



Tasmania  
Explore the possibilities

**Contents**

Contemporaneity ..... 3

    General Comments ..... 3

    The principle of improving contemporaneity in the Commission’s assessments (should it be done) ..... 3

    How any improvement in contemporaneity could be implemented (how can it be done)..... 4

        Reliable data..... 5

        Improving contemporaneity whilst using historical data..... 6

Conclusion ..... 9

# Contemporaneity

## General Comments

Tasmania has previously addressed the issue of contemporaneity through a letter in response to Western Australia's submission on the topic, and again in the Mining Revenue chapter of our response to the Significant Changes since the Draft Report paper.

This submission reiterates and expands on Tasmania's position for the purpose of addressing the Commission's latest request for comments targeting two specific questions:

- The principle of improving contemporaneity in the Commission's assessments between the assessment and application years (should it be done)
- How any improvement in contemporaneity could be implemented (how can it be done).

Tasmania recognises that the Commission is undertaking further consultation in response to a direct request for advice from the Commonwealth Treasurer. Tasmania has previously stated that we consider it the responsibility of governments to consider and negotiate an appropriate way to ameliorate any adverse outcomes that result from the Commission's assessment process, and any such actions should be undertaken outside of the GST distribution system.

## The principle of improving contemporaneity in the Commission's assessments (should it be done)

Tasmania considers that the Commission's current methodology is suitably contemporaneous when considered in the context of the Commission's primary objective of achieving horizontal fiscal equalisation.

The Commission's methodology is specifically designed to recognise the innate differences in States' revenues and expenditures which would cause their fiscal capacities to diverge and to recommend a distribution of GST revenue which would remove the impact of that divergence on State finances. On a first principles basis, Tasmania considers that all methodological changes should seek to maintain or improve the Commission's ability to deliver on its primary objective.

Tasmania is strongly of the view that the magnitude of specific changes in state circumstances should not be viewed as justification in itself for considering adjusting the Commission's methodology. Tasmania believes the adequacy of the methodology, including the issue of whether the assessment methodology is sufficiently contemporaneous, should always be considered on the basis of principle. That is, changes should be considered on the basis of how the methodology can best be structured so as to produce a recommended GST distribution that is most aligned with the principle of HFE. If the outcomes of this process are not acceptable to Government's, it becomes a matter for Government's to resolve.

Tasmania recognises that a move toward a more contemporaneous assessment may improve the relative applicability of the assessment to the states' actual fiscal circumstances in the application year. However, Tasmania does not believe this can be achieved in a reliable way that maintains or improves the methodology's capability of achieving HFE, given the compromises it would necessitate.

Specifically, Tasmania notes that greater contemporaneity can only be achieved at the expense of at least one of the following principles:

- the reliability of the data that the assessments are based on (reliability and practicality);
- the pursuit of less complexity within the methodology (simplicity); and
- the value of States' having a level of predictability in GST revenue (stability).

Tasmania believes that the current approach of basing assessments on the observed data for the latest three years achieves an appropriate balance between contemporaneity and these competing principles.

Tasmania notes that this issue was considered extensively in the 2010 Review, including within *Issues Paper 2006/04 - Contemporaneity*. That Issues Paper outlined a number of options for giving greater weight to contemporaneity and explicitly recognised the direct trade off between contemporaneity; reliability and practicality; and states' preference for stability in GST revenue.

Having considered the views of all States regarding a series of possible options, the then Commission made the decision to shorten the lagged assessment period from a five year average to a three year average. It concluded that this balance was preferred over an even more contemporaneous assessment because it provides some stability in State shares of the GST, a major source of revenue, despite volatility in State own-source revenue<sup>1</sup>.

Tasmania agreed with the Commission's analysis at that time, and continues to do so. Tasmania does not believe that recent perceptions of a lack of responsiveness or applicability of relativity's warrants a change in this deliberate and informed balance, particularly in the absence of a comprehensive analysis of a full range of options. The benefits and disadvantages of trade-offs between these competing principles were examined carefully during the 2010 Review, with significant input from States. Tasmania considers that a change to the balance between these principles deserves a similar level of scrutiny and notes that this has not occurred in this Review.

For these reasons, Tasmania does not support the principle of improving the contemporaneity in the Commission's assessments at this time.

## **How any improvement in contemporaneity could be implemented (how can it be done)**

Notwithstanding the above comments, Tasmania considers that any improvement in the contemporaneity of the Commission's methodology should only be pursued if it can be clearly demonstrated that it would not reduce the achievement of HFE. Tasmania considers that a reliable assessment, based on robust data, is vital to achieving HFE. As such, options for how contemporaneity could be improved are considered firstly in the context of the need for reliable data.

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<sup>1</sup> Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2010 Review – Main Report, pg.38.

## Reliable data

The extent to which contemporaneity can be improved is constrained by the availability of reliable data.

Western Australia has proposed that contemporaneity could be improved if the Commission were to use projections or forecasts of state circumstances as the basis for their assessment. Tasmania is strongly opposed to the use of projections or forecasts of State circumstances in the application year as the basis for the Commission's assessments.

Tasmania notes that the Commission's methodology is specifically designed to recognise innate differences (notwithstanding materiality thresholds), in States' revenues and expenditures to facilitate the recommendation of an appropriate distribution of GST revenue. Tasmania considers that an accurate assessment of these differences can only be achieved through observed historical data, rather than projections or forecasts.

Tasmania notes that the Commission considered the option of undertaking a full contemporary equalisation based on projections of states fiscal capacities, during the 2010 Review. At that time, the Commission noted a number of disadvantages, including that:

- the assessment would be complex and data intensive, which would conflict with the simplification objective;
- it would have implications for the stability of States' GST revenue;
- it is unlikely that the commission could accurately predict State's application year fiscal capacities; and
- it could expand the role of judgement in the assessment process<sup>2</sup>.

The Commission also considered the use of forward estimates rather than historical financial data, but noted they would have concerns about reduced reliability and accuracy, as well as grant design issues associated with using unaudited State data<sup>3</sup>.

Tasmania concurred with the Commission's analysis in the 2010 Review, and continues to do so. Tasmania considers that these recognised disadvantages remain valid and are sufficient barriers to warrant ruling out of the use of projections or forecasts of circumstances as the basis for the Commission's assessments.

Given that Western Australia has proposed the use of projections in this Review, it is worth noting their thoughts on the issue in 2006:

*We are strongly opposed to any use of forward estimates or projections of future economic and demographic circumstances to forecast application year relativities. None of this information is sufficiently reliable, there would be opportunities for 'gaming' behaviour by States, and such approaches would add substantial complexity.*

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<sup>2</sup> CGC 2010 Review, *Issues Paper 2006/04 – Contemporaneity*, page 10.

<sup>3</sup> *Ibid*, page 8.

*Such an approach would also require a complex system of ‘completion’ grants or relativity adjustments to correct the previous estimates when actual data became available, and ensure that equalisation was actually achieved over time<sup>4</sup>.*

A number of other states also addressed these issues in their responses to the Commission’s *Issues Paper 2006/04 - Contemporaneity*. None favoured full contemporaneity and a number noted the difficulty of forecasting or projecting data for the application year.

Tasmania also notes that the Commission again rejected the idea of using projections in their *Significant Changes* paper in this Review, stating that they did not consider State or independent forecasts of revenues in the application year sufficiently reliable for use as the basis of the GST distribution<sup>5</sup>.

The Commission also stated that it considers “that a 3 year lagged assessment is, at least in most circumstances, the most reliable practical approach to providing a reasonable estimate of State circumstances in the application year”<sup>6</sup>. Tasmania agrees with this, and considers it unlikely that a reliable, practical, unbiased assessment that is based on projections or forecasts can be developed for any assessment category.

If the use of historical data is accepted as necessary, its availability creates an unavoidable “lag” in the assessment of state circumstances, effectively reducing contemporaneity. Tasmania considers this reasonable and necessary when balanced against the need to ensure reliability in the Commission’s methodology.

### **Improving contemporaneity whilst using historical data**

From a baseline of accepting the use of historical data, the question becomes one of how contemporaneity can be improved in the context of a lagged assessment methodology. The options to do so include:

- reducing the number of data years taken into account to produce the relativities (currently three);
- giving greater weight to the more recent assessment years; and
- linking States’ GST requirements in the historical assessment year to the application year.

Tasmania is opposed to all of these options, for the reasons discussed below.

### **Reducing the number of assessment years**

Reducing the number of assessment years averaged to produce the relativities will increase the level of volatility in states’ shares of GST revenue. The use of three-year averaging is designed to deliver a level of stability through effectively “smoothing” the impact of large movements in circumstances and data irregularities, and preventing “one-off” anomalies from having a large effect on the GST distribution. Tasmania would argue that averaging is necessary for these reasons, and

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<sup>4</sup> Western Australia’s comments on the Architecture of Horizontal Fiscal Equalisation, July 2006, pg.7.

<sup>5</sup> CGC 2015 Review, *Significant Changes since the Draft Report, Commission Position Paper CGC 2014-04*, page 3.

<sup>6</sup> CGC 2015 Review, *Significant Changes since the Draft Report*, CGC 2014-14, page 3.

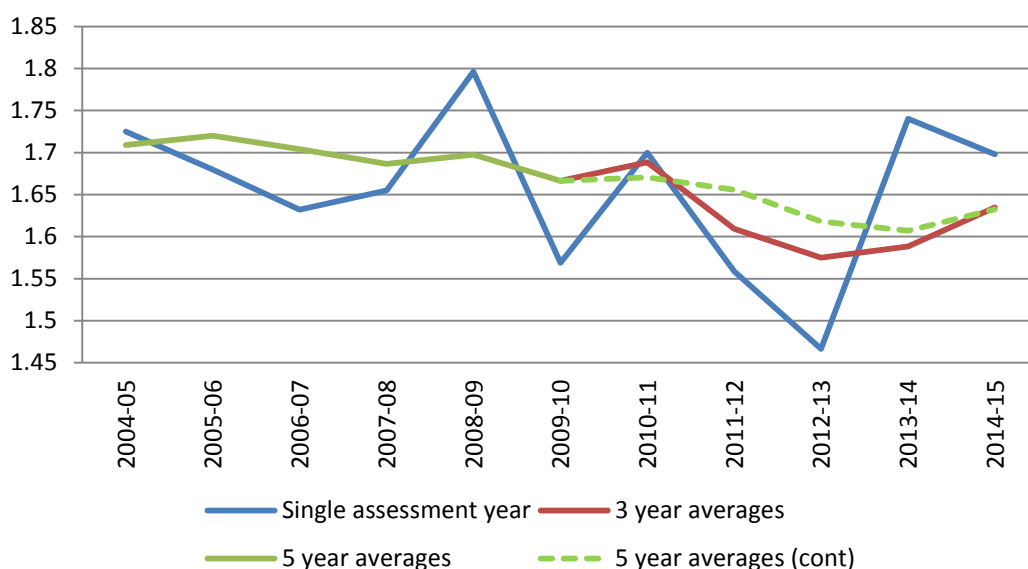
considers that the use of three-year averaging achieves an appropriate balance between contemporaneity and stability in states' shares of GST revenue.

As noted above, the assessment years were reduced from a five-year average to a three-year average during the 2010 Review. At the time, the Commission concluded that this balance was preferred over an even more contemporaneous assessment because it provides some stability in State shares of the GST, a major source of revenue, despite volatility in State own-source revenue<sup>7</sup>. Indeed, Western Australia noted in their submission that “predictability in GST revenues is very important”<sup>8</sup>, and ACT stated that they considered “stability of GST revenue... more important than the stability of total State revenue”<sup>9</sup>. Tasmania concurs with these views.

Tasmania considers it important to note that, in attempting to address volatility in certain states own-source revenues through adjustments to the contemporaneity of the assessment methodology, greater volatility will be introduced for all of the other states.

The chart below illustrates the significantly greater volatility in Tasmanian relativities that would have resulted if the assessment methodology had been based on the most recent single assessment year being applied to the application year, compared to the “smoothed” relativities of five or three-year averaging. It illustrates that the change from five to three-year averaging has increased contemporaneity without resulting in significantly increased volatility. However, further increasing contemporaneity by removing the three-year averaging would have resulted in a high level of volatility in Tasmania's relativity. The consequent fluctuations in Tasmania's GST revenue share would have caused significant budgetary challenges.

### Tasmanian Relativities\*



\* Single year relativity data for the years prior to 2007-08 were provided to Tasmania by Commission Staff and were modified by Staff so that health care grants were treated as a specific purpose payment, to be consistent with the current methodology. For comparative purposes, averages are constructed based on the same adjusted single year relativities.

<sup>7</sup> Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2010 Review – Main Report, pg.38.

<sup>8</sup> Western Australia's comments on the Architecture of Horizontal Fiscal Equalisation, July 2006, pg.7.

<sup>9</sup> ACT, Submission to the CGC's Issues Papers: 2006/04 Contemporaneity, July 2006, pg.14.

Tasmania does not believe that the potential contemporaneity gains from a reduction in the number of years used in the assessment would outweigh the loss of stability and “smoothing” effects that would result.

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

In principle, Tasmania can appreciate that giving greater weight to the more recent assessment years could result in a more contemporaneous methodology. However, Tasmania notes that any skewed weighting would also add another layer of complexity to the methodology and questions how the weighting of years could be achieved reliably and objectively.

We consider that a weighted approach would increase the level of judgement required of the Commission. Tasmania notes that the Commission shared this view during the 2010 Review, concluding that it was not viable as “there is no objective way of deciding how to give more weight to more recent years”<sup>10</sup>.

Tasmania also notes that, whilst a weighting skewed towards the most recent assessment year may be more contemporaneous, it would also be less reliable because data in the latest year is more likely to be revised. Further, weighting toward the most recent assessment year will lessen the “smoothing” effect achieved by the current three-year averaging approach, thereby increasing volatility in GST distribution outcomes.

Tasmania considers that the Commission’s 2010 Review conclusion that weighting is not a viable option is still relevant. Tasmania does not consider the potential gain in contemporaneity sufficient to warrant the increased level of judgement this option would require, nor the reduction in simplicity, stability and reliability.

### **Linking of States’ GST requirements in historical years to the application year**

In the 2010 Review the Commission considered the option of using an indexing approach where the GST each State required in the historical years was indexed to the application year by estimated movements in price levels, with any additional GST available in the application year distributed on an EPC basis.

Tasmania considers that any approach which attempts to link the historical assessment to the application year unviable as it would reduce reliability by requiring increased levels of judgement in how this “linking” should occur. For example, in the case of the 2010 review proposal, judgement would have been required to determine the indexation factor, as well as the method of distributing any residual GST. Such approaches would also add significant complexity to the Commission’s methodology.

Whilst not specifically addressed in the 2010 Review option, the issue of whether and how to subsequently “re-adjust” distribution outcomes once actual data became available would be key points of judgement and debate. If such re-adjustments were deemed necessary, their application could inadvertently undermine the contemporaneity of future years GST distributions.

Tasmania is of the view that the additional complexity and judgement required under such an option would not justify any possible gains in contemporaneity.

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<sup>10</sup> Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2010 Review – Main Report, pg.55.



## Conclusion

As discussed above, Tasmania considers that any improvement in the contemporaneity of the Commission's methodology can only be achieved at the expense of the reliability of the methodology, its simplicity, and the stability of states' shares of GST revenue.

Tasmania considers it appropriate for the Commission to seek to balance contemporaneity in the methodology against these other principles, in the context of their primary objective of achieving HFE.

The issue of contemporaneity was considered extensively in the 2010 Review. The resulting methodology was structured so as to achieve a balance between being sufficiently contemporaneous to respond to changes in a relatively timely way, whilst ensuring data reliability, and delivering a level of stability and "smoothing" through the use of three-year averaging of historical assessment years. Tasmania considers that this approach continues to achieve an appropriate balance between these competing principles in a way that best supports the achievement of HFE.

Further, Tasmania expects that most States' views regarding the balance between these principles would not have changed significantly since the 2010 Review, particularly if the issue was to be considered purely on the basis on first principles, rather than outcomes.

Tasmania notes that fiscal circumstances can (and do) change between the assessment period and the application year (and can be material), such that the application year relativity outcomes do not precisely reflect states actual fiscal circumstances for that year. However, Tasmania would argue that while full equalisation may not be realised in the application year, equalisation will be realised over time. Tasmania considers this to be appropriate when balanced against the importance of other competing principles of reliability, stability and simplicity in the context of achieving HFE.

We do not believe that the case for contemporaneity to be given a higher profile in the methodology has been demonstrated sufficiently to justify an adjustment to the Commission's methodology, nor to warrant late meddling in the HFE-based assessment outcomes.

Further, the issue of principles aside, Tasmania finds it difficult to envisage "how" contemporaneity in the Commission's assessments could be improved in a way that does not inappropriately compromise the methodology in other ways.

Any change to the level of contemporaneity in the assessment methodology could have a material impact on GST distribution outcomes. Tasmania believes any such change warrants comprehensive analysis, including adequate consultation with States. Given the significance of any such changes, Tasmania does not consider the analysis and consultation that has occurred in this Review to be sufficient to warrant changes to the methodology.

For all of these reasons, Tasmania does not support changes to improve the contemporaneity of the Commission's methodology at this time.