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SUMMARY

In first considering requests for financial assistance from claimant States the Commission concluded that grants should provide 'the amount of help found necessary for a State by reasonable effort to function at a standard not appreciably below that of other States'.

This was modified over the course of claimancy inquiries to provide grants which would enable States to function at the same standard if they made the same revenue effort. Explicit penalties for being a claimant State or for having bad policies which exacerbated fiscal weakness were no longer assessed.

The adoption by the Commonwealth and the States of fiscal equalisation for all States as an agreed policy in 1976 obviated the need for the Commission to consider the rationale for the grants it was recommending. The focus shifted to developing methods which would lead to the most appropriate grant recommendations.

While the Commission's methods have evolved over time to make use of new data sources and to reflect the growing complexity of State Government operations, some important features of that methodology can be traced back to the earliest Commission work. They include a desire:

- to capture as fully as possible all the activities of State Governments
- to ensure as far as possible that the policy choices of individual States would not determine their grants
- to recommend grants which accounted for the impact of innate differences among the States on the cost of delivering a standard suite of services or in their ability to raise revenue
- to provide advice relevant to the year in which it would be used, but based as much as possible on reliable information.

Early Commissions, dealing with only a few States, based their work on the observed spending and revenues of claimant States and the stronger States they used as a standard of comparison. They modified these observations as necessary; for example, to account for differences in policy, and used the resulting differences between States as the basis for determining an appropriate grant.

More recent Commissions, dealing with all States (and Territories), base their work on average observed spending and revenues per capita, making modifications only for innate differences among States which can be reliably measured and which have a material impact.

While both approaches, in a world of full information, should produce the same result, in a data constrained environment, the latter has some advantages. For example, it focuses attention on what is innately different among States, such as the distribution of high service cost groups of residents, rather than differences in policy which can be more difficult to quantify.

One characteristic of the Commission's methodology evident from its inception is a reliance on a quantitative approach. While not excluding the use of judgment where necessary, Commissions have based recommendations on the best available data as a means of fostering transparency which is a key element in demonstrating the impartiality of its approach.

BACKGROUND

1 The Commonwealth has provided special financial support for the fiscally weaker States since 1910. Deciding the quantum of that support was often acrimonious and highly charged, and done on the advice of a range of ad hoc advisory mechanisms. Against that background, the Federal Government established the Commonwealth Grants Commission on 17 July 1933 as an independent and ongoing Commission to provide impartial advice on the appropriate financial support for State budgets.

2 From 1933 to 1982, the Commission provided advice relating to applications by the financially weaker, or claimant, States (initially Western Australia, South Australia and Tasmania and later Queensland) for special grants.

3 The passage of the *States (Personal Income Tax Sharing) Amendment Act 1978* and the *Commonwealth Grants Commission Amendment Act 1978* broadened its role to advising on the allocation among all States, and later the two Territories, of a share of Commonwealth taxation revenue made available to them to equalise their fiscal capacities. Its role has remained broadly unchanged since then.

4 The introduction of the Goods and Services Tax (the GST) in July 2000 changed the basis of determining the pool of funds to be distributed among the States, the amount available and the context in which the Commission worked. However, it did not change the Commission's fundamental task — advising on the allocation of a given amount of general purpose funds among the States.

5 This paper tells the story of the development of Commission methods since 1933 and the evolution of equalisation as it is practiced today. Attachment A provides a timeline and brief summary of the major developments. The paper draws on Commission reports to government containing advice on State fiscal requirements and previous publications which document the Commission's history.[1]

6 The paper is divided into two parts.

- Part A describes how the Commission approached the task of deciding the basis on which special grants would be determined and how that evolved into fiscal equalisation for all States.
- Part B describes how the Commission evolved ways to bring together the available information to enable it to quantify a specific special grant or more recently a distribution of a pool of available revenue.

[1] Commonwealth Grants Commission, *Equality in Diversity, History of the Commonwealth Grants Commission, Second Edition (1995)*, AGPS, Canberra.
Commonwealth Grants Commission, *The Last 25 years* (2008), Commonwealth of Australia, Canberra.

PART A: ON WHAT BASIS SHOULD A STATE RECEIVE A SPECIAL GRANT?

Special grants

7 The Commission's first task in 1933 was to devise consistent principles for special grants. It concluded that it was appropriate for the Federal Government to assist States in grave financial difficulties but it struggled to decide the basis on which grants should be made. There was disagreement within the Commission on whether it should assess grants on the basis of financial disabilities suffered by States as a result of federation (such as the burden of tariff policies, the Navigation Act, industrial policy) or simply on the basis of States' relative financial positions. The claimant States also said the Commission should recognise how their financial positions were adversely affected by their physical characteristics (small populations, large areas, limited natural resources) and developmental difficulties, including the losses they incurred in land development schemes.

8 The First Report said:

> … the ground for a grant should be the adverse influence of Commonwealth policy, and the simplest form of the issue would be the proof of a disability through Commonwealth policy, the assessment of the loss occasioned, and a recommendation for the sum so ascertained to be given.[2]

However, the Commission concluded that it was not possible to measure 'the loss occasioned', including any benefits of federation. It said:

> It seems, therefore, to be unavoidable to use as some measure of disability the financial position of a State. We realise ... the danger of basing grants crudely on deficits; but as the evidence stands we have no alternative but to take these into account.[3]

9 Therefore, the Commission followed a principle of relative financial need and calculated special grants to enable claimant States 'with reasonable effort, to put their finances in about as good order as that of the other States'[4].

10 The Second and Third Reports made clearer what the Commission intended. The Second Report stated that 'the only ground for ... assistance is the inability to carry on without it'.[5] The Commission rejected, on principle and on the pragmatic ground of the difficulties inherent in measurement, the idea of assessing special grants to compensate the claimant States for the effects of Federal policy. It argued that Federal legislation was enacted by the Commonwealth as a whole, and that it must therefore be assumed that legislation was considered 'with full regard to the interests

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[2] Commonwealth Grants Commission, *First Report* (1933), p83.

[3] *Ibid.*, p84

[4] *Ibid.*, p123.

[5] Commonwealth Grants Commission, *Second Report* (1935), p37.

of the whole'. Parliament could, if it wished, compensate the States that might be adversely affected by Commonwealth legislation, but to provide automatic compensation would 'stultify the intended law'.[6]

11 The Commission also rejected State claims for grants on the basis of the poverty of natural resources. It said that it would be inappropriate for the Commonwealth to compensate the States for a lack of natural resources. It would 'do what nature has failed to do' and would perpetuate an uneconomic distribution of population. However, it said that assistance may be provided in relation to financial hardship that arises though economic changes, such as the collapse of world prices for a product, beyond the control of the State. Grants would be justified on the basis of financial need not poverty of resources. [7]

12 The Second Report also introduced the concept of a penalty for claimancy, ensuring that the claimant States, if they were to be raised to equality with the standard States, would have to make an above-standard effort in raising revenue or else practise economies in the range and standard of government services. This was consistent with Giblin’s view (a member of the first Commission) that States should not be raised to the Australian standard of prosperity by Federal grants alone, but by a combination of Federal assistance, greater effort in raising taxation revenue and greater economies in the provision of services.[8] Greater efforts would be required of States whose difficulties were due to their own mistakes or extravagance in the past. Lesser degrees of effort would be required by a State whose position was largely due to the effects of federal policy and an intermediate effort would be required if due to relative poverty of natural resources.[9]

13 The Third Report stated clearly for the first time that:

> Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.[10]

14 This basic principle enunciated in the Third Report remained unchanged in later claimancy inquiries, although there was considerable debate about how it should be interpreted. The question was whether 'not appreciably below' meant fiscal outcomes for claimant States roughly equal to those of the other States or outcomes allowing minimum standard of operations. However, by 1967, the Commission had begun to interpret its principle as one of fiscal equalisation rather than minimum

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6 *Ibid.*, p34

7 Commonwealth Grants Commission, *Third Report* (1936), pp62, 71-4.

8 L F Giblin, set out in R J May, *Financing the small States in the Australian Federation* (1971), OUP, Melbourne, p3.

9 *Ibid.*, p79

10 *Ibid.*, p75.

financial need – giving claimant States the capacity to function at a similar standard as other States.

15 In 1973, the basic principle was incorporated in legislation by the Grants Commission Act of that year, defining a 'grant of special assistance to a State' as one made 'for the purpose of making it possible for a State, by reasonable effort, to function at a standard not appreciably below the standards of other States'.[11]

Revenue sharing and equalisation for all States

16 In the period from federation to 1976 there was no policy or mechanism to equalise the fiscal capacities of the States. While claimant States' fiscal capacities were lifted towards those of the stronger standard States, there was no way of equalising non-claimant States.

17 The Commonwealth's 1976 'new federalism policy' made major changes in Commonwealth-State financial arrangements. As part of the policy, the Commonwealth and the States agreed a proportion of personal income tax revenue would form a pool to be shared among the States in a way that equalised their financial capacities.

18 After some debate, the Commission was asked in terms of reference to report by 1981 on whether any changes to the historically based shares of that pool were desirable, based on equalisation principles set out in the *States (Personal Income Tax Sharing) Amendment Act 1978*. The Act said:

> …payments to which the States are entitled ... should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by other States, government services at standards not appreciably different from the standards of government services provided by the other States.

19 It required the Commission to take into account:

- differences in the capacities of the States to raise revenues and
- differences in the amounts required to be expended by the States in providing comparable government services.

20 Similar definitions of equalisation were in the references for the 1982, 1985, 1988 and 1993 Reviews. However, debate during the 1993 Review suggested a more precise statement of the aim of equalisation might improve the understanding of it. Consequently, the 1999 Review reference said equalisation meant the grants to which States were entitled:

> should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources.

11 Section 5 of the *Grants Commission Act 1973*.

21 The Commission's 1999 Report rephrased that definition as:

> State governments should receive funding from the Commonwealth such 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 capacity to provide services at the same standard.

22 It considered its revised description was simpler and emphasised the key aims were to:

- equalise the State financial capacities to provide services, not their performance and
- equalise all States to the same standards which, as the reference required, were the average of those applying across the States.

23 The Commission's expression of the definition was applied again in the 2004 Review.

24 An Intergovernmental Agreement on Federal Financial Arrangements (the IGA) between the Commonwealth and the States was signed in 2009 (and a revised version in 2011). Interestingly, this did not include a definition of horizontal fiscal equalisation, but required the GST to be distributed among the States on the basis of the recommendations of the Commission based on that principle.

25 Similarly, the terms of reference for the 2010 Review did not define equalisation but made clear that simplification should be a focus of the review, provided this was consistent with equalisation. The Commission, therefore, started with its latest statement of the principle in the 2004 Review Report and modified it to reflect the emphasis on simplification.

> State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each State would have the fiscal capacity to provide services and associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

26 This definition was intended to indicate equalisation aimed to provide all States with the same fiscal capacity but that only those factors that have a material effect on State revenues and expenses would be assessed. It also signalled the introduction of direct assessment of State capital needs.

27 This definition of HFE was unchanged in the 2015 Review.

In summary

28 So the major methodological issue — on what basis should claims for special grants be assessed — was essentially settled in the mid-1930s. Any further consideration by the Commission was unnecessary because of developments in government policy. First, the *Commonwealth Grants Commission Act (1973)* incorporated a basis for assessing special grants (closely following the approach developed by the

Commission). Then when special grants were superseded by new revenue sharing arrangements, the Commonwealth and the States agreed the policy objective would be fiscal equalisation and legislated how that should be interpreted. More recently, the IGA has confirmed equalisation should be the basis of the distribution of general revenue funds among the States.

PART B: USING THE AVAILABLE INFORMATION

29 At the same time as the Commission was settling the basis for special grants, it had to decide how to quantify the appropriate grant. That required it to devise methods to answer a series of interconnected questions, including the following.

- What does 'not appreciably below' mean in practice?
- How should the practice of 'the other States' be brought together to form a standard of comparison?
- What adjustments to that joint experience should be made to reflect differences in policies of the claimants and the other States, or in circumstances causing differences in State fiscal capacities?

30 In answering those questions, the Commission adopted an approach based heavily on data and calculations, which has formed a cornerstone of the work of subsequent Commissions. While Commissions have not eschewed the use of informed judgment, reliance on data and analysis which promotes transparency is clearly evident in the work of the Commission. That approach encouraged States to develop claims based on data, and over time, increasingly more detailed data, in attempts to verify their claims for grant support. While growing sophistication of analysis provided gains in the quality of Commission decisions, that evolutionary process itself came at a cost of increasing detail. However, the 2010 Review saw the Commission pare back detail which was not considered sufficiently reliable or made immaterial difference to its recommendations.

31 In claimancy inquiries, the Commission recommended an absolute amount each claimant State required from the Commonwealth. That changed with the introduction of the policy of fiscal equalisation in 1976. From 1981, it recommended how a pool of general revenue should be shared among the States, being specifically asked to advise on whether any change was 'desirable in the State factors which prescribe the per capita relativities between the States of their tax sharing entitlements'. This marked the beginning of the use of State relativities in Commission recommendations. Box 1 provides an explanation of what relativities are.

32 How the relativities have been calculated since the 1981 Review is discussed in Attachment B.

Box 1 **What is a relativity?**

If States had the same economic, social and demographic features and Commonwealth payments were distributed uniformly among them, the Commission would recommend that the GST be distributed equally per person. Each State would be allocated the same (average) amount per resident.

However, some States are fiscally stronger than others — they have stronger tax bases, lower service delivery costs or receive above average Commonwealth payments. They need less GST revenue than other States if all States are to be fiscally equal.

That relative strength (or weakness) is measured by the State's need for GST revenue, compared to the average, and is summarised in its relativity.

A stronger State might be assessed as needing only 90% of the average GST available on a per capita basis — its relativity would be 0.9. A weaker State might be assessed as needing 110% of the average — its relativity would be 1.1.

Some people have misinterpreted a relativity to be the proportion of the GST revenue raised in a State which is returned to that State. This would only be true if the GST collected per person were the same in every State, which given differences among the States is unlikely.

To what level should claimant States be equalised?

33 The Commission had concluded in its earliest inquiries that special grants should be paid to enable a State 'by reasonable effort to function at a standard not appreciably below that of the other States'. It had also said that grants should be paid to raise a State 'to a minimum standard which will enable it to carry on with reasonable efficiency' and not to lift it 'to the high standard of welfare of the most prosperous States'. [12]

34 These statements draw attention to two aspects of the equalisation task. One relates to the standard of services a State provides and the revenue effort it undertakes while the other considers its budget outcome compared to the standard States.

35 Both issues were the subject of debate as the Commission's methodology evolved.

Service standards and revenue effort

36 Early Commissions were of the view that claimant States should not be given the capacity to deliver services of the same standard as other States and should make a

12 Commonwealth Grants Commission, *Third Report* (1936), p 10.

greater revenue effort.[13] In part this was to act as a disincentive for claimancy. Explicit, if judgmental, penalty adjustments were made to reduce the grants they should receive.

37 In addition, early Commissions adopted the view that States should not receive grants from the Commonwealth because their budgetary position had been exacerbated by poor policy choices made in the past, such as the losses South Australia incurred on Mallee wheat settlement and irrigation schemes. In the First Report, the Commission identified such policy choices and estimated their impact. A penalty was imposed on the State to ensure that the fiscal consequences were not negated by a special grant. It made no effort to isolate the impact of bad policy on the budgets of the standard States so it used an absolute standard of policy appropriateness rather than a relative standard.

38 In the Second and Third Reports, the Commission refined the way it calculated penalties. It expressed penalties for claimancy as a percentage of social services expenditure, and, for past mistakes, as a percentage of State taxation. This was to encourage the claimant States to make greater efforts than the standard States. This was in keeping with equalising claimant States to minimum standards, and ensured they had the capacity to provide services at standards a little below the average and to raise taxes at a little above average rates, if they wanted to deliver the standard level of services.

39 The grants recommended in the Third Report moved *The West Australian* to comment that 'instinct has had as much to do with the ultimate result as argument and the higher mathematics'.[14] In addition, despite the Commission's attempts at explaining that the penalty for claimancy was assessed on social services as a matter of convenience, and did not in any way imply that the State concerned should reduce such expenditure, the procedure was consistently misunderstood or misrepresented by State governments and politicians, who claimed that the Commission expected the States to reduce benefits to starving orphans and other unfortunates.

40 After 1945, the Commission removed penalties for claimancy and past poor policy, meaning grants were provided to give claimant States the capacity to provide services at the same level as the standard States, provided they raised revenue with the same effort.

The desired budget outcome of claimant States

41 From as early as 1937, the Commission, the Commonwealth Treasury and the claimant States argued over whether claimant States should receive a grant which would lift them from a deficit position to one of budget balance or to the fiscal

13 From the *Second Report* (1935).

14 Quoted in R J May, *Financing the Small Stales in Australian Federalism*, OUP, Melbourne, 1971, p68

position of the standard States, whether this were a deficit, a surplus or a balanced budget.

42 Until 1942, the special grant provided a top up for claimant States to allow them to achieve the same deficit as the standard States. However, in 1942, for the first time, the budget result of the standard States was a surplus rather than a deficit.

43 The Commission concluded the surplus in the standard States arose from the stimulus of war expenditure (excess railway profits and deferral of maintenance) and decided that it was not a 'reasonable Australian standard for our purpose'. It adopted a balanced budget standard, considering this a reasonable level at which to maintain the strength of the claimant States.[15] It also recognised at the time that it was desirable to minimise the funds transferred from the Commonwealth because of its war time requirements.

44 The Commission continued to use a balanced budget standard even when the standard State budgets were in deficit until 1952. This was because it concluded that the standard States were spending the accumulated surpluses in their reserve funds. However, from 1952 to 1974, the Commission adopted a deficit standard when the standard States were in deficit and a balanced standard when they were in surplus. The Commission did not accept arguments in favour of a surplus standard, presumably accepting that the principle of minimum need was the relevant basis for the assessment of grants.[16]

45 In 1974, the Commission finally agreed that the claimant States should be allowed full benefit of a surplus standard, following strong representations from the Commonwealth Treasury and the claimant States. It accepted that a balanced budget (rather than a surplus) standard effectively meant claimant States could not use special grants to supplement capital expenditure from loan funds or to build up cash reserves as the standard States were doing when they ran surpluses.

46 Since 1974, States have been equalised to the standard budget outcome, which is the observed average budget outcome of the standard States in claimancy inquiries and all States post 1981. This meant that State borrowings to fund deficits were equalised, leaving only differential investment and population growth as determinates of differences in future years' interest costs.

47 In the 2010 Review, the Commission maintained the position that States should have an equalised financial position, but broadened the concept from an equal budget outcome to an equal holding of financial assets. This allowed the Commission to break the nexus between borrowing for deficits and for investment, to recognise explicitly infrastructure investment in the year the investment occurred and to remove the need to assess differences in interest and dividend earnings.

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15 Commonwealth Grants Commission, *Ninth Report* (1942), p56.

16 Commonwealth Grants Commission, Equality in Diversity (1995), *op cit*, pp86-87.

Which States formed the standard States?

48 Having decided to compare claimant States with other States, the Commission needed to decide which States to use as the ‘other States’ and how their experience would be combined so that it could be used to calculate a grant entitlement.

49 A variable number of non-claimant States was used to calculate these standards, with some being excluded if the Commission considered they biased the standard in some way. For example, the Commission excluded New South Wales from the standard in the Second Report until 1937 because its services were considered too generous or too costly.

50 Throughout claimancy, apart from in the First Report where it used a population weighted average, the Commission generally adopted a simple average to calculate the standard deficits and standard levels of expenditure and revenue. This decision in favour of a simple average standard was based on the contention that in a federation the experience of each State financial unit should be given equal weight.

51 Until 1961, New South Wales, Victoria and Queensland were generally considered the standard States. However, when South Australia withdrew from claimancy in 1959, the Commission adopted a two-State standard of New South Wales and Victoria. This was despite strong objections from the Commonwealth Treasury which warned that using a two rather than four State standard could put the claimant States into a more favourable budgetary position than Queensland and South Australia. The two-State standard was used for all subsequent claimancy assessments.

52 At the end of the claimancy period in 1981, the Commission had a well-established methodological approach of comparing a claimant to a standard established by the ‘other States’. That approach was challenged by the move to equalisation for all States from 1976 where each could be seen as a claimant.

53 In the 1981 Review, the claimancy approach was modified by using each State in turn as the standard State to determine the grants required by the others and then averaging the results. This was described as a six-State rotating standard.

54 The complex and data intensive six State rotating standard approach was replaced in the 1993 Review when the Commission adopted the weighted average experience of all States as the appropriate standard to use in calculating grant entitlements. Essentially the average experience of all States became the standard against which the implicit claims of each State were assessed.

55 The change to six-State averages had no influence on the average expenses and revenue. It did, however, result in some differences in the calculation of average State policies. For example, under the rotating standard, the average tax rate was calculated as a population weighted average of the effective rates of tax in each State. This implied that the influence of each State's policy on the standard depended

on its share of the Australian population. Under six-State averages, the average tax rate was calculated as total revenue collected by the six States divided by the total of their revenue bases. This implied that the influence of each State's policy on the standard depended on the share of the total revenue base. The calculation of cost weights was similarly affected as population weights were replaced with service base weights.

56 Population and tax/service base weighted averages, giving equal weight to each Australian's experience, have been the Commission's preferred approach since then. As more Australians experience the New South Wales level of taxation or service, these carry more weight in the calculation of the average.

57 Where States follow very different policies, and when limited data are available to derive mathematical averages relating to what States tax or at what rates, or what services should be assessed and how, the Commission has at times decided average policy on the basis of what the majority of States do and whether the majority of the tax base is used or the service base supplied by States. This approach, while intuitive, has the potential to reduce the degree of equalisation achieved if it means material assessments are not made when less than the majority of States do something. As a result, in the 2015 Review, the Commission decided it would have regard to what every State did in characterising average policy. However, an assessment would only be made if it were material.

What State functions should be included in grant assessments?

58 From the beginning, the Commission took a comprehensive approach to what it regarded as relevant to determining State fiscal capacities.

59 At the time, States operated using several funds. All had Consolidated Revenue Funds (CRFs) into which State taxes and revenues from State business were paid and from which general expenditures including, for example, the wages of railway employees were made. All had Loan Funds where the proceeds of loans were paid and from which, for example, infrastructure investments were made. Most States also had a number of special and trust funds.

60 The first Commission started with published and audited budget results of States which related to the CRF. It did not deal with State Loan Funds although interest payments on State debt were CRF transactions. It made a few corrections for differences in the scope of State budgets and accounting practices but not for differences in the business undertakings which States included. Road financing was excluded from all State budgets in the 1950s because the Commission accepted there were special arrangements in place to deal with that. From the late 1960s, the impact of most business undertakings was also excluded because information was not readily available to make policy adjustments to their impact on State budgets. By 1976, only

the net impact of railways, metropolitan transport, country water and debt charges relating to forestry were included.

61 In the first relativities review, the CRF was again the focus of Commission comparisons. The range of revenues and expenditures included in 'the standard budget' of States was, with minor exceptions, similar to that which had been covered in claimancy inquiries. They were restricted to recurrent transactions and the operating transactions of selected business undertakings which affected State budgets. Modifications to ensure uniform accounting practices and a common range of functions, such as the inclusion of revenues and expenditures in government trust and special funds and of the Brisbane City Council transactions relating to metropolitan transport, continued to be made. Capital transactions, spending on functions mainly the responsibility of the Commonwealth, such as funding for universities and local government, and transactions of most business undertakings and roads and housing authorities were excluded.

62 In the 1993 Review, a major change was made to include:

- recurrent housing and roads transactions
- revenue from drivers' licence fees, motor registration charges and business franchise fees on petroleum products used to fund road expenditures
- transactions aimed at employment creation
- the net impact on State budgets of State banks, insurance offices, metropolitan water supply and sewerage, harbours and forestry operations and other public trading enterprises.

63 These changes were made because the Commission considered they would improve the degree of fiscal equalisation achieved and the transparency with which it was achieved. The distinct financial arrangements with the Commonwealth for roads and housing were changing and, in relation to roads, the general revenue pool from 1993-94 included identified roads funding. The Commission considered it necessary for needs to be assessed in relation to this. The inclusion of the net impact of all business undertakings, even if not assessed, gave greater transparency.

64 By the 1999 Review, States had moved from cash to accrual accounting, they had consolidated their separate operating funds into one fund and restructured their operations by corporatising or privatising some services and introducing many micro-economic reforms. There had also been a number of changes in Commonwealth-State financial arrangements, such as the abolition of the Loans Council capital program in 1994.

65 The Commission decided that, in the interest of comprehensive equalisation, it needed to make its assessments more consistent with what States were doing. [17] The

[17] Commonwealth Grants Commission, *Report on General Revenue Sharing Relativities 1999* Volume 2, p20.

most significant inclusion was that of depreciation. (It took the view it could not include capital transactions unless it was directed to do so.) In the 2004 and 2010 Reviews, the Commission consolidated this approach. It decided that, since the GST was intended to supplement State budgets, its comparisons should include all activities that had a direct impact on State operating accounts. It adopted the ABS Government Finance Statistics framework and defined this to include all State general government activities, excluding any Commonwealth or local government activities, except to the extent they affected State operating statements. It concluded that it was administratively simpler and more reliable to include all transactions, even if the Commission decided that differential needs should not be assessed.

66 The major change in the 2010 Review was that the Commission moved beyond State net operating balances to include all transactions in State operating statements, including the costs of acquiring infrastructure and any net lending or borrowing that resulted after this. This was required to facilitate the Commission's decision to assess State capital needs directly and upfront and to equalise State net financial worth rather than net operating balances.

67 In the 2015 Review, the Commission noted that a number of States had reversed the trend to provide urban transport and social housing activities through trading enterprises. In many States, they had been integrated into State general government sectors and had strong similarities to services provided by general government agencies, even when they were delivered by public trading enterprises. They were not fully commercial and depended on government funding to meet recurrent costs and pay for major investment; the services stem from social policy objectives; and government departments make the policy on service delivery and charges. As a result the Commission decided to treat these activities as general government activities and brought their operations into the standard budget. The main difference was that the urban transport and housing investment and depreciation needs were now assessed.

How have assessment methods changed?

68 To begin with, the basic method used to derive special grants was to calculate the amounts necessary to reduce the observed deficits of the claimant States to the level of the standard, or non-claimant, States. This approach provided a first estimate of the appropriate grant where States were delivering the same standard of service, making the same revenue effort and had the same accounting practices.

69 In recognition that accounting practices were not the same, the Commission made modifications to observed budgets to make them comparable. 'Corrections' were made to the budgets of the claimant States to bring in items usually included in the budgets of the standard States or to remove abnormal items. For example, additions were made to the Western Australia and Tasmania deficits to reflect losses on Agricultural Bank and group and soldier settlement activities which had been met

from Loan Funds in those States but were similar to items included in the budgets of other States.

70 In addition, early Commissions also recognised that differences in budget outcomes were heavily influenced by differences in State policies and that these should not be factors driving the grants claimants received from the Commonwealth. Where it could identify such differences and suitably quantify their impact, these impacts were carried through into modified budget outcomes used to calculate grant entitlements. If the Commission concluded that a claimant State was underspending on a service, it would increase the observed deficit and if it were overspending, it would reduce the deficit. In the First Report, the Commission concluded that Tasmania was severely underspending on the maintenance of railways, bridges and jetties and an amount of £160 000 was added to its grant. Similarly, if the claimant State were imposing higher tax rates, it would increase the deficit, or if lower tax rates, it would reduce the deficit.

71 As early as the First Report, the Commission also recognised that States faced different circumstances (disabilities in current terminology). Because it considered Victoria faced ‘favourable conditions’ in the provision of social services, it increased the standard level of spending to which claimant State spending was compared before calculating the above or below average spending by the claimant States and the adjustment required to their grants. In the Second Report, the Commission did a similar thing in relation to the costs of administration. Recognising that smaller States would have larger per capita overhead costs than the larger, standard States, it calculated what each State would need to spend on these administrative services, given their size. It then compared what States were actually spending with those figures to calculate the required adjustment.[18]

72 Lastly, as discussed above, because early Commissions did not seek to provide claimants with the same capacity to deliver services or the same capacity to raise revenue as the standard States, they made further adjustments to the budgets of claimant States to impose penalties for claimancy and past mistakes. The budget deficits of claimant States were therefore reduced compared with those of the standard States and consequently the special grants.

73 This assessment approach meant that, except where specific policy modifications were made or penalties were imposed, the Commission considered that a State could raise the amount it was observed to raise in revenue if it made a reasonable effort and that it needed to spend what it was observed to spend to deliver a comparable service. In today’s terminology, these were actual per capita assessments. However, the assessments which were made recognised both the need to make adjustments for policy differences and differences in circumstances.

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18 Commonwealth Grants Commission, *Second Report* (1935), p61.

74 Over time, the Commission developed different ways of making these adjustments to State deficits. For example:

- In 1937, the Commission decided that the costs of providing social services in the claimant States were necessarily higher than the costs in the standard States, due to their smaller and more dispersed populations. It began assessing allowances for 'social density', which were expressed as percentages of the standard expenditure on social services. In the first year, they were 3 per cent for South Australia and Tasmania and 7 per cent for Western Australia. The allowances were increased in future years so that in 1961, they were 14 per cent for Western Australia and 17 per cent for Tasmania.[19]
- In 1944, the Commission changed its approach to measuring revenue severity. This was initially based on an index of relative severity, derived by dividing an index of actual State taxation collections by an index of taxable capacity based on Federal income tax assessments. In 1944, a tax-by-tax approach was adopted because the Commission no longer considered the income tax approach appropriate. It calculated the amounts the claimant States would have raised in each taxation category if their rates and exemptions had been the same as for the average of the standard States. It subtracted this amount from their actual collections to derive an adjustment for that tax. These adjustments were then summed to give the total adjustment for relative severity of taxation.
- From 1949, the Commission began to make comparisons in relation to selected State business undertakings. Under what became known as the modified per capita budgetary impact comparison approach, the Commission made adjustments to the budgetary impact of an undertaking in a claimant State by reference to the average policies of the standard States concerning these revenue and cost elements. The Commission made comparisons in relation to railways, metropolitan transport and water supply, sewerage, irrigation and drainage. (Attachment C provides a summary of the Commission's approach to assessing business undertakings from 1933 to the present.)
- In 1963, the Commission adopted a unit cost method of assessment for some social services. It calculated cost per unit served (school student or occupied hospital bed day) in the standard States and multiplied this figure by the number of units in the claimant States to derive allowable expenditure. An adjustment to the State deficit was then calculated as the difference between allowable and actual expenditure. This became the eligible population (not actual users but those eligible to receive the service based on the average policy of the standard States) method in 1969 and included adjustments to per eligible population spending for special difficulties in the claimant States.

75 In 1974, the Commission adopted a new assessment methodology. This represented an important change in philosophy. The Commission moved from an actual per capita

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19 This meant that the standard expenditure was reduced due to penalties for claimancy but then increased to allow for differences in social density. The difference between this adjusted standard and the claimant State's spending was the amount by which its deficit was reduced (if above) or increased (if below).

starting point, with adjustments for known policy differences, to an equal per capita starting point, with adjustments for innate difference among the States. These innate differences had an impact on what States would need to spend to deliver the same level of service as the standard States, or what States could raise if they followed the revenue policy of the standard States.

76 Rather than comparing modified observed budget outcomes to estimate a grant, the Commission directly calculated grant needs for individual expenditure and revenue items (including other Commonwealth grants), with the sum of these needs representing its required grant. For example, revenue needs were calculated as the difference between the amount the claimant States would raise by applying the revenue effort of the standard States to its own tax base and the amount that would have been raised by applying that revenue effort to a standard tax base. The modified per capita difference method was still used in business undertaking categories but needs were assessed as the product of the claimant State's population and the difference between the modified per capita budgetary impacts in the claimant and standard States.

77 Both approaches should have, in theory, achieved the same grant outcomes. In practice they did not because of differences in the data available to support the different approaches. The direct method focused effort into the quantification of the impact of innate differences among the States; for example, the distribution of residents who imposed higher than average costs on State budgets. Less emphasis was placed on estimating the impact of differences in State policies on State budget outcomes (except in relation to business undertakings).

78 In 1977, the direct approach was given greater rigour when the factor assessment method was introduced for expenditure assessments. Under this approach, the Commission calculated or estimated the claimant State's percentage disabilities relative to the standard States for each category, which could be viewed across spending areas to assess comparability. The disability factors included those arising from differences in eligible population, scale, dispersion, and the physical and economic environment.

79 This is the method used for most expenditure categories in State relativity reviews since 1981. Disabilities recognised were expanded to include urbanisation, age-sex composition and social composition disabilities as Commission knowledge of State circumstances developed and better datasets became available. For a few categories where the Commission was unable to identify disabilities or considered States should be able to provide services at the same per capita cost, it used an equal per capita assessment to calculate what States needed to spend at average policy.

80 For revenue, the Commission largely continued to assess State revenues by applying average rates to State revenue bases. Some States argued for a return to a global revenue assessment in place of the tax-by-tax approach but the Commission has

rejected that approach in each review up to and including the 2015 Review because the global bases proposed were not what it considered States taxed or even could tax.

81 For some revenue categories, equal per capita assessments were made if the Commission was unable to reliably measure State tax bases or it considered all States should be able to raise the same per capita revenue.

82 The development of Commission methods relied heavily on the consideration of arguments and evidence submitted by State Treasuries and, up to the early 1990s, by the Commonwealth Treasury. Even so, in the first relativity reviews, the Commission relied heavily on 'broad judgment' to make its assessments. While its judgments were informed by available data and relied on much of the work it had undertaken in relation to determining special grants, many disability and revenue base assessments were relatively simple.

83 However, over time, and with extensive State submissions on the disabilities they faced and the methods required to better reflect their fiscal capacities, Commission methods became more detailed and reliant on data. The Commission recognised the need to simplify its assessments in the 1999 and 2004 Reviews. However, although States supported simplification in principle, there was no agreement on how simplification could be achieved and changes to assessment methods for reasons of simplification did not occur. This changed in the 2010 Review when the terms of reference required the Commission to simplify its assessments through aggregating categories and factors, eliminating unreliable assessments and introducing a materiality threshold to remove assessments which did not move much GST.

84 Attachment D provides a summary of the detail in assessments in selected years from 1933 to 2015. This shows that the Commission began with a few broad brush assessments, increasing the level of detail as methods became more sophisticated in response to State and Commonwealth Treasury arguments and data improved, followed by a reduction in detail with an attempt by the Commission to simplify its assessments.

Keeping State grants up to date

85 An important structural part of the processes the Commission used to provide advice to government was how it ensured the grants it recommended would be as relevant as possible to a future period. Since its earliest days, the Commission has always aimed to recommend grants or relativities that were as appropriate as possible to State circumstances in the year in which they are applied (the application year). However, past Commissions have recognised that trade-offs were required between this objective and the need for reliable data. This has resulted in the use of historical years as a guide to conditions in the application year. However, different approaches

have been adopted by various Commissions to keep their advice as up to date as possible by varying the number of historical years used as the guide, whether they would consider likely changes which might occur in the application year (and make adjustments for grants) and whether they considered it was necessary or possible to correct errors. The choices made have very much depended on the particular job they were doing (special grants or relativities) and how governments wanted them to do it, as set out in terms of reference.

86 In its 1936 Report, the Commission said it would make its recommendations on the grants required in 1936-37 on the basis of needs measured using data on State budget from 1934-35.[20] It recognised that this might not give the right answer but considered that the error would not be cumulative and even out over time as economic cycles had their impact on State circumstances.

87 Through the special grants period, the Commission adopted a single year of review (assessment year), being two years prior to the year of payment (application year). It also addressed the possibility of errors by adjusting grants for known circumstances in the application year and by adopting an advances and completion approach. In the first reports, advances reflected the Commission's judgments of the impact of current conditions on the fiscal circumstances for the year in which the grant was to be paid. For example, based upon the fiscal position in 1934-35, the Commission in its 1936 Report recommended that Western Australia receive a grant of £456 000 in 1936-37. However the Commission adjusted this by an additional £44 000 (to £500 000 in total) because of a very serious drought which affected Western Australian State finances in 1936-37. It was to be deducted from the indicated grant based on its financial position in 1936-37.

88 This approach was formalised in 1949 with the special grant explicitly divided into two parts which became known as the advance grant and the completion grant.

89 This approach did not continue with the introduction of relativity reviews. The Commission was initially asked to review the desirability of making changes to the legislated relativity factors, which, if made, were to remain in place for a number of years. Thus, there was no prospect of an opportunity to correct these until future reviews were requested.

90 In the reviews undertaken in the 1980s, the Commission used a three year assessment period to smooth any transient or abnormal influences but expressed concerns about the possibility of a growing gap between the assessment years and the application year if annual updates of relativities were not undertaken. It was concerned about the dynamic nature of many of the relevant economic and budgetary variables underlying the assessments, including the changing distribution of specific purpose payments across States, which could have substantial impacts on

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20 Commonwealth Grants Commission, *Third Report (1936)*, paragraph 237 (ii).

relativities. However, the Commission's advice on the need for annual updates was not taken up.

91 In the absence of annual updates, for reviews undertaken in the 1980s, there were either explicit terms of reference or accompanying directions asking the Commission to indicate what allowance (if any) might be made to relativities to account for trends over a longer period, or transient factors and temporal changes. The Commission chose not to make any specific adjustments because of uncertainty.

92 However, it did adopt 'backcasting' to reflect any major changes in Commonwealth-State financial relations in the data for the assessment years.

93 A decision to go to annual updates of relativities, including using three-year moving averages, was made at the 1988 Premiers' conference, to take effect from 1989.[21] This was intended to reduce the problem of allowing for trends and transient factors and temporal changes in policy which affected the appropriateness of using the same relativities for a number of years. The Commission concluded in its 1989 Report on Updates of Relativities that this approach would 'increase the likelihood that fiscal equalisation is achieved in the year of application'.[22]

94 The 1990 Premiers' conference decided that annual updates should continue and from 1990-91 and thereafter, be on a rolling five year basis.[23] This approach continued until the 2010 Review, when the Commission, not instructed by terms of reference to use a five year assessment period[24], returned to a three year period. This was because in the 2010 Review the Commission formally adopted as a supporting principle that relativities be contemporary. It concluded that three years gave the best trade-off between this principle and the need for reliable data. All States supported this lagged approach.

95 In the 2015 Review, Western Australia changed its view, due primarily to large downward movements in its iron ore royalty receipts. It now considered contemporaneity could and should be improved by using forecasts with ex-post adjustments.

96 In contrast, the other States opposed this. Queensland, South Australia, Tasmania, ACT and the Northern Territory said the lagged three year average assessments achieved horizontal fiscal equalisation and provided the best balance between supporting principles. New South Wales, Victoria, Queensland and Tasmania said that

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21 Commonwealth Grants Commission, *Report on General Revenue Grant Relativities, 1989 Update*, paragraph 1.3.

22 Commonwealth Grants Commission, *Report on Update of Relativities 1989*, paragraph 2.10.

23 Commonwealth of Australia, *Budget Paper No. 4, 1990-91*, page 50.

24 The 2004 Review terms of reference did not specify the number of assessment years either, but the Commission retain a five year period as there was limited support from States other than South Australia and Tasmania to change.

any improvement in contemporaneity would come at the expense of one or more of reliability, practicality or predictability of GST revenue. The Commission agreed.

97 A more complete history of how the Commission has dealt with the contemporaneity issue can be found on the Commission's website.

Including the two Territories

98 The Commission has played a role in recommending financial assistance for the Northern Territory and the ACT since, or in the lead up to, self-government. The Northern Territory was included in the State revenue sharing arrangements from 1988-89 and the ACT from 1993-94. The funding these Territories were receiving from the Commonwealth before they were included was added to the pool of funds to be distributed among the seven, and then eight, entities.

99 This marked the beginning of full and comprehensive equalisation in Australia.

The Northern Territory

100 The Commission recommended special grants for the Northern Territory from 1979 to 1986, following self-government in 1978. In those assessments, while standard procedures were used for revenue and business undertakings categories, the Commission assessed expenditure needs in the Territory using the modified per capita difference method (per capita needs for a category were defined as the difference between the Territory's per capita expenditure for that category, modified for differences in policy or efficiency relative to standard, and the standard per capita expenditure). This was because it did not consider it could recognise the special circumstances of the Northern Territory appropriately using the factor assessment method.

101 At the May 1988 Premiers' Conference, it was decided that, from 1988-89 onwards, the Territory's share of general revenue grants would be calculated using the same assessment methods as for the States. Even though a number of Territory specific special fiscal needs, such as those relating to its stage of development, land rights legislation and minimum establishment sizes, were recognised, the Northern Territory's general revenue funding was reduced. Therefore, for 1988-89 and each of the subsequent years, the Territory was provided with special revenue assistance to ease its transition to the equalisation distribution assessed by the Commission.[25]

102 The Northern Territory became part of the relativities review process from then on although recognition of most of its special fiscal needs, apart from land rights and a small administrative scale allowance, have been phased out.

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[25] Commonwealth Grants Commission, *Equality in Diversity 2nd Edition* (1995), paragraph 9.52.

The ACT

103 The ACT's entry into the relativities process was somewhat different. It commenced before self-government with a Commission report released in 1984 on the financial contribution the Commonwealth could seek to recover from the Australian Capital Territory community for works and services provided in the Territory. It found there was a need to establish separate accounting records for the ACT but that, on the basis of available figures, revenue raising was inadequate to finance an equitable share of the services provided in the ACT. This was the case, even though special national capital and seat of government needs were recognised.

104 Three more inquiries followed. The central requirement of the Commonwealth, set out in terms of reference, was for the Commission to assess, in accordance with the equalisation principle, the financial contributions to be made by the ACT community and by the Commonwealth to enable the ACT community to be provided with government services at levels comparable to those in the standard States. [26] The outcome for the ACT was to be a notional budget result equal in per capita terms to the average result for that year in the standard States.

105 The fourth inquiry was asked to use the same methods as those adopted in the 1988 Review. The Commission did so but recognised the need for special allowances to give the newly elected Territory Government time to adjust to policies it had inherited from the Commonwealth Government, as well as national capital and seat of government allowances.

106 In 1988-89, as part of the preparations for self-government, the ACT for the first time received a general revenue grant analogous to those received by the States and Northern Territory, based on the advice in the third report. This meant a reduction to the funding levels the ACT had received in the past. When the ACT became a self-governing Territory on 11 May 1989, arrangements were put in place to assist transition the ACT to parity with State funding levels by 1993-94.

107 From 1993-94, the ACT was included with the States and the Northern Territory in the distribution of the pool of general revenue funds using relativities assessed by the Commission in the 1993 Review.

108 All six States and both the major Australian Territories were at last included in one system for distributing general revenue funds.

In summary

109 Over its existence, the Commission has developed an approach to making recommendations for States grants which is based on an evolving horizontal

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[26] New South Wales and Victoria in the second inquiry, the six States in the third and all States and Territories in the fourth.

equalisation objective and four key assessment principles. These principles were most recently set out in the 2015 Review Report. While noting the principles were subsidiary to the Commission's primary objective of achieving horizontal fiscal equalisation and should not override that objective, the Commission said they were to be used to assist in the development of assessment methods. They required equalisation to be implemented by methods that:

- ***reflect what States collectively do.*** This principle aimed to ensure the GST distribution provided financial support for the activities of State governments – the services and infrastructure they were providing, given the revenues they were able to raise. The Commission said it meant neither the Commission, nor any other body, should dictate what States should do and State sovereignty was preserved.
- ***are policy neutral.*** This principle aimed to ensure a State's own policies or choices, in relation to the services it provides, or the revenues it raises, did not directly influence the level of grants it received. It also aimed to ensure the GST distribution methodology created no incentives or disincentives for States to choose one policy over another.
- ***are practical.*** This principle meant that assessments should be based on sound and reliable data and methods, be as simple as possible while also reflecting the major influences on State expenses and revenues. The Commission said it was consistent with the 2015 Review terms of reference which required the Commission to prepare its assessments to distribute GST revenue in accordance with the principle of HFE and 'aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data'.
- ***deliver relativities that, as far as possible, are appropriate to the application year (contemporaneous relativities).*** This principle meant that, as far as reliable data would allow, the distribution of GST provided to States in a year should reflect State circumstances in that year. Without that, the equalisation principle would be compromised.[27]

110 The Commission said these principles were aspirational and ideally all methods would embody these attributes. However, it noted that, in practice, they often required trade-offs among them — for example, between methods that capture what States do in detail and methods that are policy neutral and reliable. As a result, it concluded that precise equalisation may not be achieved but this was a necessary compromise to ensure only reliable, policy neutral and material assessments were made.

27 Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities, 2015 Review*, Volume 1, p30.

ATTACHMENT A A BRIEF HISTORY OF THE CGC: A TIMELINE

Decade	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s	2020s
Role of CGC	1933	Special grants to one or more of Qld, WA, SA, Tas				1982-83	Last special grant to a State			
		Claimant State' period								
		Absolute grants								
					1979	-1986	Special assistance grants for the NT			
						1984	-1991	ACT inquiries leading to self-government		
						1981	State revenue sharing relativities			
							Reviews in 1981, 82, 85, 88, 93,99, 2004, 2010, 2015			
						1989	Annual updates commenced and have continued to 2016			
						1988-89	NT included in relativities process			
							1993-94	ACT included		
						All States and Territories became involved				
						Relative shares of a pool				
					1974-79	Local Government financial assistance reports				
							1991	Review of interstate distribution of FAGs		
								2001	Review of Act	
								2006	Local Roads funding	
						1986	Other Territories			
							Cocos I 86,89,93			
							Christmas I 95			
							IOTs 99, 2007			
							JB 2002			
							NI 97, 2006, 2011			
								2001	Indigenous Funding	

ATTACHMENT A A BRIEF HISTORY OF THE CGC: A TIMELINE (CONTINUED)

Decade	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s	2020s	
Purpose	1933	Mitigate adverse influence of Commonwealth policy but because unable to measure this, considered financial position of State									
of grant	1936	If State unable to carry on without a grant; rejected influence of Commonwealth or poverty of natural resources as reasons for a grant									
				1967	Equal fiscal positions						
					1976	Cwth and States agreed on HFE					
Objective	1933	Grants determined to enable claimant States 'with reasonable effort, to put their finances in about as good order as that of the other States'									
	1936	Grants determined to enable claimant States to,' by reasonable effort, function at a standard not appreciably below that of other States'									
		Debate over whether this meant roughly equal outcomes or minimum standards of operation									
				1967	Fiscal equalisation established as goal						
					1973	Established in CGC legislation using 'not appreciably different' language					
					1976	New federalism and States (Personal Income Tax Sharing) Amendment Act					
						defined payments States should be entitled to: still 'not appreciably different'					
							1999	R1999 ToR: State should be able to operate at the			
								average standard if it makes average effort and			
								operates with average efficiency			
								CGC - rephased as 'same'			
								2010	materiality introduced		
Measure	1936	Equal deficits, adjusted to require extra effort and any penalties considered approriate because of bad decisions									
		1945	Penalties for claimancy (extra effort and bad decsions) suspended and direct revenue assessments introduced								
					1974	Direct expenditure assessments introduced					
			Previous adjustments to APC expenses and revenues for differences in effort and policies became adjustments to EPC								
			expenses and revenues for differences in bases and disabilities								
						1981	Grant distribution model adopted to ensure all States achieved				
							equal net operating balances				
								2010	Grant distribution model ensured all		
									States had the capaity to hold the same		
									net financial worth		
Standards	1933	Population weighted averages									
	1935	Simple averages- give equal weight to each State's experience (federation)									
						1981	Six-State rotating standard - similar to population weighting -				
							the experience of each Australian receives equal weight				
							1993	weighted average (pop, tax base, or disability)			

ATTACHMENT B HOW ARE RELATIVITIES CALCULATED? THE DEVELOPMENT OF THE DISTRIBUTION MODEL

1 The methods the Commission had developed in assessing the revenue and expenditure needs of a claimant State were applicable to the first review. However, a means of converting the assessed needs for each State into per capita relativities was required. The procedures devised to do this became known as the distribution model. Its development probably provoked more discussion than any other single issue in the first review. It was the subject of discussion papers, submissions, hearings, conferences and a report by a working party of State and Commission officers.

2 The model adopted was based on the calculation of an assessed deficit for each State (or its requirement for financial assistance from the Commonwealth). In simplified terms, this could be expressed in two ways.

- The first defined a State's assessed deficit as its assessed expenditure (average per capita expenditure plus its relative expenditure needs) less its assessed revenue (average per capita revenue less its relative revenue needs), less the average modified budget result (defined as the difference between the average modified expenditure and the sum of the average modified revenue and average Commonwealth specific purpose grants).
- The second (equivalent) formulation defined the assessed deficit as the sum of two components: the average deficit, which was defined as average expenditure less average revenue less the average modified budget result (and was thus an equal per capita amount for each State); and the revenue and expenditure needs of the State under consideration.

3 However, because of the way calculations were undertaken, the total assessed deficits of all six States in any year did not equal the total tax sharing entitlement made available by the Commonwealth in that year. As a result, the appropriate per capita relativities could not be obtained by simply dividing each State's assessed deficit by its population and expressing the results as ratios of the per capita figure for Victoria.

4 There was a 'gap' between the sum of the assessed deficits and the total available assistance. Some States and some members of the Commission believed that it should be eliminated and the total assessed deficits made equal to the total available assistance by distributing the gap on an equal per capita basis. Other States and other members of the Commission believed that the gap should be distributed in proportion to the assessed deficits (or not distributed at all, which amounted to the same thing).

5 The Commission, after much debate, adopted a compromise under which it distributed the gap according to both methods and based the calculation of the

States' shares of the available assistance on the simple average of the two results. As the gap proved to be very small when compared with the total assessed deficits and the available assistance, the differences between the factors calculated by these two methods were also very small, especially when compared with changes in the relativities from year to year.

6 The adjusted assessed deficits of each State in each year were then divided by that of Victoria, the fiscally strongest State. Victoria’s relativity became 1.000 and those of the other States greater than 1.000. The relativities for each State for each year were then summed and divided by three to obtain the recommended relativities.

7 This method of bringing together the assessments for the individual categories of revenue and expenditure remained virtually unchanged until the 1993 Review. In this review, it was changed in the following main ways.

- Disabilities were measured in each assessment category relative to revenue base or service base (usually population) weighted Australian averages instead of using rotating standards. If total actual revenues or expenses still did not equal total assessed revenues or expenses, they were scaled in a way that ensured they did. This made it possible to eliminate the gap between the total funds available for distribution and the total of the standardised deficits of the States at the category rather than standard deficit level.
- Relativity factors were expressed to an Australian average of 1.000, instead of setting the relativity for Victoria at 1.000.

8 These changes made it easier to understand the model and to follow the changes in the position of each State over time.

9 The only other change made to the distribution model occurred in the 2010 Review when the Commission decided to equalise State net financial worth rather than net operating balances. This was done to facilitate direct and upfront assessment of State capital needs (for investment in infrastructure and net lending).

10 Box B1 sets out how the relativities were calculated in the 2015 and latest Review.

Box B1 Distribution model for the 2015 Review

For each State or Territory included in the GST distribution process (State i)	
Assessed GST for State i for each assessment year:	= State i's assessed net lending **plus** State i's assessed expenses **plus** State i's assessed investment **less** State i's assessed revenue **less** State i's Commonwealth payments impacting on State fiscal capacities
Where:	
State i's assessed net lending	= the amounted needed by State i to achieve the same per capita net financial worth in the year (a)
State i's per capita relativity for each assessment year	= State i's assessed GST requirement per capita **divided by** average per capita GST
State i's per capita relativity for the review	= ∑(State i's per capita relativity for each year) **divided by** the number of years (3)

(a) Each State's assessed net lending is determined as its per capita share of net financial worth at the end of the year less its per capita share of net financial worth at the end of the previous year (measured in current year price levels excluding revaluations and other non-transactional changes).

ATTACHMENT C ASSESSMENT OF STATE BUSINESS UNDERTAKINGS

1 From the First Report, the Commission has been concerned about the impact that State business undertaking (public utilities), such as railways, water supply and sewerage, irrigation, harbours, coastal shipping, forestry, tramways and electricity supply, have on State fiscal capacities.

- In the First Report, no corrections were made for differences in the scope of undertakings which had an impact on State budgets. The Commission concluded doing so would not have a substantial effect on relative fiscal positions. It therefore largely accepted the actual differences between claimant and standard State budgets. However, the Commission concluded that Tasmania was severely underspending on the maintenance of railways, bridges and jetties and increased its grant to allow it to spend at standard levels. It also reduced South Australia's grant because it had allowed its railway assets to run down.
- While the Commission went to considerable effort to analyse the net impact on State budgets of the operations of a number of the more important State undertakings from the Second Report, including whether States were recovering costs at the same level and delivering equivalent services, it made limited adjustments for most undertakings until 1949.
- From 1949, the Commission used the modified per capita budgetary impact approach to make adjustments to the budgetary impact of railways, metropolitan transport and water supply, sewerage, irrigation and drainage undertakings in claimant States. It modified budget outcomes of the undertakings for differences between the policies applied by the claimant and standard States in relation to charging and spending. Detailed analyses of fares and service provision were firstly undertaken for railways, with broad judgment used to assess adjustments for other undertakings. These analyses of charges and spending (mainly wage policies) were extended to the other included undertakings over time.
- However, from the late 1960s, the Commission excluded the impact of most undertakings because of the difficulties it had in calculating adjustments. By 1976, the Commission was making assessments only in relation to railways, metropolitan transport and country water (including supply, sewerage, irrigation and drainage) and the debt charges relating to forestry. Systematic analysis of policy differences were made in relation to cost elements such as fares, wage costs and depreciation. Despite pressure from the Commonwealth and Tasmania to extend its comparisons, the Commission resisted, arguing it could make no precise measurement of other activities and could only scrutinise them to ensure no abnormal changes.
- From the 1981 Review, the Commission continued to examine the operating transactions of the undertakings examined in claimancy inquiries – those which incurred a charge to general revenue. It undertook assessments in relation to Non-metropolitan Transport, Metropolitan Transit, Coastal Shipping Services, Country Water Supply and Sewerage and Irrigation and Associated Drainage. It continued to assess the budgetary impact of these for each State by making modifications to reflect average State policy.

- In the 1985 Review, the Commission was asked in terms of reference whether it continued to be appropriate to apply the principle of equalisation to 'services in the nature of business undertakings', given the data problems. It concluded it was, particularly as its assessments covered only those undertakings whose activities regularly resulted in a net cost to all or most State budgets and data deficiencies were no greater than those in other revenue and expense assessments.
- In the 1988 Review, the Commission decided it would progressively adopt the factor assessment method in assessing net budgetary impacts for business undertakings. This was because policies implemented by State were becoming too diverse to confidently identify.
- From the 1993 Review, the net impact on State budgets of all undertakings were brought within the scope of the Commission's comparisons, including that of State social housing authorities, State banks, insurance offices, metropolitan water supply and sewerage, harbours and forestry operations and other public trading enterprises. However, apart from transport, housing, country water and electricity undertakings, for which the Commission recognised innate differences between States which required higher or lower levels of spending, they did not have an impact on State relativities.
- In the 1999 Review, the operating transactions of State trading enterprises, except urban transit and social housing, were replaced with State budget subsidies and budget receipts of dividends and tax equivalent payments. In the 2010 Review, social housing became a net assessment.
- In the 2015 Review, subsidies to non-urban transport, water and electricity undertakings continued to be assessed. The operating expenses and revenues of urban transport and social housing authorities were brought with in the Commission's comparisons because the Commission considered these more like State government services than business undertakings. While a net assessment continued for urban transport, housing revenues and expenses were separately assessed because the disabilities affecting them were different. Investment and depreciation by these authorities was also assessed for the first time.

ATTACHMENT D CHANGE IN DETAIL IN ASSESSMENTS

Table D-1 Comparison of detail in assessments, selected inquiries

	Revenue assessments	Expenditure assessments
Special grants reports		
1933 (1st)	Assessments of severity of taxation and death duties; Commonwealth grants.	Budget modifications for comparability, penalties for poor decisions, adjustments for under or overspending on social services, railway maintenance, to assist Western Australia to develop the north west and for errors.
1936 (3rd)	Assessments of severity of State taxation (based on income tax), local government taxation and motor taxation; Commonwealth grants.	Budget modifications for comparability, penalties for claimancy, allowances for cost differences (administration, maintenance), effects of Federal policy.
1943 (10th)	Three assessments of severity in relation to personal exertions, property and companies, one relating to Commonwealth grants.	Budget modifications for comparability. Claimancy and past financial policy penalties assessed and differences in costs of administration assessed. Costs of social services and maintenance of capital equipment not assessed in this year.
1945 (12th)	Revenue by revenue approach to severity assessment – 7 categories. One relating to Commonwealth grants.	Budget modifications for comparability. Penalties for claimancy and past loan policies suspended. Differences in costs of social services assessed.
1949 (16th)		Assessments of business undertakings commenced.
1974 (41st)	14 direct assessments of revenue and one for Commonwealth grants.	13 direct expenditure assessments and 3 business undertaking assessments.
Reviews		
1981 and 1982	24 revenue categories, plus a Commonwealth payments category	68 expenditure categories and 5 business undertaking categories. Eight different types of disability factor were assessed – units of use, scale, dispersion, social composition, age structure, economic environment, urbanisation, physical environment.
1985	28 revenue categories, plus a Commonwealth payments category	61 expenditure categories and 5 business undertaking categories. A new cross-border factor assessed.
1988	28 revenue categories, 2 user charges categories and a Commonwealth payments category	61 expenditure categories including special fiscal needs for the Northern Territory and isolation, 6 business undertakings. A non-State services factor and special factors for the Northern Territory introduced.

Table D-1 Comparison of detail in assessments, selected inquiries (continued)

	Revenue assessments	Expenditure assessments
1993	19 revenue categories	41 expenditure categories
2004	13 categories of taxes and other revenues and 8 categories of user charges. In total, there were 29 sub-categories with separate revenue bases.	39 expense categories, most of which were divided into components and multiple disabilities were assessed for each component. In total, there were 171 components and 344 disabilities.
2010	8 categories of taxes and other revenues, including Commonwealth payments. There were 13 sub-categories with a separate revenue base measure. (a)	12 expense categories, which were divided into components, with multiple disabilities are assessed for each component. There was also an Investment category and a Net lending category (14 categories in total). In total, there were 43 components and 93 disabilities.
2015	9 categories of taxes and other revenues, including 7 own-source revenue categories, a Commonwealth payments and a Net borrowing category. There were 19 sub-categories.	12 expenditure categories, including investment. In total, there were 43 components and 98 disabilities.

(a) There were no categories of user charges because they are mostly included in the Other revenue category.