Australian Government

Commonwealth Grants Commission

# HISTORY OF CONTEMPORANEITY

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# HISTORY OF CONTEMPORANEITY

## INTRODUCTION

1 In its most recent 2015 Review the Commission maintained the supporting principles from the 2010 Review, and used them to guide the development of the 2015 methodology. One of these principles, known as the contemporaneity principle, is to deliver relativities that, as far as possible, are appropriate to the application year. This principle means that, as far as reliable data will allow, the distribution of GST provided to States in a year should reflect State circumstances in that year. The Commission said that, without that, the capacity to provide services and the associated infrastructure at the same standard, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, would be compromised.

2 The trade-off between contemporaneity and data reliability, resulting in the use of three historical years to calculate relativities, means that they may not completely reflect relative fiscal capacities of States in the application year. However, in the 2015 Review the Commission said that it does not consider that State, or independent, forecasts of revenues in the application year are sufficiently reliable to use as the basis of the GST distribution.

3 The Commission said that it considered that a three 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. It said that in adopting data for three historical years as the basis for all assessments, the Commission accepted that fiscal equalisation is achieved over a run of years with a lag. While imperfect, this approach recognises that State fiscal capacity in any one year reflects the operation of the system over this run of years.

4 There are limited exceptions to the use of three historical years, essentially in the case of backcasting major changes in Commonwealth-State financial arrangements. These exceptions occur only where the financial effects of the change are reliably known.

## PAST APPROACHES TO CONTEMPORANEITY

5 The Commission has been aware of the trade-off of using historical data to derive contemporary grant requirements from its earliest days. As in the 2015 Review, the Commission has always expressed a strong preference to use the most recently

available data and not speculate on possible future outcomes. The Commission said in its third (1936) Report:

> Objection may be taken to the year for which our calculations are made. The question at issue is the amount required for grants in 1936-37, and the bases on which our recommendations are made are the finances of the States for 1934-35. Data are not available for any year later than 1934-35, and indeed, in respect to certain matters we have to use the figures for 1933-34. On that basis two alternatives are possible. We might attempt to estimate the position in 1936-37 from the fairly complete 1934-35 material and such data as are available for 1935-36. This course, however, would lead us into realms of most uncertain speculation, and would quite reasonably cause grave dissatisfaction. We have no hesitation then in choosing the other alternative, of making our recommendation with direct reference to the needs of 1934-35. [1]

6 In deciding to use the most recently available data the Commission recognised that there could be trade-offs with contemporaneity, but it considered that these would even out over time.

> …There will then be a time lag of two years, and if conditions are changing rapidly such a recommendation might prove to be in serious disharmony with the needs of the State in 1936-37. The error, however, is not cumulative. While general economic conditions are deteriorating the grant on these lines will be too small. When conditions are improving it will be too great. The differences will balance out over a term of years. When a State, on account of worsening conditions, is receiving too little, a temporary increase in the deficit must be recognized as legitimate. When conditions are improving, it may be hoped that any excess grant on this account will be used by a State so as to improve its future position, e.g., in wiping out some of the accumulated revenue deficit or in restoring the value of its capital assets. If, on the other hand, the excess grant were used to lower taxation or expand services, the State would receive a rude jolt when the tide turned the other way.[2]

7 Through the claimancy (special grants) period, the Commission addressed this issue through an advances and completion approach. In the first reports, advances to a claimant State reflected the Commission's judgements of the impact of current conditions on the fiscal circumstances for the year in which the grant was to be paid. For example, based upon the fiscal position in 1934-35, the Commission in its 1936 Report recommended that Western Australia receive a grant of 456 000 pounds in 1936-37. However the Commission was impressed with the evidence put before it on the effects on Western Australian State finances in 1936-37 of a very serious drought,

[1] Commonwealth Grants Commission, *Third Report (1936)*, paragraph 237 (ii).
[2] Ibid.

and so increased its 1936-37 grant by an additional 44 000 pounds (to 500 000 pounds in total). The Commission said the additional amount must be regarded as an advance to Western Australia on account of the 1936-37 year, and would be taken into account (that is, deducted from the indicated grant) when a grant is being recommended on the basis of its final financial position in 1936-37 (in the Commission's 1938 Report). Conversely, in buoyant fiscal circumstances, part of the indicated grant could be deferred, to be made available if required when the year of payment became the year of review.

8 New arrangements were adopted in 1949, following a submission made by Western Australia in 1948, with an extension suggested by the Commonwealth Treasury. The main effect of the new arrangements was to explicitly divide the special grant into two parts. Initially known as the first part and the second part, the two parts came to be known as the completion grant and the advance grant.

> The Commission began its assessment by calculating the grant assessed as necessary for the claimant State to reach the budget standard in the year of review [assessment year in current terminology], and then deducted from the amount so assessed the advance grant previously received by the State when that year was the year of payment to calculate the completion grant for the year of payment. The completion grant could thus be either positive or negative, depending on whether the advance grant paid in the year of review had been inadequate or excessive. The advance grant for the year of payment was then derived by estimating the 'indispensable need' of the claimant State, after allowing for a suitable margin of safety. The total grant for the year of payment was thus calculated as the advance grant for that year plus or minus the completion grant for the year of review. This system was retained for all subsequent claimancy assessments.[3]

9 During the claimancy period there was a single year of review (assessment year), being two years prior to the year of payment (application year). The last completion grant, for the year of review of 1980-81, was assessed for Queensland as described in the Commission's *Forty-Ninth Report on Special Assistance for States*, 1982. The Commission's view during this period was that contemporaneity issues were sufficiently dealt with, both through the advances and completion approach, and because special grants did not represent a particularly large component of State revenues.[4]

10 The Commonwealth and the States agreed over the course of three Premiers' conferences held in 1976 to new arrangements for the sharing of personal income tax

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3 Commonwealth Grants Commission, *Equality in Diversity, History of the Commonwealth Grants Commission (Second Edition)*, page 85.

4 Commonwealth Grants Commission, *Report on State Tax Sharing Entitlements, 1981*, Volume 1, paragraph 8.48.

revenue between the Commonwealth and the States. These arrangements were incorporated in a series of Points of Understanding which outlined the manner in which the revenue raised by the Commonwealth from personal income tax would be distributed between the Commonwealth and the States. The major element of the arrangements was that a specified proportion of personal income tax collections would be earmarked for distribution to the States as the total States' entitlements, commencing from the beginning of 1976-77. The Points of Understanding also provided for the initial manner in which the total States' entitlements should be distributed between the six States.

11 The legislation to give effect to these arrangements and incorporating the substance of the Points of Understanding was the *States (Personal Income Tax Sharing) Act 1976.* The Commission's 1981 Review of State Tax Sharing Entitlements came about from the subsequent *States (Personal Income Tax Sharing) Amendment Act 1978*, which provided for the review of the relative shares of the States in the following terms:

> The Minister shall before 30 June 1981 arrange, and, after consultations between the Government of the Commonwealth and the Governments of the States, may periodically after that date arrange, for the question whether any change is desirable in the State factors to be referred to the Commonwealth Grants Commission…[5]

12 During the course of the 1981 Review it was agreed that there would be three assessment years, 1977-78, 1978-79 and 1979-80.[6] In this review the Commission's concerns about contemporaneity were driven by the possibility of a growing gap between the assessment years and the application year likely in a system of ad hoc occasional reviews without any annual updates. In respect of contemporaneity the Commission noted:

> There was general agreement among the interested parties that relativities determined on the basis of three assessment years would cease to achieve fiscal equalisation with the passage of time and would need to be revised as tax sharing entitlements, standard revenues and standard expenditures, relative revenue-raising capacities and relative costs of providing services, and the level and distribution of specific purpose payments changed over time.[7]

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5 *States (Personal Income Tax Sharing) Amendment Act* 1978, subsection 13(3).

6 Agreed at the August 1979 conference between the Commission and interested parties. The practice of having three assessment years remained in place until the 1990 Premiers' conference decided from 1990-91 and thereafter general revenue assistance grants should be determined on five assessment years. The Commission returned to three assessment years from the 2010 Review of GST Revenue Sharing Relativities.

7 Commonwealth Grants Commission, *Report on State Tax Sharing Entitlements, 1981*, Volume 1, paragraph 8.47.

> The Commission's assessments have been based on information relating to periods two to four years before 1981-82, which is the first year in which the assessed relativities could be applied. There is no general provision in the Points of Understanding or the legislative provisions for the updating of information as a basis for revised assessments, or for the States to appeal against the Commission's findings as part of a continuing review process. Moreover, the assessments relate to the total amount of the largest single item in the recurrent budgets of the States.[8]

13 For these reasons in its 1981 Review Report the Commission considered that it was a matter for governments to address the contemporaneity question.

> The Commission was conscious of the fact that assessments based on financial data for past years of review would not necessarily reflect relative needs accurately … but it considered that unless the Commonwealth and State governments could agree on a system of advance relativities in a year of review followed by adjustments to the State factors two years after the year of review, along the lines of the advance and completion grants recommended in claimancy reviews, the distribution of tax sharing entitlements would have to be based on past financial data with all the imperfections in the assessment process which that implied.[9]

14 The Commission said in 1981 that there were two considerations affecting the contemporaneity of its assessments. One was that due to the dynamic nature of many of the relevant economic and budgetary variables underlying the assessments, individual years within the assessment years could vary substantially. A related consideration was the growing length of time between the assessment years and the application year where review relativities are fixed for a number of years.[10]

15 The Commission considered that the most appropriate way to deal with these issues was to have a series of simplified annual reviews (restricted mainly to updating data) followed by periodical major reviews every three to five years. The data for a new year would replace the data for the earliest assessment year, so that the assessments would be based on a three year moving average.[11] However the Commission's advice for annual reviews (or updates in the current language) was not taken up.

16 A further consideration identified by the Commission was the distribution of specific purpose payments (now payments for specific purposes, or PSPs). In the 1981 (and subsequent) Review the Commission identified that differences in the distribution of these payments, between assessment years and the application year, and between

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8 Ibid. Paragraph 8.49.

9 Ibid. Paragraph 2.197.

10 Ibid. Paragraphs 8.38 and 8.39.

11 Ibid. Paragraph 8.60.

actual distributions across States and an equalised distribution, could have substantial impacts on the relativities.

17 Through the reviews conducted during the 1980s the Commission's view was that it is impossible to determine relativities which will have an equitable future operation for any substantial period of time. In each review the Commission continued to express a preference to move to a system of regular reviews interspersed with annual updates.

18 In the absence of annual reviews, in each of the 1982, 1985 and 1988 Reviews there were either explicit terms of reference or accompanying directions asking the Commission to indicate what allowance (if any) might be made to relativities to account for trends over a longer period, or transient factors and temporal changes.

19 In the 1985 Review (as it had in the 1982 Review) the Commonwealth Treasury suggested that in order to examine the influence of trends on State relativities the Commission should measure the underlying trends in standardised deficits. The Treasury suggested the method for estimating trend values be simple linear regression analysis, and that the trend values would provide an alternative measure of State relativities.

20 The Commission examined the simple linear regression of trends in States' standardised deficits per capita for the seven year period 1977-78 to 1983-84. The analysis was inconclusive because the Commission considered the results to be heavily influenced by inflation, which would vary by State and for which it was unable to make an adjustment due to a lack of data. The Commission was not satisfied there was sufficient positive evidence of identifiable trends for which it could make an allowance in its findings.[12]

21 In relation to transient factors contributing to movements between years, the Commission considered that within its normal processes it made modifications which have the effect of excluding the impact of extraordinary budgetary items from its assessments. However it observed that there might be other natural occurrences affecting State relativities that could not be reasonably quantified on the data available.

22 Due to its being inconclusive previously, the regression analysis to identify trends was not repeated in the 1988 Review.[13] Instead, the Commission's view remained that regular reviews and annual updates was the correct approach. In relation to transient events and temporal changes the Commission considered:

- the use of three-year averages would dampen effects of transient events

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12 Commonwealth Grants Commission, *Report on Tax Sharing Relativities 1985*, Volume 1, Chapter 4.

13 Commonwealth Grants Commission, Report on Tax Sharing Relativities, 1988, Volume 1, paragraph 4.6.

- temporal changes largely related to Commission 'backcasting' changes in Commonwealth-State financial relations.

23 A decision to go to annual updates of relativities, including using three-year moving averages, was made at the 1988 Premiers' conference, to take effect from 1989.[14] One stated aim from the introduction of annual updates was to reduce the problem of allowing for trends and transient factors and temporal changes in policy which affect the appropriateness of using same relativities for a number of years.

24 The 1989 Update relativities differed from the 1988 Review relativities by more than some States expected, although change was consistent with the view expressed by the Commission in the 1981 Review in relation to the dynamic nature of economic and budgetary conditions. Consequently, the Commission was asked in the second half of 1989 to report on updates of relativities.

25 The Commission reported its findings in its *Report on Update of Relativities 1989*. The Commission framed its Report by considering the following criteria/objectives for evaluating update options:

- Equalisation
- Contemporaneity or up-to-dateness
- Stability
- Predictability
- Economy of effort.

26 In relation to contemporaneity, the Report explained how it was intended to be improved through the update process:

> The annual update arrangements were intended to improve the contemporaneity of relativities by maintaining this two-year lag instead of allowing it to increase between reviews. We consider that if the relativities are as up-to-date as possible (that is, the lag between the most recent year of the period of review on which relativities are determined and the years in which the resultant relativities are applied is as short as practicable) it will increase the likelihood that fiscal equalisation is achieved in the year of application.[15]

27 In particular, in this report the Commission made clear that it was interested in relativities appropriate to the application year (which was why it considered temporal and transient factors), not in achieving equalisation over time, as argued by New South Wales and Western Australia.[16] With some prescience, the Report also discussed the same issues as those raised by Western Australia in the 2015 Review:

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

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

16 Ibid. Paragraph 2.7.

> If the time lags in applying relativities could be eliminated, volatility in economic conditions could be prevented from producing fluctuations in the relative levels of total State resources. This is because adjustments of general revenue grants would offset the fluctuations in the relative amounts of a State's standardised own-revenue and specific purpose payments within a year. However, because time lags are unavoidable and it is not possible to predict precisely the relativities which will be appropriate for a particular year of application, annual updates may add another element of instability to that caused by differential fluctuations in other State revenues. This will happen when a State's own-revenue turns down at the same time as its share of grants declines.[17]

28 The Report said that the Commission's view was that equalisation (including up-to-dateness, or the consistent lag between assessment and application years) and stability of fiscal capacities of States (an average of a number of assessment years) were the most important criteria. It said that while predictability and economy of effort (resources required by States and the Commonwealth to complete a review/update) are relevant considerations, they were subsidiary to fiscal equalisation and stability of fiscal capacities. New South Wales and Western Australia said that the stability of general revenue grants was an important, if not the most important consideration.[18]

29 In the Report the Commission recommended retaining annual updates between reviews using a review (assessment) period of three years, although not ruling out a move to a five year period at a later date. As it happened, in the 1990 Update the Commission was asked to produce relativities on both a three and a five year basis. The 1990 Premiers' conference agreed that annual updates should continue and from 1990-91 and thereafter be on a rolling five year basis.[19]

30 In the 1993 Review the terms of reference directed the Commission to base its relativities on five assessment years, while in the 1999 Review the Commission was asked to calculate relativities on both a three and five year basis, and to comment on which set of relativities were more consistent with the principle of fiscal equalisation. The Commission said adoption of either would achieve fiscal equalisation in 1999-2000, but if equalisation was sought in the longer run as well as for individual years, it was important changes to the length of the assessment period be made as infrequently as possible, so that each year of assessment has equal weight over

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[17] Ibid. Paragraph 2.15.

[18] Ibid. Paragraphs 2.21-2.22.

[19] Commonwealth of Australia, *Budget Paper No. 4, 1990-91*, page 50.

time.[20] The 1999 Premiers' Conference agreed to use the relativities based on a five year assessment period.[21]

31 The terms of reference for the 2004 Review were silent on the number of assessment years to be used. However South Australia and Tasmania raised the issue of contemporaneity, saying the current process was not delivering equalisation in the application year because it did not deliver the level of assistance those States needed to provide the average level of services in that year.

32 Analysis provided to the Commission during the 2004 Review showed that:

- For States which experience economic cycles, equalisation is achieved in the medium term. But the time lags involved can result in both grants and State tax revenues falling at the same time, which may exacerbate their budgetary cycles.[22] Thus the process may not deliver the assistance a State needs to give the capacity to provide the average level of service in a particular year.
- For States which experience a sustained downward (for example, South Australia, Tasmania) or upward (for example, Western Australia) economic trend, equalisation cannot be achieved until the trend reverses. In some cases, the trend has not reversed in 20 years. In these cases, the current (lagged average) process will not deliver the assistance a State needs to give it the capacity to provide the average level of service in a particular year. [23]

33 The 2004 Review Report confirmed the Commission's decision to calculate relativities based upon five assessment years. After its Conference with the Heads of Treasuries on 23 October 2002, the Commission decided to stay with a five year assessment period rather than return to a three year period. No State supported the South Australian proposal to adjust relativities because of long term trends in States' relative fiscal positions and so the Commission decided it need not be considered further.

34 The 2010 Review terms of reference were also silent on the number of assessment years to be used. However the Commission said that relativities should reflect, as closely as possible, conditions in the States in the year they affect the distribution of GST revenue. Consequently, in the 2010 Review the Commission formally adopted as a supporting principle that relativities be contemporary. It said that the principle meant, as far as possible, equalisation should reflect State circumstances in the year the funds are used.[24] The Commission noted that fully contemporaneous relativities would be based on data for the year they are applied, but as reliable data for the

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20 Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1999*, Volume 1, page xiv, paragraphs 10-12.

21 Commonwealth of Australia, *Budget Paper No. 3, 1999-2000*, Chapter 1, 1999 Premiers' conference.

22 This was Western Australia's issue in the 2015 Review.

23 Agenda Paper AP2002/25 *Is the current process achieving full contemporaneity?*

24 Ibid. Page 37, paragraph 55.

future were unavailable, the principle was constrained by the need for reliable data, leading to relativities being based upon historical years.

35 The Commission considered a number of options for improving contemporaneity, concluding that the two most viable approaches were reducing the number of assessment years (from five to three) and 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.[25]

36 It rejected:

- a fully contemporaneous approach as being more complex, unreliable and unacceptable to States
- a weighting approach because there is no objective way of deciding how to give more weight to more recent years
- a two part (advance and completion) approach as it would reduce transparency and would be more complex.

37 The Commission decided to make relativities more contemporary by basing them on the average of the relativities assessed for the three most recent years because it was the simplest method of making the relativities better reflect State GST requirements in the application year. This change was consistent with Commission concerns expressed in the 1989 Report on Update of Relativities that contemporaneity was at risk with an increasing time period between assessment years and application years. By reducing the number of assessment years from five to three the Commission reduced the average time period between assessment and application years from four years to three years.

> Under the previous methodology, the data used in making the assessments was an average of five years' historical data. While the use of five year averaging reduces volatility that might be found in some of the data, when State circumstances change quite quickly, it produces relativities which are inconsistent with observed State fiscal circumstances in the year the relativities are to be applied. We recommend a shortening of the averaging period to three years, believing this strikes a better balance between capturing current developments and smoothing data volatility.[26]

38 No State opposed reducing the assessment years from three to five, although Western Australia said the change should be phased so as to give each assessment year an equal weight in being used to calculate relativities. Similarly to when the number of assessment years was increased from three to five, the change to three year averaging was not phased.

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[25] Ibid. Pages 53-55, paragraphs 3-10.

[26] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2010 Review*, Volume 1, page 6, paragraph 23.

39 While it assumes the fundamental structure of the assessment years continues in the year relativities are applied, the Commission did note that an exception arises when there are major changes in federal financial arrangements. In this event, assessments are adjusted to reflect any major changes in payments that occur between the historical years and the year the recommendations are applied. This is referred to as backcasting and is achieved by applying the application year distributions to the assessment year aggregates of the backcast payments.

## SUMMARY

40 The absence of application year data has been an issue for the Commission since its earliest inquiries. In its third (1936) Report, the Commission decided it would not try to estimate conditions in the application year but would base its recommendations on historical data — the year of assessment.[27] In deciding to use historical data, the Commission built lags into the special grants it recommended for claimant States.

41 The Commission acknowledged that one-off factors (for example, natural disasters) could cause the circumstances of the application year (or year of payment) to diverge from the year of assessment (or year of review). It made judgements to adjust the special grants paid in an application year where it considered circumstances warranted. These 'advances' were recognised when the application year subsequently became the assessment year. The Commission did this by assessing a completion grant. This was the difference between two assessments of special grant. The first was when a year was the application year and before the conditions of that year were known (its advance grant). The second assessment occurred two years later, when the conditions of that year were known. Thus, any divergence in circumstances was corrected two years later.

42 With the introduction of all-State equalisation (in the 1981 Review), assessing a margin of error ceased and completion grants were discontinued. Whereas in the special grants era the Commonwealth financed these margins of safety, the new approach meant that States, rather than the Commonwealth, would have to fund these margins of safety. Thus, margins of safety could not be provided to every State. With the discontinuation of completion grants there was no redress if the circumstances estimated for the application year (as captured by the relativities) diverged from States' actual conditions.

43 In addition, methodology reviews were initially only scheduled to be held every three years, with the intention being that relativities would remain unchanged between

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

reviews[28]. Therefore concerns with contemporaneity began to be expressed in terms of the increasing time period between assessment years and the application year.

44 To partially balance these concerns, the Commission moved from a one year assessment to three years, with the move to annual updates commencing in 1989. The advantage of extending the assessment period was to provide greater smoothing to relativities. It meant an aberrant year received less weight in the calculation of relativities, but it also meant it remained in the assessment period longer and so influenced two additional inquiries. Notwithstanding this, subsequent terms of reference (for the 1990 Update) expanded the number of assessment years to five. However in the 2010 Review, with the introduction of its explicit principle for contemporaneity, the Commission reduced the number of assessment years back to three.

45 Under the contemporaneity principle, the Commission aims to deliver relativities that, as far as possible, are appropriate to the application year. This principle means that, as far as reliable data will allow, the distribution of GST provided to States in a year should reflect State circumstances in that year. In its most recent 2015 Review the Commission maintained the supporting principles from the 2010 Review, and used them to guide the development of the 2015 methodology.

28 Largely due to the differences between State shares of financial assistance grants between the old and new approaches, this only occurred between the 1985 and 1988 Reviews.