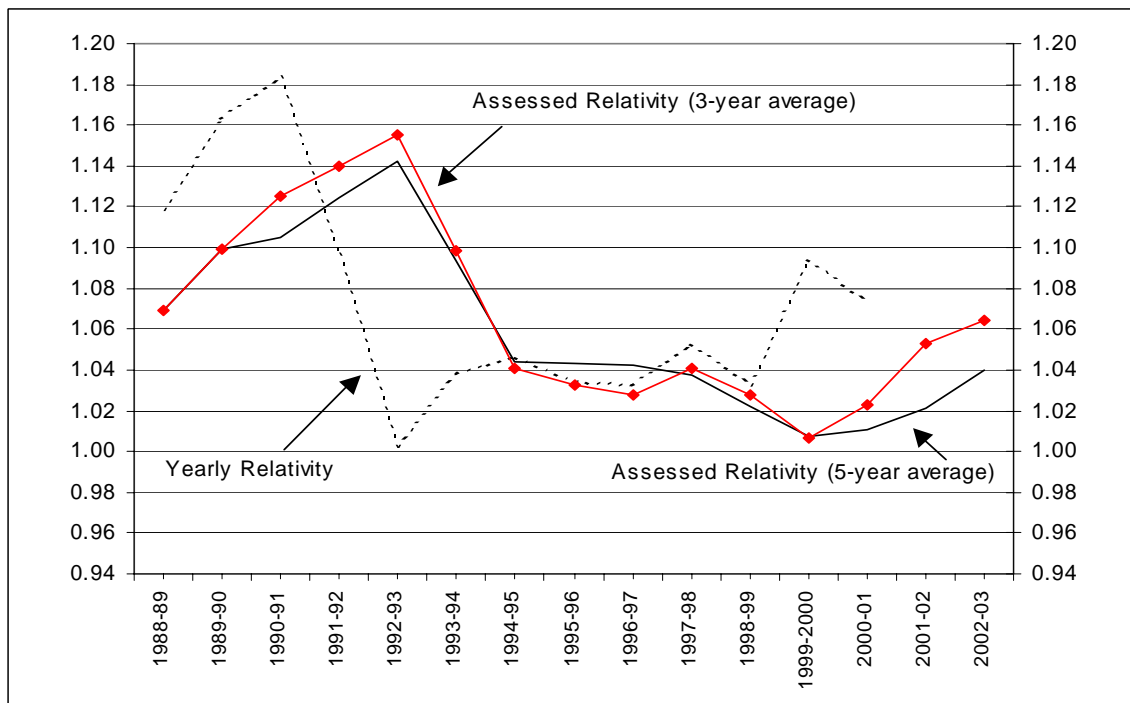


Chart 4 Western Australia

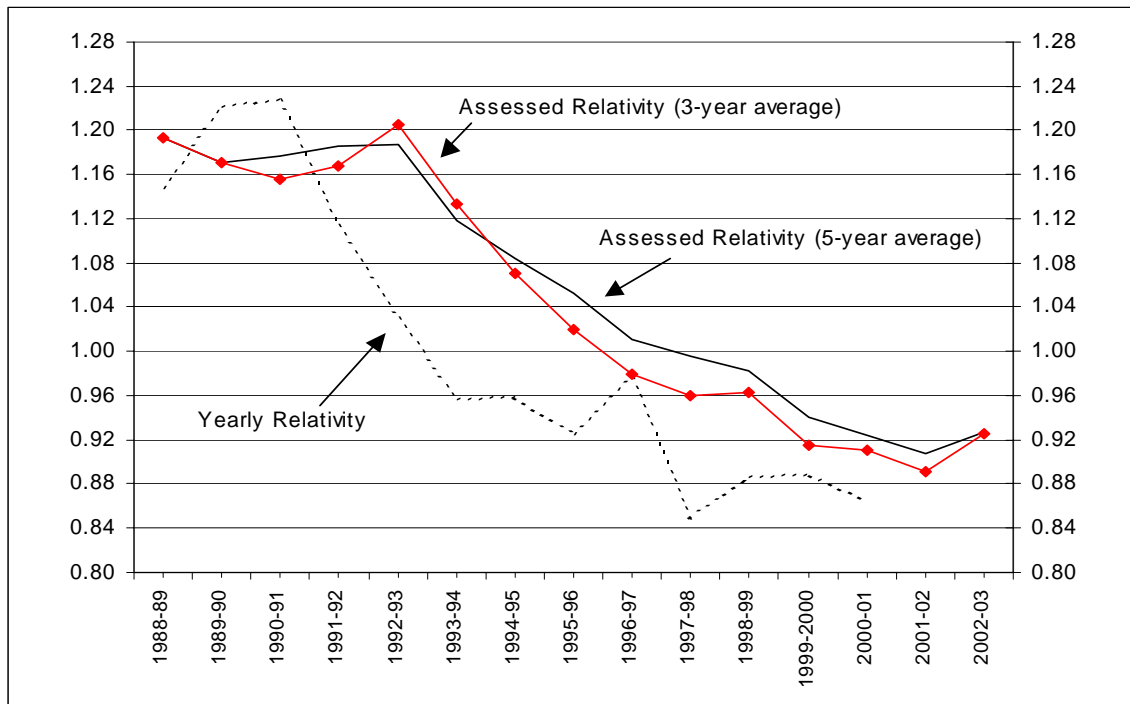


Chart 5 South Australia

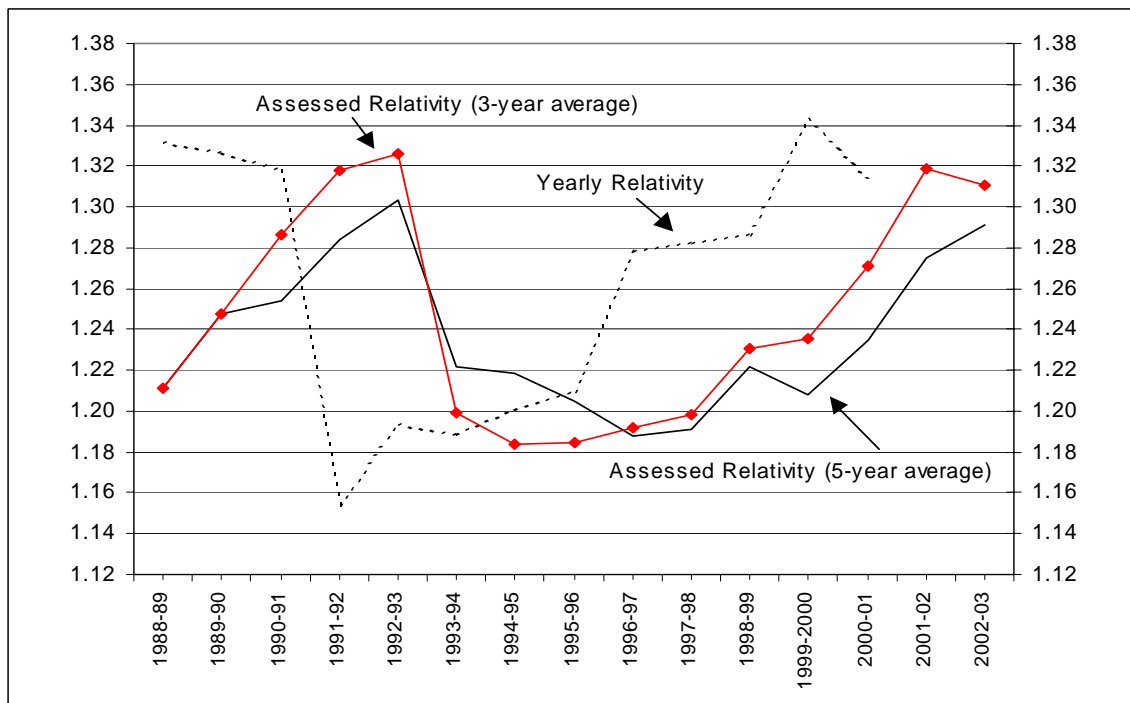


Chart 6 Tasmania

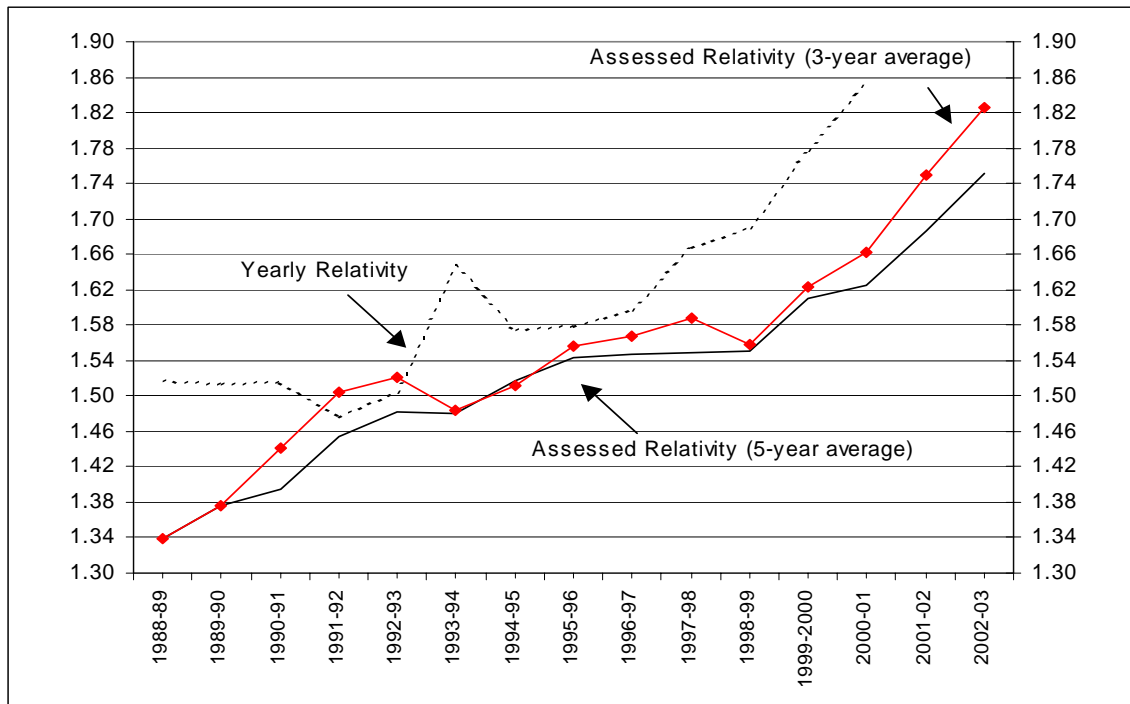


Chart 7 Australian Capital Territory

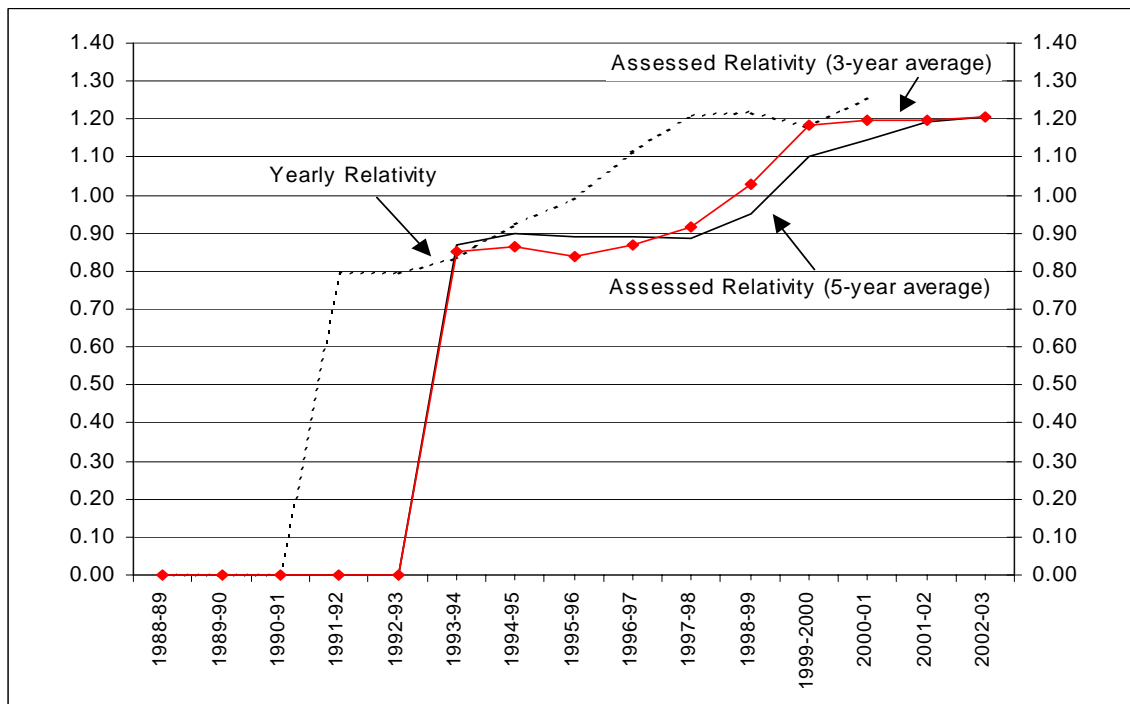
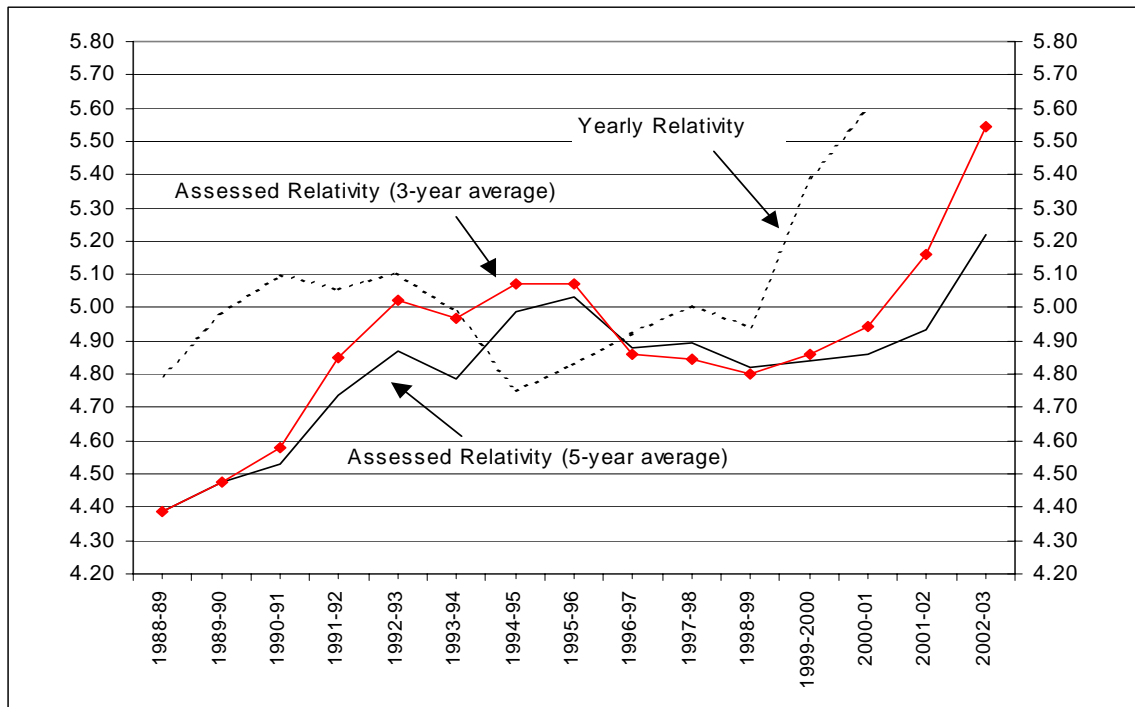


Chart 8 Northern Territory



**THE IMPACT OF THE AMOUNT OF ASSISTANCE AVAILABLE FOR
DISTRIBUTION**

1. The effects of the amount available for distribution pool on the up-to-dateness of the relativities can be understood by examining the differences between the amount available in the application year and the amount used in calculating the relativities. The following transformation of equations are helpful to understanding the current procedures of equalisation using only one year's relativities in the assessment period:¹³

$$G_{it} = R_{(t-1)i} S_{ti} G_{st} \quad (1)$$

$$G_{it} = \left(1 + \frac{N_{(t-1)i} / P_{(t-1)i}}{G_{s(t-1)} / P_{(t-1)s}}\right) S_{ti} G_{st} \quad (2)$$

$$G_{it} = S_{ti} G_{st} + \frac{N_{(t-1)i}}{G_{s(t-1)} S_{(t-1)i}} S_{ti} G_{st} \quad (3)$$

$$G_{it} = S_{ti} G_{st} + N_{(t-1)i} \frac{S_{ti}}{S_{(t-1)i}} \frac{G_{st}}{G_{s(t-1)}} \quad (4)$$

$$G_{it} \cong S_{ti} G_{st} + N_{(t-1)i} \frac{G_{st}}{G_{s(t-1)}} \quad (5)$$

where:

- G indicates either the pool of the grants or the grant State i gets;
- R indicates the relativity;
- S is the population share;
- N is the assessed needs, which can be positive or negative;
- i the subscript, indicates State i ;
- t indicates the application year;

¹³ The actual process is more complicated than this. First, the relativities used in the allocation are the average of the yearly relativities of the assessment period. Second, when adjusting the population shares using the relativities, there is an implied rescaling so to ensure the sum of the grants each State gets equal the total pool.

- l represents the lag between the assessment year and the application year (a minimum of 2); and
- s indicates all States (the Australian total).

2. The first equation represents the application of the relativity for State i to its population share to derive its share of the grant. The second equation shows that the relativity is equal to 1.0000 plus the State's per capita needs as a proportion of the per capita level of total assistance available for distribution. Equation 5 is an approximation and is derived by assuming that the State's share of the Australian population remains constant between the assessment and the application years. It shows that a State's grant in the application year can be thought of as consisting of two parts:

- (i) its population share of the pool (the first term on the right hand side of equation 5), and
- (ii) the needs in the assessment year increased by the growth in the assistance available for distribution between the assessment year and the application year.

3. A State's needs can be positive (if the relativity is above 1.0000) or negative (if the relativity is below 1.0000). If a State is assessed to have positive/negative needs, its share of the grants will be greater/smaller than its share of the population. If a State's needs are zero, its relativity will be 1.0000 and its share of the grants will be equal to its share of the population.

UPDATE GUIDELINES

1. The States have previously agreed with the Commission that, given the usual consultative procedures, it could, under specified circumstances, make minor changes to the assessments during updates. The conditions were that changes could be made:

- (i) to incorporate the latest available figures for the assessment period for financial and other data in series presently used in assessments;
- (ii) to take account of major changes in Commonwealth-State financial relations, including functions transferred up to the commencement of the application period, and of major new or changed specific purpose payments (SPPs);
- (iii) to accommodate other budget developments;
- (iv) to amend assessment methods (for example, by using estimates) where data previously used were no longer available;
- (v) by using new or better data not previously considered; and
- (vi) to correct errors in calculations.

2. In addition, it was agreed in principle that, subject to consultation with the States, it would be reasonable to give the Commission scope to remove inconsistencies with the general approach, where this would have only minor effects on relativities.