



**Response to the  
CGC Issues Paper 2006/04**

***“Contemporaneity”***

**Department of Treasury and Finance**

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## INTRODUCTION

1. The following covers Tasmania's response to the issues raised in paragraphs 56-64 of the CGC Issues Paper 2006/03 *Architecture of HFE* and/or in the CGC Issues Paper 2006/04 *Contemporaneity*.
2. Analytically, the issues need to be addressed on two levels:
  - the technical issue of bias in the relativities - if the pool growing at a different rate to the underlying revenue and/or expenses is giving rise to a contemporaneity problem that needs to be addressed;
  - the contemporaneity options – taking the technical problem as given and addressing the pros and cons of each option as a means to address it.

## CONTEMPORANEITY

3. On balance, notwithstanding the concerns the Commission raises, Tasmania considers the current approach of applying historically derived relativities to the future remains the most appropriate way of implementing equalisation.
4. As a purely mathematical exercise, Tasmania accepts a technical argument for bias. However, Tasmania questions whether a material bias could actually be sustained in reality given the interdependence between the components of state budgets. That is, an increase in the growth of the pool does not occur in isolation of corresponding changes in revenue, expenditure and/or the budget result. The case has yet to be sustained that due to the growth in the pool, a sustained material bias will otherwise be a feature of the 2010 Review and out-year relativities.
5. Tasmania points out that the circumstances leading to this theoretical bias – different rates of growth between revenue, expenses and the pool – have always been a feature of HFE relativities, but were presumably considered to be within an acceptable tolerance limit in the pre-GST years. In the pre-GST period illustrated in Table 1 of Issues Paper 2006/04 (1993-94 to 1998-99), during which the pool grew at a slower rate than revenue and expenses, the effect of the bias would have been opposite to that of the post-GST period – that is, the bias would have disadvantaged states with an assessed relativity factor greater than one. In this sense, the bias can, and has, worked in both ways.
6. Nevertheless, the material presented in paper 2006/04 *Contemporaneity* appears to support a change in post-GST budgetary relativities relative to those pre-GST. However, there are a number of caveats regarding the interpretation to be placed on this data.
7. The post-GST period the Commission has examined (2000-01 to 2004-05) is necessarily the transitional period following the introduction of the GST (refer tables 1 and 2). It has also been a period of rapid growth in states own-source revenue. While a “boom” period for states in revenue terms, it followed a

decade or more of financial constraint. In a budgetary context, states were still operating as if an environment of financial constraint was the present reality. Revenue was consistently underestimated and budgeted expenditure allocations were accordingly conservative. In Tasmania's case, this unbudgeted revenue growth facilitated the rapid retirement of general government debt. It is not anticipated that this own-source revenue growth will be sustained into the future. It is far from clear that this period can be used as a basis for inferring anything in terms of shifts in previously stable historical relationships, increased future volatility or changes in relative expenditure needs.

8. It has always been the case that fiscal circumstances can change between the assessment period and the application year such that the application year relativity outcomes are not reflective of states actual fiscal circumstances for that year. This has been the subject of many past debates but the conclusion has been that, pragmatically, there is no viable alternative. In support of the use of historical data, the Commission has previously argued that while full equalisation may not be realised in the application year, equalisation will be realised over time.
9. It is too early to be making judgements that the pool will grow significantly faster than the growth in revenues and/or expenditures or that there will be an instability in the relationship between growth in the pool in the assessment years and growth in the pool in the application year.
10. In a dynamic sense, the introduction of the GST pool represents a one-off change (albeit subject to a five year transitional period). It can be argued that the annual growth in the GST pool is becoming factored into states' budgetary expectations. This means that the budgetary allocations now beginning to be observed should not be regarded as more volatile or less constrained relative to past pre-GST years, but rather as the base of new core stable relationships for the years to come. That is, the allocative patterns of the underlying assessment years, for future application years, are arguably no less indicative than the relevant pre-GST data years were indicative of the pre-GST application years. In this circumstance, it is far from clear that the degree of "bias" in post-GST years will materially differ from that of the pre-GST years.
11. Notably, the years 2004-05 to 2008-09 inclusive will be the data input years for the 2010 Review application year (2010-11). These data years should more fully reflect the way in which states will have allocated the post GST "growth" revenue following the end of the guarantee period.

## **GIVING GREATER WEIGHT TO CONTEMPORANEITY**

12. The CGC Issues Papers 2006/03 and 2006/04 canvassed the following specific issues/options:

### ***Changing the treatment of SPPs***

13. "Absorption" has historically been viewed as a subset of "inclusion". The difference between the two is that under an absorption approach the

Commonwealth receipts are treated as if they are general purpose revenue and so absorbed within the assessment period pool, instead of deducted from each states total financial assistance requirement, prior to the calculation of the assessment year relativity factor. On the expenditure side there is no difference in the two approaches. The expenditure is included within the expenditure standards and needs assessed. The Commission ceased to use absorption as a treatment option in the 2004 Review.<sup>1</sup>

14. Tasmania accepts that an “absorption treatment” would make the relativities more “contemporaneous” and agrees that the stability impacts are unclear. However, Tasmania questions what, if any, simplification this would achieve {summing the  $O_i$ 's (states “included” SPP receipts) and adding them to  $G_s$  (the total GST/HCG pool) rather than deducting the  $O_i$ 's from each state's TFAR (total financial assistance requirement) for each assessment year does not achieve a real reduction in “moving” parts}. The inclusion/exclusion assessment would still need to be made or, alternatively, currently excluded SPPs (in the order of 15 per cent of total SPPs) would need to be brought into the expenditure standards.
15. SPPs comprise a relatively small component of the overall equalisation budget. It seems to be something of an ad hoc, partial approach to addressing contemporaneity.
16. More fundamentally, Tasmania is unclear as to the conceptual basis to justify such a treatment.

#### ***Shortening the assessment period***

17. In relation to shortening the assessment period, Tasmania has previously argued for a three-year average in lieu of a five-year average relativity calculation. The rationale is that, as this is a more contemporaneous measure, it is likely to be a better approximation of the actual economic circumstances of the application year, particularly for traditionally lower-growth states such as Tasmania which otherwise would never “catch-up”. The associated reduction in the number of assessment years required would simplify the assessments.
18. It can be argued that, if the relativities better reflect the actual application year conditions then, in principle, the overall revenue outcomes will also be more stable (reflecting complementary movements in HFE grant outcomes and states net financial position otherwise). On this “in principle” basis, the application year relativity could conceivably be based on the most recent single year historical relativity. While this is the most volatile of the alternative measures, it is also the most contemporaneous.
19. However, notwithstanding the conceptual appeal of this argument, the political reality is that for budgetary purposes, states require some minimal degree of

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<sup>1</sup> For practical purposes, the treatment of the Health Care Grants continues to be “absorption” but the Commission considers that it is complying with the Australian Government’s direction as to how they should be treated rather than making a methodological decision to “absorb” them”.

budgetary certainty for planning purposes. A three-year average relativity outcome is both more “predictable”, and more stable in this context, than a single year relativity outcome (and, most states consider a five-year average is even more so). A three-year average therefore represents the grant stability floor below which no state is likely to support a reduction. That is, in the trade-off between grant stability and contemporaneity, all states, including Tasmania, will necessarily give preference to grant stability as budgetary certainty takes primacy over contemporaneity.

#### *Giving greater weight to more recent years*

20. The issues here would be what weights should be applied and how these should be determined. It is probable that this would be an extremely contentious process. There are no independent benchmarks as to what would be appropriate weights nor is such an approach likely to add to confidence in the Commission’s assessed relativity outcomes. It would add further complexity to, rather than simplify, existing processes. Further, as it could be argued that these weights would need to be allowed to vary with circumstances over time, this would not necessarily be a one-off impact as suggested in the paper. This is not seen as a credible option for further development.

#### *Using forward estimates*

21. Making projections of the relative fiscal capacities of the states in future years would be highly contentious. Pragmatically, this is likely to result in reduced rather than increased confidence in the HFE outcome. States own recent experience in forecasting own-source revenues for budgetary and other purposes suggests major issues around the reliability of forward estimates. In this context, Tasmania disputes the statement (2006/04, paragraph 26) that there would be no impacts on stability or simplicity. States would be unlikely to enter into such an arrangement without some system of ex-post “actual” data verification against forward estimates and grant re-dress.
22. In principle, Tasmania considers that a system of advance and completion grants could realise a “contemporaneous” distribution, albeit with a delivery lag.
23. South Australia has previously proposed a system of retrospective adjustments in relation to the current system of historically derived relativities to address the contemporaneity “gap” between application year relativities and the subsequent “actual” relativities realised for that year. The South Australian modelling suggested that this retrospective adjustment was needed to address the persistent shortfall in equalisation otherwise realised (refer South Australia’s 2002 submission to the 2004 review and the CGC Discussion paper 2002/2 Contemporaneity and Equalisation Over Time).
24. A number of states rejected the South Australian proposal on conceptual grounds. Questions were raised about the robustness of the modelling and the arguments underpinning it. On practical ground, concerns were held in relation to additional complexities and transitional costs.

25. In practice, an advance and completion system presents budget uncertainties for states. There would remain considerable pressure on the Commission to make accurate projections to minimise the degree of adjustment subsequently required. This approach would also introduce new sources of contention (for example, how to treat post-completion revisions to data that would have material grant redistribution implications).

***Moving from a relative assessment of fiscal capacities to an absolute assessment***

26. The rationale for this approach rests on the presence of material bias in the application year relativities due to growth in the pool between the assessment years and the application year, as outlined in paragraph 13 of the Issues Paper 2006/04. Tasmania accepts the technical argument that bias can arise under such conditions but considers the case has yet to be made that the post-GST conditions justify such a permanent adjustment to the relativities calculation. As previously noted, the transitional years 2000-01 to 2004-05 do not provide a sufficient basis on which to make such a judgement. A longer, post-GST historical time series is required.
27. In the event that such a case is made in the future, Tasmania considers that the equalisation amounts would need to be indexed to convert them to application year prices. The most appropriate form of indexation would be indexation to the annual average growth of State expenses and revenue. This would also need to be done on a per capita basis to allow adjustment for population growth between the assessment years and the application year.
28. It is also clear that such an “equalisation amounts” approach would add further complexity to the determination of grant outcomes. It would also need to be established that, following these indexation adjustments, there was a material difference between an EPC distribution of this net pool growth component and the HFE relativity distribution.

***Full contemporary equalisation***

29. This is effectively dismissed within the Issues paper as too problematic and Tasmania strongly endorses this conclusion. It is not seen to be a credible proposition for all the reasons the Commission itself cites. It adds to complexity, it adds to uncertainty, it is computationally complex and data intensive; it would require considerably more Commission judgements to be made. Overall it would be de-stabilising to the HFE system.

**CONCLUSION**

30. States have been asked to comment on whether
- they consider the stability of GST revenue to be more important than the stability of total State revenue
  - any of the contemporaneity options should be investigated further; and

- the Commission should bring forward its consideration of contemporaneity.
31. Tasmania considers that the stability of GST revenue takes primacy over the stability of total state revenue in the context of the Commission’s assessment processes. If using forward estimates is ruled out, then even the most contemporaneous assessment will be based on data which is two years old. On this basis it is unlikely that changes in GST revenue are likely to be balanced by changes in own-source revenue. GST revenue is around 50 per cent of Tasmania’s revenue. Total revenue stability is not possible if GST revenue is not stable. In this context, Tasmania considers that, notwithstanding the developments as outlined in Issues Paper 2006/04, the historical assessments basis still remains appropriate and that the case for contemporaneity to be given a higher profile within the Commission’s assessments has yet to be made.
32. Of the six “contemporaneity” options outlined in the Commission’s paper, Tasmania considers only three have any potential merit in terms of further development. The others are simply non-credible/problematic on data grounds.
- Absorption of SPPs is an interesting proposal, however, Tasmania would need to see a stronger conceptual argument for its introduction.
  - A three-year averaging period has been previously supported by Tasmania.
  - Adjustments to correct for size of pool effects would be premature in advance of a material case being made for the need for such an adjustment.
33. Tasmania is clearly of the view that there is no case for bringing forward consideration of contemporaneity “solutions”. There is insufficient information on which to base an informed judgement as to whether there is a viable long-term contemporaneity issue associated with the post-GST pool. At a broader level, these would represent method changes which should, if they are to be introduced, be introduced as part of a Review package.