Australian Government

Commonwealth Grants Commission

A HISTORY OF THE COMMISSION'S APPROACH TO ECONOMIC DEVELOPMENT

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CONTENTS

PART A: AN OVERVIEW

INTRODUCTION

1 This paper traces Commission approaches to assessing State spending on economic development. Part A provides some general observations about the main features of past Commissions' approaches to economic development, in both the special grants era and the era of multi-State fiscal equalisation. Part B considers Commission approaches on a review by review basis.

SPECIAL GRANTS ERA – 1933 TO 1981

2 The Commonwealth Grants Commission (CGC) came into existence in 1933 at a time when the less populous States were experiencing financial difficulties, due in large part to their policies of heavy borrowing for State development projects.

3 Early on the Commission determined that the only basis for recommending grants was financial need which was established in the context of State budgets. In the early 1940s, South Australia asked the Commission to assess special grants consistent with the principle of maximising economic welfare, that is, of securing the optimum distribution of productive resources and labour between different industries and different regions in such a way as to maximise economic welfare in Australia as a whole, and not merely on the basis of financial need to enable claimant States to function at a standard not appreciably below that of other States. In response the Commission said that the function South Australia was asking it to perform was not the role of the Commission.

4 During the special grants era the size of grants recommended by the Commission was directly affected by any spending by the claimant States on economic development which was above (or below) the average amount set by the standard States. This was due to the Commission's assessment methods as well as practical difficulties in assessing economic development expenditure. An overview of the Commission's method for assessing grants during the special grants era is provided in Box 1.

5 After compiling the claimant and standard State budgets on a consistent basis the Commission would compare the main revenue and expenditure items. It would then seek to establish if any differences between a claimant State and the standard States were due to State policy (for example, a below (or above) average revenue raising effort or a higher (lower) standard of service delivery), or factors beyond State control. If differences were due to policy the Commission would make an adjustment to the budget of the claimant State. These comparisons, and any adjustments,

required detailed information about the circumstances of the States and the factors which gave rise to differences in observed budget outcomes.

6 Over time, the Commission's methods for comparing the main revenue and expenditure items became more systematic. However, there were some areas of State budgets for which comparisons were difficult. This included expenditure on economic development programs, debt charges arising from State infrastructure investment and support for State business undertakings responsible for services such as railways, electricity, water and ports. The difficulty lay in the very different circumstances of the States particularly the very different industrial bases and stages of economic development.

Box 1 Overview of Commission methods in the special grants era

The Commission was established in 1933 and given the task of inquiring into applications by (claimant) States for special grants of financial assistance.

The Commission based its recommendations on:

> 'the amount of help found necessary for a State by reasonable effort to function at a standard not appreciably below that of other States'.[1]

In practical terms, this meant the amount of assistance needed by the claimant State to give it the same per capita budget result as the standard States (normally, but not always, New South Wales and Victoria). Thus, the starting point was a comparison of the excess of the claimant State's *actual* budget result over the *average* budget result of the standard States.

However, it was necessary to ensure the claimant State's adverse budget result was not accentuated by the adoption of below standard revenue raising policies or above standard expense policies. For a range of revenues and expenses (but not all), the Commission adjusted the claimant State's budget result by replacing its actual revenues and expenses with its assessed revenues and expenses.

Thus, the special grant recommended by the Commission was equal to the excess of the claimant State's *assessed* budget deficit over the *average* budget deficit of the standard States.

7 The Commission was fully aware of the potential for State economic development policies to affect the level of assistance they recommended. Early in the special grants era it made adjustments which reduced the grants for South Australia and Western Australia because of their above average loan losses, which were attributed to a greater degree of recklessness in capital expenditure. 'Penalties' were imposed on South Australia and Western Australia for 'reckless' borrowing from 1933 until 1941.

8 After 1941, although the Commission was cognisant of the potential for State development policies to affect special grants, there were relatively few occasions when it made adjustments for non-standard economic development policies. This

1 Commonwealth Grants Commission, Third Report, 1936, page 75.

was mainly due to the fact that when the claimant States incurred high development expenses, the Commission had great difficulty in attributing the above standard expenditure to State policy or factors beyond the control of the State. On the whole, the Commission tended to err on the side of caution by not making any adjustments to the grants. The main exception was State support for railways which was an area which was subject to a high degree of scrutiny and frequent adjustment.

9 The Commission’s methods and practical difficulties in comparing economic development expenditure of the claimant and standard States meant that in effect the Commonwealth supported claimant State economic development spending through the special grants process.

REVIEW ERA – FROM 1981

10 In the review equalisation era, which commenced in 1983, the Commission’s methods and its approach to economic development expenditure changed. Between 1983 and 1993 States economic development policies continued to affect grants, for example, through the actual per capita assessment of debt charges and recognition of the Northern Territory’s special fiscal needs; however the influence was restricted. By the 1993 Review, the Commission had dropped the actual per capita assessment of debt charges, limited the effects of business undertakings on the distribution of general revenue grants and started to assess business development expenses on an equal per capita basis. These changes were largely driven by policy neutrality concerns.

11 The Commission’s decision to adopt an equal per capita assessment of economic development expenditure has been attributed to the extent to which spending is affected by State policies and disagreement amongst the States about the drivers. There has been no consensus on whether needs are greater for a relatively large industry well-suited to a State or for a relatively small industry inhibited by a variety of difficulties which invited State intervention. For example, States with large tourism industries have claimed greater needs because of the industry's size; States with smaller tourism industries have claimed greater needs because of difficulty in attracting tourists.

12 Notwithstanding these difficulties, some States have argued that if revenue from economic activities were included in the equalisation process, the expenses required to support these activities should also be assessed. Other States argued that the practical difficulties of adjusting revenue bases for the effects of economic development policies and of assessing related expense needs were too great for the Commission to proceed down that path. A significant issue for the Commission in the review era has been the treatment on revenue and expenditure from the North West Shelf project in Western Australia which is discussed in Box 2.

13 The Commission has found, after extensive discussion and considering all State views, that it is unclear whether a State with above average levels of economic activity needed to spend more or less on economic development.

SUMMARY

14 Apart from making some adjustments in the early special grants era for 'extravagance' in State economic development policies, the Commission allowed special grants to be directly influenced by the economic development expenses. Between 1983 and 1993 States economic development policies continued to affect grants, although the effects were more limited reflecting the Commission's growing policy neutrality concerns. Since the 1993 Review the Commission has not allowed State economic development policies to affect general revenue grants due to the extent to which this spending is affected by State policies and a lack of consensus about the drivers.

PART B: REVIEW BY REVIEW

15 Part B considers Commission approaches to economy economic development on a review by review basis.

THE SPECIAL GRANTS ERA

The 1933 report

16 In 1933 the Commission considered claims for financial assistance from Western Australia, South Australia and Tasmania. To help the claimant States prepare their submissions the Commission provided advice on how it would assess claims and the nature of the information required to support their claims. The Commission took the view that the onus of proof lay on a claimant State to show that it was suffering from disabilities and that it was impossible for it to discharge its functions without special assistance.[2]

17 The 1933 report set out the current financial position of the States. The Commission observed that circumstances including the First World War, the depression and changes to Commonwealth-State financial relations had far reaching and diverse effects on the States. The States had relatively high debt levels due in part to the war but also the policy of heavy borrowing for development projects 'which were beginning to fail almost as soon as they were begun'. The Commission observed that loan losses, mainly due to development projects, largely accounted for all the State deficits at the time. [3]

State claims

18 The claims submitted by Western Australia, South Australia and Tasmania had some common themes. They attributed their financial difficulties to federal policies and the high costs of economic development.[4]

19 They claimed that the economic effects of losing the ability to levy tariffs, and the federal Navigation Act and industrial policy, had been particularly severe for the primary producing States.

20 Western Australia identified the high costs of development due to its size, population dispersion and poor soil quality; isolation from large population centres; dependence

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2 CGC, 1933 Report, page 8.

3 CGC, 1933 Report, page 25.

4 CGC, 1933 Report, page 55.

on primary industries; and its inability to adequately develop secondary industries due to interstate free trade. In addition, it made claims for losses it had incurred due to the settlement of immigrants which had arrived as a result of arrangements agreed by the British and Australian Governments, and losses with respect to soldier settlement. Western Australia argued that this development work was national in character, and that the Commonwealth should bear some part of the loss.

21 Tasmania argued that its financial difficulties meant it had been unable to maintain adequately State assets or provide adequate assistance for the development of State resources, and it faced high development costs due to the State's physical characteristics, low taxable capacity, small population and the small proportion of the State capable of economic development.

22 More generally, the claimant States noted that the real value of Commonwealth financial assistance had declined.

23 South Australia and Western Australia each requested grants of £2 million and the amount claimed by Tasmania was £1 million.

Commonwealth Treasury view

24 The Commonwealth Treasury argued that the claimant States had not acknowledged the general advantages from federal policies enjoyed by all the States or the specific advantages enjoyed by the claimant States. The specific advantages included:

- the construction and operation of the Northern Territory and Port Augusta-Oodnadatta railway and the Trans-Australia railway
- the relatively high level of Commonwealth assistance which flowed to the claimant States for primary industries, losses associated with State soldier settlement schemes and unemployment relief
- support for civil aviation services in more remote areas including north west Australia and Tasmania
- support for shipping and submarine telephone services linking Tasmania to mainland Australia.

Commission response

25 After investigating the State claims the Commission concluded that the immediate cause of their adverse financial position was losses arising from development policies. The Commission was of the view that the claimant States needed to accept some responsibility for their adverse position.

> For the year 1932-33 the deficits of the claimant States, as disclosed in their budgets, amounted in total to £1,928,000, while the losses for the year on their own activities amounted to £5,858,000. If those had not been incurred the States named would have been able to balance their budgets and to reduce taxation by a very considerable amount. If the

> principle of responsibility were applied strictly, the States concerned should provide for the deficiency. Other States have made serious losses which they are meeting. To ask these States to assist the claimant States to meet their deficits is to ask them to accept the burdens arising from a policy for which they have no responsibility.[5]

26 The Commission acknowledged that all States had a responsibility for the development of the nation but the issue was whether the above average losses of the claimant States were due to a greater degree of recklessness in capital expenditure. The Commission stated:

> 'if … a State appears to have markedly exceeded the general level of recklessness in capital expenditure, then we think it should be taken into account in assessing a grant. Such a State might reasonably be penalised. … It might fairly be expected to submit to 5% to 10% heavier taxation than would otherwise be expected of it, or conversely, to curtail its social services, or make other economies of the same amount.'[6]

27 On this basis South Australia's grant was reduced by £110 000 to take account of losses incurred in the South Australian mallee wheat settlement, irrigation schemes and railway rehabilitation. The Commission concluded that a much larger adjustment should be made to Western Australia's grant to take account of group settlement losses which were 'badly planned at every stage and, in many respects, badly administered'.[7] However, this was entirely offset by a positive adjustment, because the Commission considered that the Commonwealth should bear some of the losses for the group settlements and some of the losses attributed to the development of the north-west. The Commission found no basis for making an adjustment to Tasmania's grant.

The 1936 Report

State claims

28 The claims submitted by the claimant States in 1936 were not very different from those presented in 1933. South Australia, Western Australia and Tasmania again sought compensation for losses associated with the unequal incidence of the tariff, the burden arising from federal industrial policy, the Navigation Act and unequal effects of free interstate trade. The claimant States argued that these policies had contributed to their financial difficulties by inhibiting their ability to appropriately support economic development.

29 Western Australia claimed disabilities arising from the development of a large territory with a relatively small population and limited resources, and the financial

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5 CGC, 1933 Report, page 54.
6 CGC, 1933 Report, page 125.
7 CGC, 1933 Report, page 125.

burden of developing the north-west. Tasmania again argued only a small proportion of the State was suitable for economic development, it was unable to provide adequate assistance or facilities for the development of its resources and it faced high development costs owing to the physical characteristics of the State.

Commission response

30 ***Financial need principle.*** The Commission said it was concerned only with lessening the financial inequalities among the States on the basis of financial need. Assistance would only be provided to a State experiencing financial difficulty, and the amount would be sufficient to make it possible, with reasonable effort, to maintain Australian standards of government. Furthermore, assistance would be provided regardless of the cause of financial difficulties provided a State had taken all reasonable steps to retrieve its position.[8] To the extent that the difficulties were due to a State's own mistakes or extravagances in the past, the effort required would be greater, but no State was expected to reduce its standards of government below a certain point. Thus, while the cause of financial difficulties was not considered relevant to the decision about whether to recommend a special grant, it was a relevant consideration in determining the amount.[9]

31 Not all the claims presented by the States were based on the principle of financial need. Other grounds put forward were:

- the financial superiority of the Commonwealth
- federal policy
- the poverty of natural resources.

32 The Commission said that the Commonwealth's superior financial position was the result of constitutional arrangements and it did not consider its role was to correct the imbalance. The latter two claims would only be considered to the extent that they directly affected State budgets.

33 The Commission recognised that the tariff and other federal policies had different effects in different States and that the tariff policy had imposed a severe burden on the claimant States.[10] However, it ruled out recommending grants to fully compensate States for losses associated with federal policy because they could offset grants provided on the basis of financial need or result in grants being recommended to States which were not experiencing financial difficulties. The Commission considered that the principle of financial need and the process it had adopted for determining grants would provide all the special relief necessary for the differential effects of federal policy on the people of different States. Furthermore, any

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8 CGC, 1936 Report, page 79.

9 CGC, 1936 Report, page 79

10 CGC, 1936 Report, page 81.

recognition of the effects of federal policies should not amount to full compensation because this would take away the incentive to change to more profitable forms of production.[11] In any case, a rough measure of the net effects of all Commonwealth policy on the claimant States led the Commission to conclude the costs did not outweigh the benefits.[12]

34 Turning to the question of poverty of natural resources, the Commission said:

> The natural resources in question are those of soil and climate, minerals and timber, fur and fish, and the like. "Poverty" is meant to convey briefly that they are relatively unprofitable at present world demand for their products at to-day's stage of production technique. They may be exhausted or not now worth development. Changes in price, improvements in transport (or innovation) may at any time make them of value. At present they are unprofitable relatively to Australian standards. "Poverty" of resources in this sense may be wholly or partly the cause of the inferior financial position of the State. Its effect on the budget will be adequately and properly met by a grant according to "needs ".
>
> Poor resources will have also, of course, a depressing effect on general welfare in comparison with other States. In so far as resources become poor through exhaustion or through price changes, there may be a case for relief to individuals as with those affected by federal policy. Here, however, the provision of relief will be the direct obligation of the State Government, with the same caution as before--that it must not take away the incentive to move to better natural resources. As before, the necessary expense to the State will be taken into account in assessing needs, and will be reflected in the special grant. As with disabilities due to federation, there can be no direct compensation for the lower income of the community resulting from relative poverty of natural resources.[13]

35 The Commission concluded that if federal policies or poverty of natural resources contributed to the financial difficulties of a State this would be reflected in the State's budget and a special grant would be justified on the basis of financial need. Special grants would not be recommended to directly compensate for lower community incomes arising from federal policies or poverty of natural resources.

36 ***Penalties for losses on loan expenditure.*** In the previous two reports the Commission had required a greater revenue effort from South Australia and Western Australia due to very high loan losses related to their development policies. Penalties were applied again in 1936. South Australia and Western Australia were expected to make additional effort equivalent to 7% and 5% of normal taxation respectively.[14] The smaller penalty for Western Australia was arrived at after taking into consideration

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11 CGC, 1936 Report, page 84.

12 CGC, 1936 Report, page 126 (SA) and page 128 (WA)

13 CGC, 1936 Report, page 84.

14 This was in addition to the penalty for claimancy which was expressed in terms of social services expenditure.

the moral responsibility of the Commonwealth for some part of the losses on group settlement and the especially adverse effects of tariff policy on industry in Western Australia. No additional effort was required from Tasmania on account of past mistakes or extravagances.[15]

37 The Commission described the excesses of South Australia in the following terms.

> It is quite possible to find faults with South Australia, but the fact is that she pioneered dry farming, and by her experiments has demonstrated both for pastoral industry and wheat-growing the use to which country with a very low rain-fall can be put, and also the limits to that use. A large amount of loan money spent on these experiments will be unproductive. Her worst faults have been to repeat experiments after the limits of profitable development had been determined by experience, and to continue assistance to farmers in marginal territory when all hope of success had disappeared. Railways were allowed to depreciate until a very expensive rehabilitation scheme was necessary. Miscalculation and mismanagement are clear in the irrigation schemes.[16]

38 The losses in Western Australia are summarised in the following paragraphs.

> The main causes of Western Australia's inferior financial condition are the serious losses arising from the reckless financing of wheat settlement in an area (not) well suited to wheat, and the attempt at dairying settlement in the high rainfall areas in the extreme south-west. We cannot but think that a great deal of loan expenditure on the wheat areas could have been avoided. …
>
> The most unfortunate experiment was the attempt to settle migrants in the extreme south-west for dairying. The only favourable factor was the heavy rainfall. Soil and settlers were unsuitable and miscalculation and mismanagement were present. The settlement of migrants was adopted as a part of the policy embodied in the Empire Settlement Act and the Commonwealth Government joined the British Government in urging it. … The actual responsibility of the Federal Government in planning the scheme was slight, but we think some weight should be attached to its association with the policy as a whole.
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> On the other hand, the inefficiency in the execution of the scheme cannot be attributed to anybody outside Western Australia. This criticism does not originate with the Commission. The reports of royal commissions during the last fifteen years have condemned nearly every phase of the work, and there is little doubt that the losses are far greater than they need have been with careful planning, even if it be conceded that the scheme was a justifiable experiment.[17]

39 ***Avoiding grant dependency.*** The Commission considered that the principle of providing support to States in financial difficulties, and the procedure it had adopted

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[15] CGC, 1936 Report, pages 124-125.

[16] CGC, 1936 Report, page 126.

[17] CGC, 1936 Report, page 128.

for measuring the grant, would not encourage bad finance, perpetuate inferiority, and lead to a decay of the independence and sense of responsibility of the State.[18] It argued that the principles and procedures for determining grants were designed to ensure each State received just the right amount to remain financially viable without impairing responsibility.

The 1937 Report

40 In 1937 the Commission continued to require a greater revenue effort from a claimant State if its financial position was the result of extravagance or mistakes. This larger effort continued to be expressed in terms of a higher level of taxation. The practice was continued despite objections from South Australia about the size of the penalty imposed in 1936. The Commission noted that the extravagance or mistakes of South Australia and Western Australia were evident in their higher levels of borrowing. South Australia and Western Australia had borrowed £180 and £200 per capita compared with an average of £128 per capita, which the Commission said showed that borrowing had been excessive.[19]

41 This time the penalties imposed on South Australia and Western Australia were 6% and 5% respectively. The Commission said that in comparing these penalties it was important to note that the original penalty imposed on Western Australia was 10% but since it was felt that the Commonwealth had some responsibility for the north west of Western Australia, and some responsibility for the group settlement schemes in Western Australia, the additional taxation effort was reduced to 7%. (See Box 2 for a summary of the Commission's approach to the development of the north west of Western Australia.) This was further reduced to 5% because it was felt that the net effects of Federation and Federal policy had disadvantaged Western Australia more than South Australia. South Australia's penalty was also reduced, falling from 7% to 6%, because some borrowings had become more productive.[20] No penalty was imposed on Tasmania.

42 Tasmania's 1937 submission included a claim of £18 000 for a 'shortage of expenditure on forestry' which was rejected on the basis that it was not consistent with the principle of financial need and outside the province of the Commission.[21]

The 1938 Report

43 South Australia again urged that the penalty for losses on loan expenditure was unjustified. It said that its higher per capita borrowings for railways, roads, wharves

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18 CGC, 1936 Report, page 79.
19 CGC, 1937 Report, page 53.
20 CGC, 1937 Report, page 83.
21 CGC, 1937 Report, page 71.

and waterworks were necessary to support its primary industries. South Australia also noted that Western Australia's penalty had been reduced on the basis that the Commonwealth had some responsibility for losses on group settlements, and argued the same view could be applied to the irrigation schemes of South Australia. South Australia said there had been a consistent reduction in borrowing and this was an added reason for removing the penalty.

44 In response, the Commission said the penalty was not based on the relative per capita losses of the States but a full consideration of all aspects of State borrowing policies and judgment about the extent to which States should bear the consequences of their own mistakes. Failure to take account of excessive loan losses in determining special grants would impose further burdens on the Commonwealth for uneconomic investment of public funds.

45 Western Australia's very high loan losses attracted particular attention. The Commission recognised the difficulties faced by Western Australia in providing roads, ports, harbours and water infrastructure but considered that Western Australia should have been making a greater effort to recover a greater proportion of debt charges via motor taxes and other charges. The Commission concluded:

> … recent unproductive loan expenditure is throwing an additional burden on the budget, and thereby increasing special grants to a degree which we think unjust …[22]

46 The penalties imposed on South Australia and Western Australia was set at 6% and 5% additional taxation respectively.[23]

47 Once again, no penalty for past mistakes was imposed on Tasmania although the Commission expressed concern about the state of public finances in

48 Tasmania. Ongoing losses on the operation of the State's railways were very high, and, the Commission observed that the 'Tasmanian railways are apparently in a hopeless financial position'. The Commission formed the view that if a negative adjustment was not made to Tasmania's grant then positive action to address the situation might be postponed.[24] In the end, the Commission made only a small adjustment (£7 000) to Tasmania's final grant because it did not want to add to Tasmania's difficulties.[25]

The 1939 Report

49 South Australia and Western Australia continued to ask the Commission to assess grants on grounds other than financial need.

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22 CGC, 1938 Report, page 63.
23 CGC, 1938 Report, page 78-79.
24 CGC, 1938 Report, page 64.
25 CGC, 1938 Report, page 81.

50 One of the disadvantages claimed by Western Australia was the difficulty of establishing and maintaining secondary industries which could compete with the large scale efficient industries in the eastern States. The Commission was of the view that any economic and other disadvantages would be reflected in the State budget and therefore the recommended grant, and again ruled out direct compensation through the special grants process. In the response to Western Australia's claim it was noted that the causes of Western Australia's failure to attract new secondary industries were not just isolation and federal policies, but local policies including the State's generous workers' compensation scheme and high basic wage rates which were set by the State Court of Arbitration.[26]

51 South Australia submitted a compensation claim for losses incurred by the State Railway Department for the Port Augusta-Port Pirie and Red Hill-Port Pirie railways. In response, the Commission said that under its methods the total losses on railway operations is reflected in the State budget and, as grants are based on the relative financial position of the States as reflected in their budgets, any losses related to the new railways come into the grant calculations. If these losses were separately assessed, and added to the special grant, there would be a duplication of payment.[27]

The 1940 Report

52 The 1940 Report includes a useful summary of the Commission's position on penalties for losses on loan expenditure.

> When the principle of imposing a penalty for extravagance was first established by the Commission, the view was expressed that, in determining the degree of effort required, a broad survey of the circumstances of a claimant State should he made, and should include, not only the State's record of unproductive expenditure, but also any adversity it had experienced as well as its economic prospects. The Commission has always held the view that a claimant State should make a special effort to bear a reasonable proportion of the losses arising from extravagant loan expenditure incurred on its own responsibility. The effort the Commission requires has in the past been expressed in terms of severity of taxation.[28]

53 The Commission made it clear that a claimant State could not expect to invest in unproductive works and enterprises and to get the resulting losses made up in the form of special grants.[29]

54 Reports in this era included detailed examination of the causes of financial difficulties in the claimant States and advice about how their situation could be improved. The

26 CGC, 1939 Report, page 57-58.
27 CGC, 1939 Report, page 61.
28 CGC, 1940 Report, page 53.
29 CGC, 1940 Report, page 63.

1940 Report described expenditure by Western Australia on the expansion of the Harvey Irrigation Scheme. The project involved the construction of a new dam and distribution channels for an additional 13 000 acres. Costs were to be met from land rates but it seemed likely that the revenue would fall short of the amount needed to meet debt charges. The Commission concluded:

> The time has arrived when unproductive expenditure should be reduced as far as possible. It seems reasonable, therefore, that the charges fixed on irrigation should bear a fair relationship to the annual charges involved in the capital outlay of the State. We suggest that, in view of the unfortunate experiences of all States, and in particular Western Australia, in the great losses on land settlement schemes, immediate action is necessary in the early stages of this proposal to ensure that there shall be no repetition of past history.[30]

55 South Australia and Western Australia again argued that the penalties were unnecessary. South Australia said that the loan losses, for which the penalties were imposed, were incurred many years ago, that for some years now it had displayed moderation and care in loan expenditures, and that in some years its loan expenditure was less than any other State except Victoria. Western Australia argued that loan losses of the past were due partly to Commonwealth policy, and that it was difficult for the State to maintain essential services and secure budgetary stability while the present penalties were retained.[31] After considering the 'causes of financial embarrassment' in South Australia and Western Australia a penalty of 5% was imposed on each State.[32] This was the last time penalties of this nature were applied.

56 South Australia's 1940 submission included a special memorandum urging the Commission to assess special grants consistent with the principle of maximising economic welfare — of securing the optimum distribution of productive resources and labour between different industries and different regions in such a way as to maximise economic welfare in Australia as a whole, and not merely to enable claimant States to function at a standard not appreciably below that of other States.[33]

57 In response the Commission said that the function South Australia was asking it to perform was not one it was appointed to undertake. The role of the Commission was to:

> … put the States in a relatively equal financial position, and they would then each be free to adopt a positive policy of development which each considered justified. It may be that States do require advice on developmental policy and that the policies of various States should be co-

30 CGC, 1940 Report, page 64.
31 CGC, 1940 Report, page 53.
32 CGC, 1940 Report, page 89.
33 CGC, 1940 Report, page 68.

> ordinated; but we consider that developmental policy in a federal system must be left to the various political authorities within it.[34]

The 1941 Report

58 The 1941 Report was prepared when the initial impacts of the Second World War were affecting the finances of the Commonwealth and States. The war and federal war-time policy imposed a greater burden on the claimant States than the non-claimant States, particularly Western Australian and Tasmania. The Commission considered that the system of special grants was an effective way to partially counter some of the adverse effects of the war on State finances.

59 South Australia again argued that the principle of optimum location of means of production should be adopted for determining the need for grants. The Commission said there was no guarantee that this principle would prevent the concentration of industry, and the grants recommended on the basis of financial need tended to protect the States with little industrial production. It reiterated the view expressed in the 1940 report that economic development in a federal system must be left to the various political authorities and this was not the Commission's task.[35]

60 Western Australia presented new information in defence of its borrowing policy. It said in the absence of the loan expenditure Western Australia would likely be in greater need of Commonwealth financial assistance because the loan expenditure had reduced unemployment and unemployment relief expenses, and the resulting works contributed to the development of the State.[36] It argued that the Commission should take account of this when determining the penalty to be imposed on loan losses.

61 The Commission remained concerned about the considerable amount of loan money being spent on unproductive capital works particularly in Western Australia and Tasmania. It said if any negative adjustments were made to special grants on account of past losses, it was only after it ascertained some definite mistake or extravagance. In this context, the Commission had visited an irrigation scheme in Western Australia. It made the following observations.

> The Commission has given close attention to the economic and financial aspects of the irrigation schemes established in the Waroona, Harvey and Collie districts by the government of Western Australia. On our last visit we inspected the areas, and discussed with irrigation officers the problems of water supply, capital cost and rating for those areas. While we are satisfied about the soundness of the schemes in general, and about the enhanced productivity of the areas as a result of irrigation, we have some doubts concerning the relation of capital cost to the charges made

34 CGC, 1940 Report, page 69.

35 CGC, 1941 Report, page 34.

36 CGC, 1941 Report, page 42

> to the settlers. In general we are convinced that where, as in these areas, the provision of irrigation services by the State has resulted in a marked rise in land values, there is evidence of increased profit to the land-owners of which the State should take a fair share. Costs of the schemes should be recovered through charges to the settlers proportionate to the increased profitability of farming in the irrigated areas, and we are able to find no justification for the government's hesitation about increasing the charges for water services in these areas.
>
> The question of increasing the irrigation rates has been discussed by responsible officers with the Minister on a number of occasions in the last four years; but the recurring water shortages in the Harvey and Waroona districts, and the undeveloped stage of the Collie scheme, were given as reasons for postponing a decision on this matter. This seems to us to be wrong in principle especially during a period when farmers benefiting from the scheme were receiving very remunerative prices for their products. There seems to the Commission to be a tendency on the part of the State authorities to disregard the real benefits, both direct and indirect, to the settlers, and some disposition to regard depressed conditions as common to all primary producers in the State. Such a view is clearly not tenable for the areas under discussion, and we are convinced that steps should be taken to adjust the rate immediately for the areas served by such schemes. … In this connexion we are emphatically of the opinion that a more rigid attitude towards contributions of land-owners is called for.[37]

62 In the end, the Commission only made adjustments to the grants for Western Australia and Tasmania due to excessive road expenditure. Debt charges associated with road and bridge expenditure were relatively large and the States had not made the same effort as the standard States to raise motor taxes to offset their impact on the budget. Adjustments of £65 000 and £28 000 were made to reduce the grants for Western Australia and Tasmania respectively.[38]

63 The report included observations on some major development issues which were affecting State finances for which it was keeping a watching brief. One was the 'wheat situation', and especially the use of marginal lands for wheat farming, a practice supported by the States. The effects of the war on world demand for wheat and a supply glut had reduced the price of wheat, and States were implementing policies to support farmers and facilitate industry restructuring. The Commission did not make any negative adjustments to special grants on account of the wheat situation but it did comment on circumstances in Western Australia.

> The Commission realises the grave difficulties inherent in the wheat situation, and especially in the case of marginal lands. We have the utmost sympathy with efforts to preserve sound land and settlement policies. We are prepared to give State Governments every credit for intelligent

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[37] CGC, 1941 Report, page 79.
[38] CGC, 1941 Report, page 88.

> attempts to preserve the capital already sunk in settlement, and for reconstruction plans which do not flout stubborn economic facts. Western Australia is following a plan which aims to assist the transfer from wheat to pasture, with the ultimate objective of converting large areas to a sounder basis for use as pastures. According to a statement issued to the press *(The West Australian,* 11th July, 1941) by the Minister for Lands and Agriculture (Mr. F. J. S. Wise, M.L.A.), the Commonwealth Government has now taken action under the National Security Act to prohibit the growing of wheat for grain in areas known as marginal. Provided the transfer of people from such lands towards other more profitable industries is not retarded by unwise assistance in the form of subsidies or advances, we see no reason to criticise.[39]

1942 to 1945

64 Tasmania and Western Australia asked the Commission to relax its requirement that claimant States make a greater effort than the standard States as a means of recognising ‘the adverse effects of the war on the Federal system’. Tasmania claimed that the changes in industrial structure and the location of industry produced by the war, and deliberate Commonwealth policy, could disturb the economic balance of the Federation and result in future financial instability. In particular, the shift of labour and capital to the eastern States to support the war effort could be difficult to reverse when the war finished.

65 The Commonwealth Treasury rejected this argument on the basis that any war-induced changes to State budgets would be reflected in the special grants recommended by the Commission. Furthermore, any effort to offset the shift in resource as a result of the war could hamper the war effort.

66 More generally, the Commonwealth Treasury said special grants were not the appropriate means to achieve structural change. Treasury noted that an analogous argument had been put to the Commission two years earlier when Professor Isles urged that grants should be assessed so as to equalise 'economic welfare' by offsetting the tendency to excessive centralisation. The Commission agreed that it was not its role to recommend grants specifically designed to compensate a State for the adverse effects of Federal war policy, and that its methods of assessing special grants take into account the effects of Federal policy in so far as they are shown in the finances of the States.[40]

67 In 1943, Tasmania submitted similar claims about the adverse effects of Commonwealth wartime policies but again the Commission concluded:

> The place of disabilities in the assessment of special grants appears to us to be this. A disability may be reflected partly or wholly in a State budget,

39 CGC, 1941 Report, page 66.

40 CGC, 1942 Report, page 43 to 44.

> e.g. in reduced revenues. To this extent our methods will take care of its financial aspect. The remedy for a disability may consist in a governmental policy which will involve increased State expenditure, possibly in collaboration with the Commonwealth. This too will be taken care of by our methods. Farther than that we do not think that we should go.[41]

68 Notably, during the war as differences in the financial strengths of the claimant and non-claimant States widened and the non-claimant States were enjoying strong surpluses, the Commission decided to adopt a balanced budget as the first measure of assistance required by the claimant States.[42]

1946 Report

69 South Australia again argued:

> That it would be proper and desirable to make a special addition to the grant otherwise payable to permit the State to take special action to improve, in the interests of the whole Commonwealth, the relative economic position of South Australia.[43]

70 The Commission again rejected the claim noting it was not its function to advise the Commonwealth on economic development of the Federation. To the extent that economic inequalities affected State finances and the development policies of the Commonwealth and States were reflected in State budgets, they would have a bearing on special grant recommendations.

1947 to 1981

Economic development and business undertakings

71 From the late 1940s it became the Commission's practice to examine the impact on the State budgets of public utilities, for example, railways, harbours, electricity, metropolitan water and sewerage, country water and irrigation. These businesses provided much of the economic infrastructure required to support State development.

72 The Commission regularly made adjustments to the recommended grants to reflect the impact of financial results of State business undertakings on State budgets. This was despite the difficulty in finding a satisfactory basis for comparison due to the different financial and administrative arrangements in each State. For railways, the process it adopted was to use comparisons of the levels of fares and freight rates, modified by broad judgment concerning railway operating costs. For other business undertakings the Commission considered the net impact on Consolidated Revenue.

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41 CGC, 1943 Report, page 11.
42 CGC, 1943 Report, page 12.
43 CGC 1946, page 38.

73 In 1959 South Australia claimed that the Commission should take account of broader development considerations when making comparisons of railway revenue and costs. It argued that considerations related to the economic development of the State should be taken into account. South Australia had a policy of controlling rail freight costs to support its secondary industries, particularly those which sold a large share of their products in the eastern States. It claimed it had benefited Australia as a whole and reduced the dependence of the State on special grants. The Commission did not agree that its assessment of railway finances should include any allowance for the effect of assistance to industry.

> In the Commission's view it is not the function of special grants to subsidise directly the economic development of a State, even though they may be applied indirectly to meet costs arising from economic development. The purpose of special grants is to enable financially weaker States to discharge their functions at standards not appreciably below those of other States, while making a reasonable effort from their own resources. Any adjustment made for railway finances arises out of the method followed by the Commission for examining the effort made by a State both in revenue and in expenditure. [44]

74 By the 1970s the Commission's approach was to observe the average State policy, and either include the net budget impact of the business undertakings if most States provide budgetary support, or exclude them altogether.

Miscellaneous expenditure

75 In the early 1960s the Commonwealth Treasury raised concerns about the growing proportion of expenditure in the unadjusted or miscellaneous field in State budgets. Unadjusted expenditure included spending on functions such as agriculture, public works, lands and surveys, and labour and industry. Since it was not included in the Commission's comparisons, any increase in spending in these areas increased the size of special grants.[45] At the time Western Australia was recording high levels of spending in developing the north-west of the State, some of which was funded by the Commonwealth. The Commission said that the main difficulty in assessing this spending was that there was no expenditure in the standard States, or "yardstick", against which it could be compared.

> The causes underlying the rising level of expenditure are not simple. They involve considerations of national development; and, insofar as the rate of development is accelerated by expenditure of Commonwealth funds on capital projects, the cost to the State budget is likely to continue to increase.[46]

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44 CGC, 1960 Report, page 39.

45 This was the equivalent of an actual per capita (APC) assessment in the current methodology.

46 CGC, 1961 Report, page 27.

76 It is worth noting that during the special grants era, for the most part, States retained the full benefit of any Commonwealth grants for specific purposes and the expenditure of the specific purpose grants actually increased the size of special grants. As an exception, in 1950 when South Australia received a small grant from the Commonwealth for the construction of the Morgan-Whyalla water system, it agreed not to claim assistance via special grants process for losses on this project; and any State assistance would be excluded from the expenditure used to calculate special grants.[47]

77 Debate about the treatment of expenditure in the unadjusted field intensified during the 1960s. The Commission continued to resist submissions from the Commonwealth Treasury to expand the scope of its assessments. It made the following observations regarding the difficulty of assessing expenditure on agriculture, which varied widely between States.

> It is not merely that the topographical, climatic, demographic, and historical factors operating in each of the States may affect expenditure and in one case require a greater expenditure on some particular aspect of agriculture and in another case require a lower expenditure on the same aspect. In truth there is no logical basis for assuming that there is a national interest in ensuring that the level of agricultural activities should be brought anywhere near uniformity throughout the continent. Indeed little consideration is necessary to lead to the conclusion that the national interest must surely point in a different direction because of differences in the circumstances and conditions of the States, of the stage of development which they have reached, and of their resources. It would be contrary to the national interest to impose equality in the development or expenditure in the agriculture sectors of their respective economies, merely because this artificial imposition assisted in the assessment of a grant.[48]

78 The Commission went on to provide examples of the unique circumstances facing the Tasmanian apple industry and Western Australian wheat industry. It also made reference to the unique set of circumstances affecting the development of north-west Western Australia.

79 In addition to identifying the practical difficulty in making comparisons in unadjusted field of State expenditure, the Commission said it did not want to be seen as passing judgment on the appropriateness of State spending.

> The Commission begins with an assumption that the considered decision of a claimant State Government, and Parliament, to undertake expenditure in the area in question would prima facie be entitled to the utmost respect, since it would have been determined by the authority exercising responsible power and having the most detailed and expert

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47 CGC, 1950 Report, page 73.
48 CGC, 1964 Report, page 58.

knowledge of the facts determining the necessary expenditure. It would be a matter of some gravity for any other body to "revalue" this expenditure or take steps without warning to reduce a special grant because of a conclusion that there was an excess in the expenditures on these particular subject matters.[49]

80 The Commonwealth Treasury remained concerned about the growth in the field of miscellaneous State expenditure. In 1968 it acknowledged the difficulty of making comparisons in this area and put forward a proposal to limit the increase in the amount which the claimant States could recoup from the special grant through growth in expenditure in the unadjusted field. The claimant States strongly opposed the proposed approach but accepted that the Commission might use it in formulating broad judgment, provided they were given the opportunity to comment. The Commission did not make any changes to its treatment on miscellaneous expenditure but said it would continue to investigate the issue.[50]

81 Ongoing pressure from the Commonwealth Treasury to extend its comparisons to miscellaneous expenditure and revenue led to changes in the 1976 inquiry. By this time the Commission was directly measuring needs and, for miscellaneous expenditures and revenue, the base measure of need was the difference between the modified per capita figures and the average of the modified per capita figures for the corresponding items in the standard States.[51] This amounted to an actual per capita assessment. However, these base amounts were modified by known differences in State policies or efficiencies.

State borrowing[52]

82 A persistent characteristic of the claimant States in the post-depression and post-war period was high per capita borrowing. This contributed to their high per capita debt charges and unfavourable budget outcomes, and consequently their special grants. Heavy borrowing had been incurred by all States on the development of resources and the provision of essential services but the amounts for the claimant States were significantly higher. The 1968 Report noted that borrowing has doubled in the last decade.

> The factors mainly responsible have included—an increase in demand for education facilities and housing arising from population growth and rising living standards; economic growth increasing the need for electricity and water supplies; the development and exploitation of natural resources, such as land settlement and mining, and the consequential increase in

[49] CGC, 1965 Report, page 59.
[50] CGC, 1968 Report, page 91.
[51] CGC, 1976 Report, page 77. 'Modified' in this case refers to the adjusted budget numbers. In effect needs were the difference between the actual claimant State expenditure or revenue and the standard State figure.
[52] During this period borrowing was usually referred to as loan expenditure.

demand for transportation and communication facilities and related services.

The particular characteristics of each State, including the topography and climate and the distribution and character of natural resources, population and economic activity, influence the pattern of loan expenditure. … Because of their extensive land areas a relatively high proportion of loan expenditure has been incurred on railways by Queensland and Western Australia and to a lesser extent by New South Wales. In South Australia and Western Australia the arid nature of much of the country has led to relatively heavy loan expenditure in providing assured water supplies both to the metropolitan and rural areas, including the costly necessity for reticulation by pipeline over long distances. The lack of good natural harbours has imposed a greater relative expenditure on harbour works in those two States. The greatest single item of expenditure in Tasmania has been hydro-electric works but this relatively high capital expenditure has not imposed any burden on the budget as the scheme is financially self-supporting. In Tasmania road expenditure has been relatively much greater than in any other State, reflecting the high cost of road construction and maintenance due to topographical conditions and the need to provide access roads in difficult terrain for forest exploitation. [53]

[53] CGC, 1968 Report, pages 33 to 34.

Box 2 Development in North West Western Australia

Costs associated with the development of north-west Western Australia have been included at various times since 1933 in Western Australia's submissions to the Commission. In more recent times grants in lieu of royalties from Barrow Island and the North West Shelf have also been included in the calculation of grants.

Special Grants Era

In 1933, Western Australia claimed that development in the north west was of strategic importance to the nation and the Commonwealth had an obligation to provide some compensation for the losses Western Australia had incurred to establish a coastal shipping service and the meatworks at Wyndham. The Commission agreed that the region was strategically important and Western Australia had 'made a praiseworthy effort to develop it'. A positive adjustment of £200 000 was made to Western Australia's grant to recognise the moral responsibility of the Commonwealth for the development of the region.[54]

Again in 1936, Western Australia claimed compensation for losses incurred in developing the north west. The Commonwealth Treasury disputed the strategic importance of the region and argued that 'any money which the Commonwealth could afford to spend on defence would be better spent elsewhere'. It argued that claims for direct compensation for losses of this nature did not satisfy the financial need principle which had been articulated in the 1936 report. The Commission considered that any losses associated with unprofitable State investments in the north-west, such as the meatworks, and which were included in the Western Australian budget, added to the special grant recommended for Western Australia.[55] This was seen as being consistent with the Commission's principle of financial need.

Throughout the special grants era much of Western Australia's expenditure on development in the north-west was included in the unadjusted portion of State budgets. This meant that State spending on land development projects in the region, and losses incurred by the State Shipping Service, which were funded out of Consolidated Revenue, increased Western Australia's grant. The 1963 Report provided the following statement on development in the north-west.

> In the post-war period increasing interest has been shown in the North-West of Western Australia. The opening up of iron ore deposits, an accelerated oil search program, irrigation work in the Kimberleys and the upgrading of the road systems have all contributed to the rapid development of the area. These developments have resulted in certain problems for the State government concerned, involving both investment of capital and the allocation of increased revenue expenditure. The Commonwealth Government has shown great interest in various developmental projects and has provided part of the capital expenditure. It agreed to provide financial assistance amounting to £5 million over the period of 5 years from 1st July 1958, for approved projects north of the

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[54] CGC, 1933 Report, page 134.
[55] CGC, 1936 Report, page 128 to 129.

> 20th parallel of south latitude. Most of this grant was expended on the Ord River project. … In addition to this scheme the Commonwealth Government has agreed to bear half the cost of providing beef roads in the Kimberley area, the total expenditure on which is expected to reach more than £7 million. As settlement proceeds the State will inevitably face increasing expenditure on housing, electricity supply, water supply and social services. These expenditures affect the State budget and result in increasing the amount of the special grant sought from the Commission. Were it not for the various forms of expenditure in these areas the special grant of £5 372 000 might be reduced by an amount in the order of £2 400 000. Of this later amount, social services expenditure accounts for £369 000, other departmental expenditure, £970 000, and loss on State Shipping Service, £1 056 000. The revenues received from these areas are not substantial.[56]

Losses of the State Shipping Service remained an issue for the Commission as the amounts continued to grow. In the 1965 report, the Commission said that including the losses in the grant calculation was committing the Commonwealth Government to a payment on account of north-west development, though the process was somewhat concealed by the assessment of the Special Grant. It proposed a limit on the size of losses. The amount was set at £1.2 million. It was hoped this would provide some incentive to improve efficiency.[57]

In the 1967 report the Commission anticipated that Western Australia might become less grant dependent in the future due to the discovery of new mineral reserves. In the following year Western Australia withdrew from claimancy for special grants, and the Commission noted that the most important factor in this development had been the discovery of nickel, iron-ore, bauxite, oil and other minerals resources which had paved the way for a widespread expansion of mineral production.[58] This also coincided with other changes in Commonwealth State financial relations.

Review era

Since 1988, Western Australia has raised concerns about the Commission's treatment of grants in lieu of royalties for the North West Shelf and expenditure on the development of the project. In the 1988 Review, the Commission was asked to consider the appropriate treatment to be accorded to the various components of the assistance arrangements made between the Commonwealth and the Western Australian governments to offset the losses expected to be incurred by the State Energy Commission of Western Australia (SECWA) under the 'take-or-pay' provisions of the gas contract with the North West Shelf joint venture participants. Despite repeated requests from Western Australia, the terms of reference for the 1988 Review did not include any direction that the various elements of the assistance arrangements should be excluded from usual fiscal equalisation procedures.

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56 CGC, 1963 Report, pages 18-19.

57 CGC, 1965 Report, pages 74-79.

58 The withdrawal from claimancy from 1968-69 was also facilitated by an agreement between the Commonwealth and Western Australia that a payment of $15.5 million would be made for two years to replace any special grant which might have been paid. See CGC, 1968 Report, page 42.

The Commission acknowledged that applying the normal fiscal equalisation processes to the assistance provided to Western Australia had the effect of reducing the benefit to Western Australia that the assistance arrangements were designed to provide. The Commission concluded that the ultimate decision on how the elements of the assistance arrangements should be treated was essentially of a political nature. This accorded with the advice given by the Prime Minister in correspondence with the Premier of Western Australia, copies of which were made available to the Commission by the Commonwealth Treasury, that 'the Commonwealth will, in the context of the 1987-88 review of the Commission's recommendations, take into account the burden that the Western Australian Government will be carrying in meeting State Electricity Commission of Western Australia's losses in determining the arrangements to apply in subsequent years'. [59] The Australian Government made no adjustment to the Commission's recommended relativities on account of the north west shelf assistance arrangements in 1987-88, or any subsequent update.

The Commission's approach to the treatment of payments in lieu of royalties from the North West Shelf has been unchanged since the 1993 Review although the way in which the Commission has implemented this treatment has changed. Initially the payment was assessed with other specific purpose payments which affect State grants but more recently the payment has been included in the mining revenue assessment.

Western Australia has repeatedly raised concerns about this treatment arguing that the Commission has been inconsistent in its treatment of the costs and benefits of the project. It has said this asymmetry penalises Western Australia and creates a disincentive for States to invest in projects to increase their economic activity.

In the 2015 Review, Western Australia asked the Commission to assess the net revenue only it receives from the project (by deducting its expenditure amortised over the life of the project from the SPP) or, alternatively, not to assess any of the revenue as the project would not have proceeded in the absence of the State's investment. The Commission decided not to adopt either of these approaches because it did not think it possible to assess what was done in relation to the North West Shelf project in isolation from many similar projects across Australia in the past. It concluded that revenue from the North West Shelf should continue to be part of the equalisation process as it contributed to Western Australia's fiscal capacity and needs relating to economic development were appropriately assessed.

59 CGC, 1988 Report, page 7.

THE REVIEW ERA

The 1981 Review

Issues

83 The main issues were:

- identifying drivers for services to industry including agriculture, fisheries, mining and tourism
- identifying drivers given differences between States in the stage of development and industrial composition.

State views

84 ***Services to industry.*** The States argued that the Commission should assess State spending in particular industries including agriculture, fisheries, mining and tourism. States were involved in industry regulation as well as developing and promoting these industries. States could not agree on the appropriate drivers.

85 ***Stage of development and industrial composition.*** New South Wales and Victoria argued the concentration of industry in major cities and the associated problems of pollution and congestion required greater expenditure and proposed a number of drivers of State spending in this area including city populations, manufacturing employment and the level of unemployment. The less populous States said they faced scale and dispersion disabilities and that their manufacturing bases were relatively under-developed and required greater government assistance.

86 New South Wales and Victoria supported a separate assessment of decentralisation expenses. The smaller States did not favour this approach as they considered decentralisation and development expenses too inter-related.

Commission decisions

87 ***Services to industry.*** The Commission decided to assess agriculture expenses recognising that State spending was influenced by the number of farms, value of output, scale and dispersion. The assessment included a judgment based allowance for physical and environmental factors. Fishery expenses were assessed using value of output, number of persons employed on fishing boats, length of coastline and population. There was no attempt to disaggregate expenses within these industries by function, for example, regulation and industry development.

88 Net mining expenses, which were mainly for regulation purposes, were assessed on an actual per capita basis[60] because the Commission had no reason to assume that major differences in policy or efficiency existed between the States. Zero needs were assessed for State tourism development and promotion activities because both high and low levels of tourist activity were seen as disabilities and there was general agreement that policy differences accounted for a substantial proportion of differences in State government expenditures on tourism.

89 ***Stage of development and industrial composition.*** The Commission considered making separate assessments for decentralisation expenses and development expenses. However, it decided that these expenses could not be separated because there was no objective way to establish whether State expenditure was intended to attract new industrial activity or alter the geographic distribution of existing industry.

90 The Commission could find no evidence of a direct connection between the proposed drivers and development expenditure and it adopted an equal per capita (EPC) assessment. The Commission made the following observations.

- State expenditures were largely in metropolitan areas and no State was relatively disadvantaged by dispersion.
- The function required relatively little departmental establishments in all States and so a scale factor was not warranted.
- There were different costs associated with each stage of development and these were likely to be offsetting.

91 The Commission's view was that the different levels of State spending on industrial development either reflected State policy, or were associated with differences in business and physical potential, the realisation of which it was not appropriate to influence through the equalisation process.

The 1982 and 1985 Reviews

92 The assessments made in the 1981 Review remained virtually unchanged.

The 1988 Review

93 The main issues were:

- the Northern Territory's claims for special fiscal needs related to its unique circumstances
- the Services to industry assessment including the treatment of economic development expenses.

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60 At the time this was referred to as the per capita difference method.

94 ***Northern Territory special fiscal needs.*** The Northern Territory was included in the equalisation process for the first time. It made a number of claims for special fiscal needs including that the services to industry assessments should include some special allowances to: recognise its relatively undeveloped industrial base, and that the low level of private and public sector infrastructure had an impact on services to industry expenditure requirements and on business undertakings; compensate for the effects of Commonwealth industrial policies; recognise its need to provide infrastructure to assist its industries; and recognise its tourism expenditure needed to be higher as it was directed more to international and interstate tourists than other States.

95 The Commonwealth Treasury responded that no special fiscal needs for the Northern Territory should be recognised in relation to capital expenditure because the Commission was concerned only with the distribution of general revenue grants and needs relating to public infrastructure were being met from the Commonwealth's general purpose capital grants which at that time did not affect the recommended general revenue grants.

96 The Commission decided to include a single assessment of special fiscal needs to cover all services to industry. The assessment did not accept all the claims for special needs. For example, the Commission did not accept that differential needs should be assessed for industrial development, or that needs should be assessed to offset the claimed differential effects of Commonwealth policies. In the absence of cost data, the Commission used broad judgment to assess an allowance of $16 million for the special fiscal needs of the Northern Territory which related to the services it needed to provide for its developing industries.

97 ***Services to industry.*** The Commission had great difficulty in deciding how to assess services to industry expenses. The difficulty lay in the degree to which spending was affected by State policies and disagreement amongst the States about the drivers. There was no agreement on whether needs were greater for a relatively large industry well-suited to a State than for a relatively small industry inhibited by a variety of difficulties which invited State intervention. For example, a State with a large tourism industry claimed greater needs because of the industry's size; a State with a smaller tourism industry claimed greater needs because of its difficulty of attracting tourists.[61]

98 The Commission considered that States had two broad sets of objectives in providing services to industry: the first to assist the maintenance or expansion of production and employment within the State and to protect or enhance the State's sources of revenue; the second to regulate the industry for safety and health purposes, and to

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61 CGC, 1988 Report, page 49.

protect consumers and producers. The Commission said it was not clear that the former activity should be subject to fiscal equalisation.

99 The Commission had little information distinguishing expenditure on regulation from expenditure on research, extension and other activities directed to the maintenance or expansion of production in the States. Further, as this type of distinction was a Commission initiative and not the subject of submissions, the Commission did not wish to introduce a major new initiative without consulting the States. The Commission therefore generally maintained the 1985 review methods of assessment in the Services to industry categories until the parties had an opportunity to consider these issues and address them in greater detail. In a few cases, however, it extended its policy of assessing zero needs for expenditures directed to economic development; tourist promotion expenditures were, for example, treated in this way.

100 In the context of the discussion about how economic development expenses should be treated in the fiscal equalisation process, the Commission made it clear that fiscal equalisation is not intended to achieve economic equalisation and, provided this is accepted, the scope for inefficient or uneconomic allocation of resources as a consequence of fiscal equalisation is minimised.[62]

The 1993 Review

101 ***Services to industry.*** In the 1993 Review, the Commission more clearly articulated the distinction between regulation, training, research and promotion activities. It considered that regulation and training expenditure was aimed at such things as ensuring safety in mines and educating farmers about the safe handling and use of agricultural poisons, and these services were directed to wider public interests, not exclusively or necessarily to the interests of the industries. However, expenditures on research and promotion are often sought by the industries concerned and directed largely to their own interests. Examples of expenditures of this kind are those aimed at the elimination of pests and diseases; training in good farm practices; the promotion of tourism; and the attracting of large industrial activities to the State. Services like these aimed to improve the profitability of the industries concerned, to prevent unnecessary losses of production, or to encourage growth, although the benefits are not necessarily confined to the industry, and may flow on to other parts of the economy within and beyond State borders.

102 The Commission remained unsure about how far fiscal equalisation should extend to services to industry, particularly those directed at promotion or to seeking a competitive advantage for industry in the State. The Commission obtained data from the States which allowed it to split services to industry expenses into three components and decided to assess them as follows.

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[62] CGC, 1988 Report, page 137

- For expenditure on regulation and training, which it saw as directed to a wider public interest, differential needs were assessed for economic environment, administrative scale, dispersion and input costs.
- A similar assessment was made for half the expenditure on research, on the ground that much research is essentially aimed at promoting or developing the industry concerned within the State.
- An equal per capita assessment was adopted for expenditure on promotion, except that a scale factor was allowed for promotion expenditure for tourism, which is consistent with national objectives and generates some external benefits.[63]

103 ***Northern Territory special fiscal needs.*** In the 1988 Review, the Northern Territory was given an allowance of $16 million per year in the Services to industry category. At the time the Commission had said the assessment was for developmental and promotional activities which, in the future, should be funded by some means other than through general revenue grant relativities. In the 1993 Review the Commission concluded that with the passage of time since self-government, these allowances were no longer justified and, accordingly, were discontinued in the assessment.[64]

The 1999 Review

104 The Commission continued to assess economic development expenses (referred to as industry assistance) on an EPC basis. The scope of the assessment was narrowed to include only promotion, development and assistance for individual businesses or regions.

The 2004 Review

105 In the 2004 Review, the Commission re-examined the treatment of assistance for economic development but chose to continue with an EPC assessment because it could not identify the underlying influences that create differences between States and it was not convinced that equalisation could be improved by alternative approaches.

106 Western Australia argued that this treatment was inconsistent with equalisation principles. While revenues from economic activities were included in the equalisation process, Western Australia considered that the expenses required to support these activities were not adequately recognised. The Northern Territory agreed.

107 The other States acknowledged that all States provide assistance for economic development, but said they often do so for different reasons and that the assistance

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63 CGC, 1993 Report, page 28.
64 CGC, 1993 Report, page 34.

takes many forms. They argued that the practical difficulties of adjusting revenue bases for the effects of economic development policies and of assessing expense needs were too great for the Commission to proceed down that path.

The 2010 Review

State views

108 In the 2010 Review, Western Australia objected to the EPC assessment of economic development expenses, arguing that developing economies needed to invest to promote development, and assessing revenue without recognising expenses incurred in promoting and supporting the underlying economic activity was inappropriate. It illustrated its argument with estimates of the effect on its budget of potential development in the north-west of the State. Western Australia said that after allowing for State expenditure and the redistribution of GST following increased State revenue, the State budget would incur a substantial loss. By contrast, the budgets of all other States would gain through higher GST shares.

109 The Commission discussed this issue with Heads of Treasuries (HoTs) in 2007 and sought input from the States about how to make an assessment. Most States did not support an assessment of economic development expenses on the basis that it was too difficult to identify the underlying drivers or establish a causal link between State developmental activities and State revenues. A number of States noted that State policies in this area were varied and within each State's own control. South Australia said it was unclear whether a State with above average levels of economic activity needed to spend more or less on economic development.

Commission decision

110 After extensive discussion and considering all State views the Commission decided to continue to assess economic development expenses on an EPC basis because of the difficulties in identifying the underlying drivers. It also decided it would not offset economic development expenses against revenues.

111 Although the Commission continued with an EPC assessment, it introduced a new capital assessment which took account of the implications of growth for State investment in infrastructure. The new capital assessment partially allayed Western Australia's concerns about the EPC assessment of economic development expenses.

The 2015 Review

112 Due to the shortened time frame for the 2015 Review the Commission did not revisit the Services to industry assessment and continued to assess economic development expenses EPC. The Commission did, however, consider the treatment of mining

related expenditure in some detail. This followed a terms of reference for the review which instructed the Commission to:

> have regard to the recommendations of the final report of the GST Distribution Review to … consider the appropriate treatment of mining related expenditure.

113 The 2012 GST Distribution Review had concluded that, while most of the direct mining related needs of Queensland and Western Australia were recognised in the Commission's assessments, some small gaps existed. It recommended the Commission re-examine mining related expenditures in the next methodology review.

State views

114 Queensland and Western Australia said they face higher costs due to the presence of a large mining industry not recognised in the Commission's assessments. They described expenditures they incur and proposed how the Commission could assess them. Western Australia presented detailed assessment proposals and estimated its unrecognised needs were about $2 billion per annum.

115 New South Wales, Victoria and the ACT said they did not support any further changes to the assessments to recognise mining related expenditure needs because it has not been demonstrated that mining States face higher costs or that the current assessments do not adequately recognise mining related needs. New South Wales said the GST Distribution Review concluded there are no significant unrecognised mining related expenditure needs. New South Wales and Victoria noted the high level of private sector investment in mining infrastructure, and Victoria said this meant that the mining industry would require less government investment than other industries.

116 Queensland said there are inherent problems with the category by category approach adopted by the Commission for examining mining related needs due to data and methodological limitations as well as materiality issues. Queensland said the ideal approach for recognising mining related expenditure is to assess net mining revenue. However, it said this approach is not practical due to issues such as the lumpy nature of capital expenditure supporting the mining industry, timing differences between expenses and the resulting revenues, and difficulties in measuring costs such as opportunity cost and risk. Queensland said the next best option is to apply a discount to the mining revenue assessment. Failing this, the Commission should aggregate all the relevant expenses and make an assessment using a broad indicator such as private sector investment in the mining industry.

117 Western Australia was broadly supportive of the category by category approach the Commission adopted. It did not want the Commission to make a separate mining

expenditure assessment. It said if the Commission was unable to quantify its costs through the expenditure assessments, it supported a discount to the mining revenue assessment as a 'rough justice way' of addressing this.

118 South Australia, Tasmania and the Northern Territory supported an examination of mining related expenditure but said the Commission should apply its assessment guidelines, including materiality, when considering new assessments. They said this approach is more transparent and accurate and less subjective than discounting the mining revenue assessment. The Northern Territory said any assessments should recognise the stage of development.

Commission response

119 The Commission said that it understood that States with rapidly expanding mining sectors were experiencing significant budgetary pressures dealing with the growth in demand for State services and in the provision of related infrastructure associated with population growth. The Commission said it had given careful consideration to how well its assessment methodology captured the impact of mining activity on State fiscal capacities, and whether a given sized mining sector has a different impact than say a similar sized finance sector with the same growth profile.

120 The approach it adopted was to systematically consider category by category the potential influences identified by the mining States, and in particular, any potentially unrecognised mining related expenditure needs. The Commission used the same assessment framework used for all other assessments because there was no basis for deciding that mining expenditures should be accorded special treatment compared with, for example, State spending on agriculture, manufacturing or service industries.

121 Mining related expenditure was defined as spending directly associated with the development and management of mining activities. The Commission examined the data provided by the States, including Western Australia's Royalties for Regions data. In most cases, the expenditure States identified as relating to mining was a small part of what they spend. The data indicate direct mining expenditure was less than one quarter of 1% of total State expenditure.

122 Where a conceptual case was established, reliable data were available and it was material, the Commission made an assessment. Following this approach two new assessments were introduced in the 2015 Review for planning and regulation of investment projects and capital grants to local government. However, in respect of the other issues raised by Queensland and Western Australia, the Commission concluded that, in most areas, States with significant mining sectors face no higher expenses per capita than States with a different industrial composition.[65]

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[65] CGC, 2015 Review Report, pages 43 to 44.