Australian Government
Commonwealth Grants Commission

2025 Methodology Review

Fiscal equalisation, supporting principles and assessment guidelines consultation paper

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Introduction

1 On 9 February 2023, the Commonwealth Treasurer provided the Commonwealth Grants Commission (the Commission) with terms of reference for the 2025 Methodology Review of GST Revenue Sharing Relativities (2025 Review).

2 As part of the 2025 Review, this discussion paper sets out the Commission's preliminary positions and seeks state comments on the supporting principles and assessment guidelines.

3 As set out in *Commission's position on approach and work program for the 2025 Methodology Review*, the Commission will apply a consistent framework for reviewing the supporting principles and all assessment methods. The starting point will be to consider whether experience with the application of a principle or other developments since the 2020 Review have raised an issue with the suitability of the existing supporting principles or assessment methods, or indicate that those principles or methods can be improved.

4 This discussion paper applies that framework to the supporting principles and assessment guidelines. State submissions are sought on the issues raised in this paper by 19 May 2023. After taking into account state submissions, the Commission will release, by 9 June 2023, a position paper outlining its approach to fiscal equalisation, supporting principles and assessment guidelines.

5 As outlined below, some aspects of the application of the supporting principles will be considered when reviewing specific assessment methods. Given this inter-relationship, the Commission may need to revisit some of the supporting principles following the review of all the assessment methods. Any changes to the Commission's position on the supporting principles will be identified in the draft report to be released in June 2024.

Horizontal Fiscal Equalisation

6 The Commission provides independent advice to the Commonwealth Government on how Goods and Services Tax (GST) revenue should be distributed among the states and territories (states). The distribution of GST revenue is governed by legislation and terms of reference issued by the Commonwealth Treasurer.

7 The terms of reference issued by the Commonwealth Treasurer require the Commission, in making its recommendations, to take into account the *Intergovernmental Agreement on Federal Financial Relations* which provides that GST revenue will be distributed in accordance with the principle of horizontal fiscal equalisation. Prior to changes to GST distribution legislated in 2018, it was usual in methods reviews for the Commission to articulate its understanding of how the concept of horizontal fiscal equalisation was to be interpreted and applied.

8 Changes to the GST distribution arrangements legislated by the Commonwealth Parliament in 2018 include a new equalisation benchmark linked to the fiscally stronger of New South Wales or Victoria, a GST relativity floor, and transitional arrangements to phase in the new benchmark and give states a no-worse off guarantee until 2025-26. Under these changes, the concept of horizontal fiscal equalisation remains relevant to the first step in determining states' GST distributions — calculating states' relative fiscal capacities, or 'assessed relativities.' This first step is necessary to identify the fiscally stronger of New South Wales or Victoria, the benchmark set by the legislation.[1]

9 The Commission's preliminary view is that the approach to horizontal fiscal equalisation articulated in the 2020 Review remains appropriate for the first step in determining GST distributions in keeping with the 2018 legislated changes. In line with the conclusion in the 2020 Review, it is proposed that the assessment of state relative fiscal capacities continue to be determined such that:

> after allowing for material factors affecting revenues and expenditures, each state would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own-sources and operated at the same level of efficiency.

10 As noted by the Commission in previous reviews, the determination of state relative fiscal capacities is not an exact science — it depends on the availability of appropriate data and requires the Commission to undertake estimates, apply judgments, and make trade-offs in its assessments. In making these judgments, the Commission follows the processes outlined in its assessment guidelines and seeks to make its judgments as consistent and understandable as possible.

11 In assessing each state's GST needs in line with horizontal fiscal equalisation, the Commission assesses the amount the state would need to spend to provide all-state average services and infrastructure and the revenue it could raise from its own sources if it made the average effort. The Commission also takes into account payments other than GST that each state receives from the Commonwealth.[2]

12 Recognising the practical aspects of assessing state spending needs and revenue capacities, the Commission's approach to achieving horizontal fiscal equalisation involves minimising, as far as possible, differences in the fiscal capacities of the states to provide services.

[1] Terms of reference ask the Commission to provide the relativities that would have applied had the 2018 legislated arrangements not been enacted. Horizontal fiscal equalisation is also relevant to calculating those 'no worse off' relativities in accordance with Section 5 of the *Federal Financial Relations Act 2009*.

[2] Not all Commonwealth payments are taken into account. Some payments are excluded by the Treasurer's terms of reference ('quarantined payments'). In the case of payments that are not quarantined, the Commission includes those that relate to state-type services for which the Commission assesses states' expenditure needs. The Commission's approach to other Commonwealth payments will be covered in a subsequent paper.

Consultation question

Q1. Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?

Supporting principles

13 In determining the GST distribution among the states, the Commission's core task is to identify influences, referred to as 'drivers', beyond the direct control of states that cause their fiscal capacities to diverge.[3] By assessing these influences, the Commission is able to determine the GST share each state would need to provide the same (average) level of services – that is, each state's relative fiscal capacity as represented by its 'assessed relativity'.[4] The Commission's assessments are based on each state following broadly the same (average) policy in delivering services and in raising revenue. The Commission is not aiming to assess capacity if the 'best' policy was implemented, but rather reflect the average policy across states.

14 To assist its core task, the Commission has developed a set of supporting principles. First adopted in the 2010 Review, the supporting principles were retained in the 2015 and 2020 Reviews with some clarification of their purpose and scope.[5] The 4 supporting principles are: 'what states do', policy neutrality, practicality, and contemporaneity.

15 The supporting principles are guiding considerations for the Commission in designing and evaluating alternative assessment methods. They are subsidiary to the objective of horizontal fiscal equalisation in calculating assessed relativities. Ideally, assessment methods would embody the attributes of all the supporting principles although, as noted, horizontal fiscal equalisation is always the primary consideration. In practice, alternative assessment methods often involve trade-offs between principles. The Commission has not established a relative weighting or hierarchy of the supporting principles. Instead, it uses its judgment in each case to determine the most appropriate measure of states' relative fiscal capacities.

[3] Drivers were known as 'disabilities' in the 2020 Review and earlier reviews.

[4] Assessed relativities are calculated for each assessment year by comparing each state's relative ability to raise revenue with its relative cost of providing services. See Box 1-1 in *GST Revenue Sharing Relativities 2023 Update*].

[5] The supporting principles evolved from the '3 pillars of equalisation' first articulated in the 2004 Review: capacity equalisation, internal standards, and policy neutrality.

‘What states do’

16 This supporting principle implies that Commission methods should, as far as practicable, reflect what states collectively do. The Commission does not make judgments about what states could, or should, do. Instead, the Commission bases its assessments on the average policies of all states.

17 Where states follow different policies, the Commission needs to determine the average policy it uses as a benchmark for its assessments. The Commission takes a ‘weighted average’ approach, where average policy reflects the average of what all states do, recognising that some states may choose not to impose a tax or to provide a service.[6]

18 Under this approach to average policy, if even one state does something (for example, raises a source of revenue or provides a service), it becomes part of what states collectively do. However, a differential assessment[7] will only be made if it has a material effect on the GST distribution.[8] In this way, average policy is not a binary consideration, where states collectively either do, or do not do, an activity; rather, it is a continuum, where:

- the average effective tax rate for a particular tax base reflects the total amount of revenue collected by all states from that tax as a proportion of the total tax base
- the average per capita spending on a service depends on the total amount of money spent on that service, regardless of the states in which that money is spent.[9]

19 The ‘what states do’ principle ensures that the Commission’s assessments reflect the full range of state expenditures and revenues.[10] Assessments should also reflect the material factors beyond an individual state’s control that affect costs of delivering state services and capacity to raise revenues. As the roles, functions, priorities and circumstances of the states change, along with changes in the costs of delivering services or ability to raise revenues, so should the assessment of their fiscal capacities.

[6] Under this approach, each state contributes to the average policy in proportion to its share of the total revenue base or total service population. The approach uses the data on ‘what states do’ to inform the decisions on what assessments are made and how those assessments are made.

[7] A differential assessment is an assessment of states’ costs of providing services or their revenue raising capacity that is not an equal per capita assessment.

[8] Materiality thresholds represent a minimum change to the redistribution from an equal per capita assessment of a revenue or expense before the Commission will recognise a driver. In the 2020 Review, a driver was considered material if it redistributed more than $35 per capita for any state, across all categories.

[9] The effective tax rate on a base is a reflection of the extent to which the tax base is taxed by all states. The average per capita spending depends on the proportion of the population receiving the service. Where a tax is imposed by only one state, for example, a differential assessment will only be material where the revenue raised by that state is sufficiently large and/or the revenue base is sufficiently unevenly distributed.

[10] Differential assessments of those expenditures and revenues are only made where those assessments are material (and are supported by reliable method and data).

20 The Commission aims to capture changes in what states do by updating assessments using the latest available data. However, where what states do changes significantly between reviews in ways that are not captured by existing assessment methods, the Commission may not achieve the best measure of states' relative fiscal capacities. The case for flexibility to change methods in such circumstances will be considered in a future discussion paper.[11]

Consultation question

Q2. Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?

Policy neutrality

21 The policy neutrality supporting principle has 2 related aspects. First, a state's policy choices (in relation to the revenue it raises or the services it provides) should not directly influence its GST share. Second, the Commission's assessments should not create incentives or disincentives for states to choose one policy over another.

22 In most cases, the Commission is able to broadly achieve policy neutral assessments using its weighted average policy approach. Under this approach, a state's policy choice will only affect the assessment to the extent it affects the average revenue or expenditure (that is, it cannot 'directly' influence its GST share).[12]

23 An exception arises where a revenue base is concentrated, for example iron ore production in Western Australia. In this case, the policy of Western Australia has a dominant role in determining average state policy, which can raise issues in the event of a change to a mining royalty rate. This issue will be explored as part of consultation on the mining revenue assessment.

24 Policy neutrality concerns can also arise when states ban mining activity (for example, bans on coal seam gas and uranium production and/or exploration). In this situation, the absence of activity in a state is due to its policy choice rather than to an absence of the tax base. This issue will also be explored as part of consultation on the mining revenue assessment.

25 Another example of policy neutrality concerns is the potential for a state's tax policy changes to cause existing methods to no longer accurately reflect the state's relative fiscal capacity. The Commission's *Occasional Paper No. 2: GST distribution and state tax reform*, stated that, if the reform policies of an individual state were having a material effect on that state's GST share then, under the Commission's policy neutrality supporting principle, the Commission could seek to identify and mitigate

[11] Clause 6 of the 2025 Review Terms of Reference asks the Commission to consider whether there is a case for it to be given flexibility to consider alternative methods where there is a significant unanticipated shock or where major policy reforms are enacted between reviews.

[12] Assessments reflect the average policy of states. That is, assessments are 'policy neutral', not 'policy free'.

such effects. Making an adjustment in such circumstances would ensure the Commission's assessment more accurately capture states' fiscal capacities and avoid GST distribution operating as a possible disincentive to reform. This issue will be examined in the discussion paper on flexibility to change methods between reviews and in consultation on the assessment of stamp duties on conveyances.

Consultation question

Q3. Does the policy neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?

Practicality

26 The practicality supporting principle means that assessments should be based on sound and reliable data and methods, and should be as simple as possible, while also capturing the major influences on state expenses and revenues. This supporting principle assists in meeting the terms of reference requirement that the Commission should 'aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data.'

27 This principle recognises that, while state fiscal capacities are affected by a wide variety of factors, the suitability and acceptability of the recommended GST relativities may not be improved by including factors when sufficient data are not available to measure their effects or when those effects are small. It is supported by the inclusion of materiality and reliability criteria in the assessment guidelines.

28 Another aspect of the practicality supporting principle relates to the need for relativities to be formulated and delivered in a way that is 'fit for purpose' for state budget processes. In the 2020 Review the Commission recognised that, while stability and predictability were not essential to achieving horizontal fiscal equalisation, they were of practical relevance in its choice of methods through their impact on state budget processes.

29 The Commission's preliminary view is that the practicality supporting principle remains relevant to ensuring assessment methods are simple, reliable, and fit for purpose. Possible changes to the existing materiality thresholds are considered under the assessment guidelines section below.

Consultation question

Q4. Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?

Contemporaneity

30 The contemporaneity supporting principle aims to ensure that, to the extent reliable data will allow, the distribution of GST provided to states in a year should reflect state circumstances in that year. A fully contemporaneous approach would equalise state fiscal capacities in the application year. However, robust data is not available until the application year has passed. In the absence of such data, the Commission has based its recommendations on historical data. Since the 2010 Review, the assessment period has been the most recent 3 years for which reliable data are available.

31 The 2020 Review considered a range of alternative approaches, ranging from continuing with historical data while reducing the gap between assessment and application years, to using forecasts of conditions in the application year.[13] The Commission decided not to use forecasts of revenues and expenditures since errors in forecasts have at times been large, particularly for revenue. It concluded that the use of forecasts with large errors would almost certainly require consequent adjustments to GST distributions to compensate for these errors. The Commission's view in the 2020 Review was to continue to use the most recent 3 years for which reliable data are available with each year receiving equal weight. This was considered to provide an appropriate balance between contemporaneity, stability, and predictability.

Implications of 3-year assessment period

32 Because state circumstances can change significantly between assessment years and the application year, data for the assessment years may not reflect circumstances in the application year. This has been the case with volatile commodity prices, as evident with the impact of movements in iron ore prices on Western Australia's assessed relativity.

33 Western Australia's iron ore prices rose significantly for a number of years, peaking in 2013-14, before declining in subsequent years. Under the 3-year lagged assessment period, Western Australia's assessed revenue in each application year during the upturn in iron ore prices was substantially less than its actual revenue. As a result, its GST distribution in the application year exceeded what it would have received if a more contemporaneous assessment period was used. Conversely, the assessed revenues of the other states were larger (although the impact was not as evident as for Western Australia) than they would have been if the assessment period were more contemporaneous, implying smaller GST distributions than otherwise.

[13] For more information on the options considered by the Commission in the 2020 Review see CGC 2017-05-S Staff Research Paper 2020 Review – Options for improving contemporaneity.

34 In the downward phase of the iron ore cycle, the opposite occurred. Western Australia's assessed revenue in each application year was greater than its actual revenue and its assessed GST requirement was less than it would have been under a more contemporaneous assessment process.

35 Fiscal equalisation was broadly achieved over time, with the 'overestimate' of GST needs in the upturn of the price cycle being partly offset by the 'underestimate' in the downward phase. The 3-year moving average assessment period smoothed the fiscal effects of the commodity price boom on relativities and the distribution of GST.

36 Iron ore prices have entered another price cycle, reaching a record price in 2021 and have remained high, although there is considerable uncertainty as to their future course. The 2018 legislated changes to GST distribution and the introduction of a GST relativity floor will insulate Western Australia from the impact of volatility in iron ore prices on its GST distributions while iron ore prices remain relatively high.

37 Since the 2020 Review, the COVID-19 pandemic highlighted potential issues with the 3-year lagged moving average assessment period if the economic impact of the pandemic on some states was significantly more negative than on other states. If some states experienced a large and rapid deterioration in their actual fiscal circumstances relative to other states, the lagged 3-year assessment period would have resulted in a significant gap between their GST distribution in the application year compared with a more contemporaneous assessment of their GST needs. As with the case of a commodity price boom, approximate fiscal equalisation would be achieved over time as the impacted states recovered and their assessed GST needs were higher than their actual requirements.

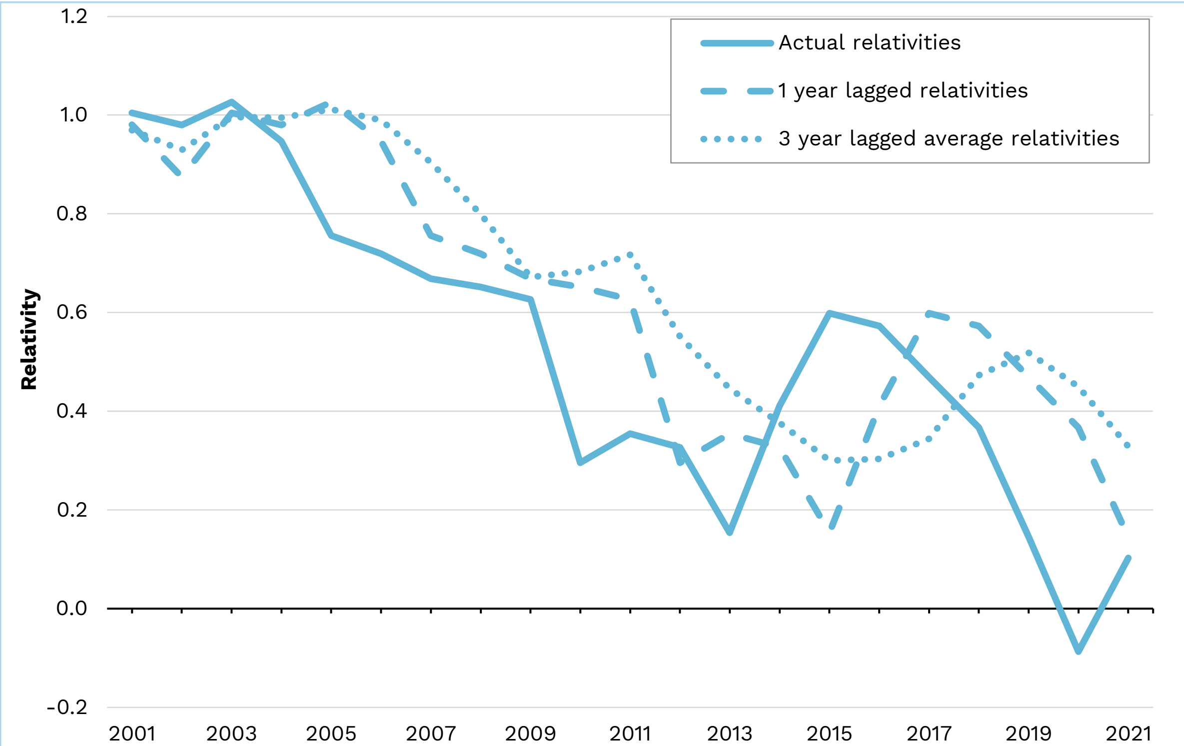
Changing the length of the assessment period

38 In the 2015 Review, Western Australia argued that its rapidly changing circumstances meant that 3-year averaging was no longer appropriate. It argued that only a forecast-based model was appropriate. At that time, the Commission considered the unreliability of forecasts meant that GST advances (based on forecasts) and completions (based on differences between forecasts and reliable results) would result in a more volatile and less contemporaneous result than using historical data.

39 The experience of COVID-19 may, however, warrant re-consideration of how the contemporaneity principle is applied. While the Commission is not inclined to base its recommendations on forecasts for the application year, another option is to shorten the assessment period, to say one or 2 years. While the data would still be lagged, with a shorter assessment period the average age of the data on which the Commission's recommendations are based would be reduced.

40 There is, however, a trade-off between responsiveness (or contemporaneity) and stability (or predictability). This is highlighted in Figure 1, which compares Western Australia's relativities since 2001-02, based on a 3-year assessment period and a one-year assessment period, with its actual experience in the application year. The actual experience for a state in the application year is not known until that year becomes a historical completed year. In 2013-14, the price of iron ore peaked, resulting in a very low GST requirement for Western Australia. However, the distribution of GST in 2013-14 was based on circumstances 2 to 4 years earlier. The circumstances prevailing in 2013-14 only affected the GST allocation 2 to 4 years later.

Figure 1 Western Australia assessed relativities with different assessment period



Note: 'Actual relativities' represent the actual experience for a year and are calculated once the year is completed and data are finalised. They contribute to the lagged average in subsequent years.
1 year lagged relativities differ from the actual relativities due to data revisions.

Source: Commission calculation.

41 Overall, the 3-year assessment period smooths the impact of volatile commodity prices on Western Australia's GST distribution relative to a one-year assessment period. Figure 1 also shows that a lagged relativity based on a single assessment year is not necessarily a better reflection of a state's needs in a year than lagged relativity based on 3-year average data.

42 Using a single year of data can also increase the extent of revisions. For example, Figure 1 shows that a one-year (lagged) relativity for 2015 16 for Western Australia would have been 0.15. However, once final data became available this was revised down to 0.03, reflecting the actual experience in 2013 14.

43 Using 3 years of data may produce a less contemporaneous result when a state is experiencing a long-term trend. That is, if a state's relativity is consistently increasing, a 3-year average will increase the lag and reduce contemporaneity. However, if a state's relativity is volatile, a 3-year average may be a better predictor of application year relativities than a more volatile one-year average.

44 The Commission remains of the view that it should not base its recommendations on forecasts for the application year due to data reliability concerns. It recognises that, in circumstances of significant volatility in commodity prices or an economic shock, its approach of basing its recommendations on data from the 3 most recent completed financial years can result in a sizeable gap between a state's assessed GST needs in the application year and its actual needs. However, fiscal equalisation is still broadly achieved over time. It is not evident that shortening the assessment period will always result in a better assessment of a state's GST needs in an application year compared with an assessment based on a 3-year average.

45 The Commission's preliminary view is that the 3-year lagged moving average continues to provide an appropriate balance between contemporaneity, predictability and smoothing the impact of fiscal shocks.

46 Terms of reference require the relativities for the distribution of GST in 2025-26 to be based on the assessment years 2021-22 to 2023-24 inclusive.

Consultation question

Q5. Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

Preliminary view on the supporting principles

47 The Commission notes that significant experience, expertise and effort have gone into developing, refining and improving the supporting principles since they were introduced in the 2010 Review. In particular, the 2020 Review involved extensive consultation on, and consideration of, the supporting principles.[14]

48 In the 2020 Review, the Commission considered suggestions by some states for additional principles and concluded that this would not be operationally useful. The terms of reference for the 2020 Review also asked the Commission to consider whether there should be a ranking or hierarchy of the principles. The Commission did not support such an approach, noting that the balance of considerations may differ depending on the circumstances of each assessment area and, where possible, assessment methods should have regard to all supporting principles.

[14] Further detail on the Commission's consideration of supporting principles and their implementation in the 2020 Review can be found in Vol 2 Chapters 2 and 3 of the Report on GST Revenue Sharing Relativities, 2020 Review.

49 The Western Australian Treasury has recently proposed an additional supporting principle called 'policy consistency'.[15] The proposal is that this principle would require the Commission to calculate revenue bases and drivers that reflect, as far as practicable, the same policies across states. The Commission's preliminary view is that it does not see merit in introducing such a principle. While there will inevitably be a range of different policies affecting a state's revenue capacity, it is unlikely to be possible to identify, and make reliable adjustments for, such differences. The current approach of calculating for each state tax base (with some adjustment to the base as required and the application of the policy neutrality principle) a weighted average tax rate across all states is considered to be the most practical approach to assessing a state's own-source revenue capacity.

50 Overall, while aspects of the existing supporting principles could benefit from some elaboration, the Commission's preliminary view is that there are no developments that bring into question the appropriateness of the 4 existing supporting principles, nor a need to introduce any new principles.

Consultation question

Q6. Do states agree there is no need to introduce any new principles?

Assessment guidelines

51 Since the 2004 Review, the Commission has used assessment guidelines to support a consistent approach to developing assessment methods and ensure that those methods are conceptually sound, reliable, and as transparent and simple as possible.

52 The guidelines are also a key part of the Commission's quality assurance process. They ensure all relevant steps in the decision-making process are followed and that the process is transparent.

53 Attachment A contains the assessment guidelines used in the 2020 Review. They set out the criteria for a driver of GST needs to be included in the Commission's assessments and for when a discount is to be applied.

54 The Commission's preliminary view is that the 2020 Review assessment guidelines remain appropriate with the exception that materiality thresholds could be increased.

Consultation question

Q7. Do the assessment guidelines, and the Commission's application of those guidelines, remain appropriate?

[15] Western Australian Department of Treasury, Principles of Horizontal Fiscal Equalisation – Western Australia Occasional Paper, March 2023.

Materiality thresholds

55 The Commission has applied materiality thresholds to its assessments since the 2010 Review. Terms of reference for that review asked the Commission to simplify its assessments, including by applying materiality thresholds. Materiality thresholds were incorporated into the assessment guidelines. The Commission increased those thresholds in the 2015 and 2020 Reviews.

56 In the 2020 Review, the Commission used materiality thresholds to handle 2 circumstances.

- A driver was considered material if it redistributed more than $35 per capita for any state, across all categories. Under the Commission's assessment guidelines, when that threshold was reached, the driver was included. It was included in all assessments where there was a conceptual case for its inclusion and reliable and robust data, regardless of its materiality in individual assessments.
- Data were adjusted where necessary to improve interstate comparability, but only if the adjustment redistributed more than $10 per capita for any state.[16]

57 The Commission mainly uses materiality thresholds during a review when it is designing new assessment methods. However, the assessment guidelines, including materiality thresholds, also apply where methods are changed in annual updates.[17]

58 The Commission aims to apply its assessment guidelines in a consistent and considered manner. In line with that approach, materiality thresholds are not applied mechanistically. For example, where volatility means an assessment moves above and below the threshold in different years, the Commission exercises its judgment on the most appropriate outcome.

Increasing the materiality thresholds

59 When the materiality thresholds were first introduced in the 2010 Review, they were $10 per capita for assessment of a driver and $3 per capita for data adjustments.[18] The Commission's intention was to periodically increase the thresholds to ensure simplification gains were not eroded over time.

[16] Since the 2020 Review, the Commission has based its materiality tests on the redistribution from an EPC assessment of revenue or expenditure, averaged over 3 assessment years. This was a departure from the previous practice of expressing materiality thresholds in terms of the effect on the GST distribution. It recognised that the GST distribution is no longer solely based on assessed fiscal capacities.

[17] In a few cases, assessment methods specify that the materiality of assessments (or parts of assessments) be tested in updates. For example, the existing mining revenue assessment involves testing the materiality of individual minerals in each update, to determine whether minerals should be separated from, or collapsed into, the residual 'other minerals' group.

[18] In the 2010 Review, there were 2 additional thresholds. A category size threshold and a category redistribution threshold. These were discontinued in the 2015 Review.

60 In the 2015 Review, the Commission increased the driver assessment thresholds to $30 per capita and the data adjustment threshold to $10 per capita (Table 1). These increases, in part, reflected the Commission's consideration of the recommendation of the *GST Distribution Review* that the Commission pursue further simplification by substantially lifting the materiality thresholds.

61 In the 2020 Review, the driver assessment threshold was increased to $35 per capita such that it retained its value after adjusting for price and wages increases, as measured by the State and Local Government Final Consumption Expenditure[19] deflator. The data adjustment threshold was unchanged at $10 per capita.

Table 1 Size of materiality thresholds

Threshold	2010 Review	2015 Review	2020 Review
	$pc	$pc	$pc
Driver assessment	10	30	35
Data adjustment	3	10	10

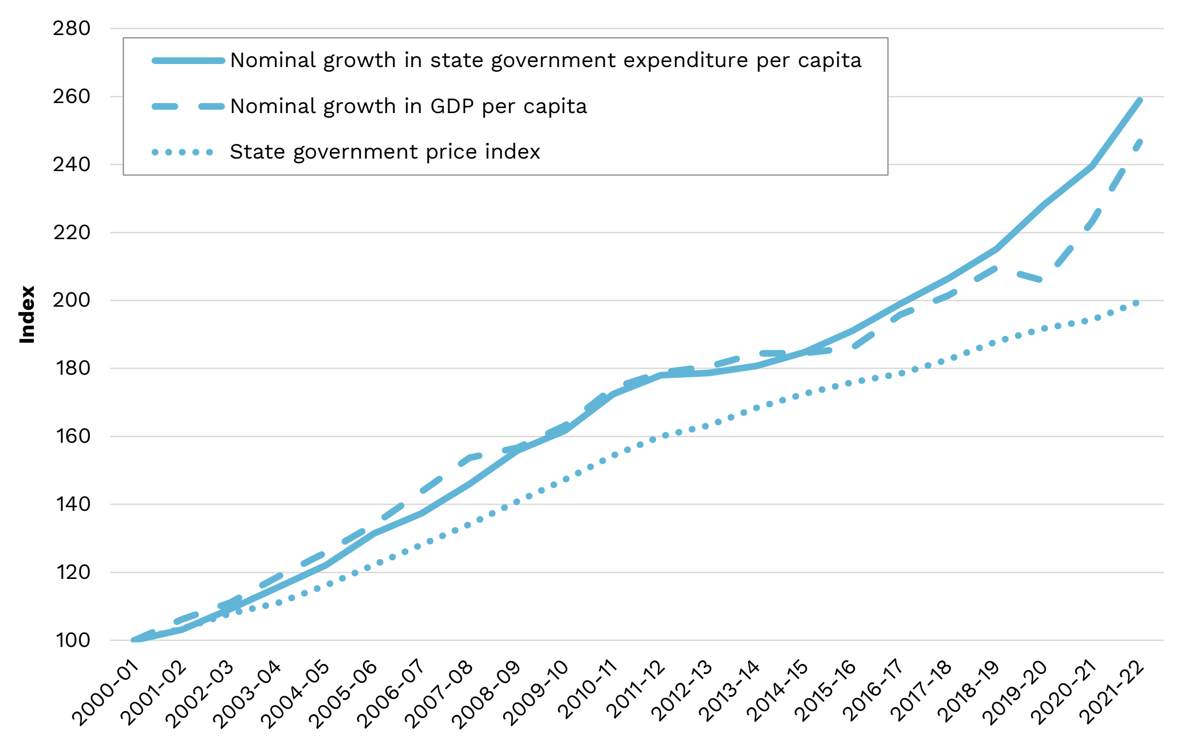
62 An issue for the 2025 Review is whether materiality thresholds should again be increased. Given the thresholds are expressed in nominal dollars, increasing them to maintain their real value would mean the simplification gains from past reviews are not eroded. The Commission has considered 2 options for increasing the thresholds.

- Increase materiality thresholds broadly in line with the increase in the State and Local Government Final Consumption Expenditure chain price index, as in the 2020 Review. This index is a good measure of inflation of the basket of goods and services states consume, and the Commission uses it to index the administrative scale, national capital, and cross-border assessments.
- Increase materiality thresholds broadly in line with the increase in the state expenditure per capita (Figure 2). This would ensure that increasing standards of state services do not lead to increased complexity in the Commission's assessment methods.[20]

[19] Australian National Accounts: National Income, Expenditure and Product, Cat No 5206.0, Table 4 Expenditure on Gross Domestic Product, Chain Price Indexes.

[20] For example, real per capita size of State government spending has grown 30% since 2000-01. Similar growth in future years would mean that, without any change to state demographics or priorities, the per capita effect of each driver would also increase 30%. In the absence of an equivalent increase to materiality thresholds, drivers that were immaterial could become material.

Figure 2 Growth in state government expenditure, GDP and the state government price index



Source: Commission calculation based on ABS data.

63 Table 2 compares the options for increasing materiality thresholds.

- Increasing the driver assessment threshold for growth over the 5 years to 2020-21 suggests a new threshold of $40 per capita (state price index) or $45 per capita (state spending per capita).
- Increasing the data adjustment threshold for growth over the 10 years[21] to 2021-22 (under both options) suggests a new threshold of $15 per capita.

Table 2 Options for increasing materiality thresholds

	Driver assessment threshold		Data adjustment threshold	
Indexation	5-year growth	Indexed size	10-year growth	Indexed size
	%	$pc	%	$pc
No increase	0.0	35.0	0.0	10.0
State spending per capita	29.6	45.4	44.4	14.4
State price index	11.9	39.2	24.7	12.5

Source: Commission calculation based on ABS data.

[21] While the driver assessment threshold was increased in the 2020 Review, the data adjustment threshold has not been increased since the 2015 Review.

64 The materiality thresholds aim to ensure only the main influences on state fiscal capacities are recognised and the assessments remain as simple as possible. Increasing the thresholds broadly in line with growth in states spending per capita would ensure that increases in standards of state services (as opposed to only increases in the prices faced by states) do not erode the value of the thresholds. The Commission's preliminary view is that the thresholds should be increased to $45 per capita (for assessment of a driver) and $15 per capita (for a data adjustment).

Consultation question

Q8. Should the materiality thresholds be increased broadly in line with state spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

Discounting assessments

65 For some assessments, the Commission accepts the conceptual case for including a driver, but it has concerns with the data or the assessment method with which to measure that driver. In these cases, the Commission can decide whether to use the data or method with a discount, or to not assess the driver. The 2020 Review assessment guidelines provided guidance on the circumstances in which discounting should be used and the levels of discount the Commission could apply (Attachment A).

66 The Commission currently has 4 levels of discount — low (12.5%), medium (25%), high (50%) and no assessment (100%). The level of discount applied depends on the Commission's judgment about the reliability of the data or method.

67 Concerns about the reliability of data can arise when those data are incomplete, dated, unreliable, not fully fit for purpose, or a combination of all of these factors. Where the Commission uses proxies, it may choose to apply a discount due to concerns about the suitability of those proxies. For example, the Commission applies the low-level discount to its wage costs assessment partly due to concerns about how well private sector wages proxy wage pressures in the public sector.[22]

68 In some cases, the Commission addresses data concerns by adopting a blended assessment. Blending is used where the Commission has concerns about available data but considers discounting towards an equal per capita assessment does not provide the best measure of fiscal capacities. For example, in the urban transport assessment, the Commission decided to blend modelled urban transport expenses with urban population shares rather than discounting towards an equal per capita assessment, since urban population was the relevant service population.

[22] The wage costs discount also reflects concerns about how accurately the ABS Characteristics of Employment data measure wage costs and how well the econometric model controls for differences in productivity.

69 There are instances where the Commission does not consider discounting to be appropriate. The Commission has not used discounts to address policy neutrality concerns or general uncertainty. Where a conceptual case for an assessment exists but there are some concerns with the data or method (or how well they measure the relevant drivers), a discounted assessment often results in a better measure of fiscal capacities than not making an assessment. This is not the case where an assessment method broadly captures fiscal capacities but involves policy neutrality concerns or general uncertainty. In the latter cases, applying a discount is likely to lead to an inferior assessment of fiscal capacities. There is an element of uncertainty with all assessment methods given that it is not an exact science. But it is not evident that such general uncertainty materially affects the assessment of state fiscal capacities. For example, while conceptually differences in tax rates or state development policies may affect observed revenue bases, discounting the revenue assessments for those policy differences would not necessarily result in better measures of revenue raising capacities. A discount for differences in development policies would assume that in all cases, states with above average revenue raising capacity are in this position because of greater, or more effective, historical state development policies.

70 The Commission does not discount as a means of more actively encouraging efficiency. The Commission equalises states to the average cost of service delivery that incorporates the average level of technical efficiency. If a state is more efficient than average, its own budget benefits. If it is less efficient than average, it must finance this above average inefficiency itself.

71 The Commission does not discount judgment-based estimates, because in making that judgment the Commission has already incorporated all relevant information and weighted it according to its reliability.

72 The Commission will consider the consistency of its use of discounting towards the end of the review.

73 The Commission's preliminary position is to retain the 2020 Review discounting framework as it considers this allows it to better capture states' fiscal capacities while recognising the limitations of the data and methods in some circumstances. It welcomes state views on the circumstances in which discounting should be used and the levels of discount. The case for discounting particular assessments will be considered as part of consultation on those assessments.

Consultation question

Q9. Does the 2020 Review approach to discounting remain appropriate?

Consultation

74 The Commission welcomes state views on the consultation questions identified in this paper (outlined below). State views should be compiled in accordance with the 2025 Review framework. States are welcome to raise other relevant issues with the Commission.

Q1. Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?

Q2. Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?

Q3. Does the policy neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?

Q4. Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?

Q5. Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

Q6. Do states agree there is no need to introduce any new principles?

Q7. Do the assessment guidelines, and the Commission's application of those guidelines, remain appropriate?

Q8. Should the materiality thresholds be increased broadly in line with state spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

Q9. Does the 2020 Review approach to discounting remain appropriate?

Attachment A: Assessment guidelines for the 2020 Review

1 The Commission organises its work by making assessments for individual categories. Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand if undertaken in a separate category. The Commission will include a driver[23] in a category when:

- a case for the driver is established, namely:
  - a sound conceptual basis for these differences exists
  - there is sufficient empirical evidence that material differences exist between states in the levels of use or unit costs, or both, in providing services or in their capacities to raise revenues
- a reliable method has been devised that is:
  - conceptually rigorous (for example, it measures what is intended to be measured, is based on internal standards and is policy neutral)
  - implementable (the driver can be measured satisfactorily)
  - where used, consistent with external review outcomes
- data are available that are:
  - fit for purpose — they capture the influence the Commission is trying to measure and provide a valid measure of State circumstances
  - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the states and over time and are not subject to large revisions.

2 The Commission will adjust data where necessary to improve interstate comparability. However, the Commission will only make data adjustments if they redistribute more than $10 per capita for any state in the assessment period.

3 The Commission will include a driver in its final assessments if:

- it redistributes more than $35 per capita for any state in the assessment period (the materiality test will be applied to the total effect the driver has on the redistribution from an EPC assessment of revenue or expenditure, averaged over the 3 assessment years)

[23] Drivers were known as 'disabilities' in the 2020 Review and earlier reviews.

- removing the driver has a significant effect on the conceptual rigour and reliability of assessments.

4 Where a case for assessing a driver in a category is established, but the Commission has concerns with the underlying data or assessment method, a uniform set of discounts will be used — low (12.5%), medium (25%), high (50%) or no assessment (100%). The Commission will use higher discounts when the Commission has greater concerns with the underlying data or assessment method.