Australian Government
Commonwealth Grants Commission

2025 Methodology Review

Commission's position on fiscal equalisation, supporting principles and assessment guidelines

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Summary of Commission positions

Following consultation with states and territories (states) the Commission has decided its position on fiscal equalisation, supporting principles and assessment guidelines for the 2025 Review. Given the interaction between some of the principles and the review of assessment methods, the Commission may need to revisit its position on the supporting principles during the review. Any changes to its position will be raised with the states and identified in the draft report in June 2024.

Horizontal fiscal equalisation

- 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. This is in line with state views.
- While all states supported the Commission's position, several states said that horizontal fiscal equalisation is not achieved in practice, with reasons ranging from the impact of the 2018 legislated changes, to the aspirational nature of the goal given practical limitations. Some states queried the overall effectiveness of horizontal fiscal equalisation, particularly its impact on the incentive to undertake efficiency enhancing reforms.
- The Commission acknowledges that horizontal fiscal equalisation 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. The Commission seeks to make its recommendations for the distribution of GST revenue as consistent, transparent and understandable as possible. In making decisions, the Commission will engage with states and consider their views.

Supporting principles

- There are no developments that bring into question the appropriateness of the 4 existing supporting principles, nor is there a need to introduce any new principles.
- This position was not supported by all states. Western Australia proposed introducing 2 new principles, 'policy consistency' and 'conservatism'. These were not supported by other states.
- While all states support retaining the existing 4 supporting principles, several states said there was a need to more clearly define these principles and emphasise that the primary objective is horizontal fiscal equalisation. The Commission agrees with this view. This paper presents further guidance on several aspects of the existing supporting principles.

'What states do'

- The 'what states do' principle, based on the weighted average policy of all states, remains appropriate.
- While all states supported this approach, several noted the difficulty of determining an average policy when an assessment was dominated by one state (such as in the case of mining) and when what states do is changing (for example, through tax reform and efforts to address structural disadvantage).

- The Commission recognises the issues raised in determining average policy when one state dominates revenue raising capacity and this is considered in the consultation paper on mining. The impact on GST distribution arrangements from tax reform is considered in the consultation paper on stamp duty on conveyances and as part of the consultation on the case for flexibility to change methods between reviews.

Policy neutrality

- The policy neutrality principle remains appropriate.
- While all states supported the policy neutrality principle as being appropriate, some said it was problematic. While one state said it was not achieved in practice, other states emphasised it was a supporting principle and the primary objective was horizontal fiscal equalisation.
- The Commission recognises that in a small number of cases it will need to use its judgment where a supporting principle may conflict with the primary objective of fiscal equalisation. This includes cases where a revenue base is concentrated in one state, and this is considered in the consultation paper on mining. The Commission will work with states to ensure its methods are not an impediment to state tax reform, and this is covered in the consultation on the case for flexibility to change methods between reviews.

Practicality

- The practicality principle remains relevant to ensuring assessment methods are simple, reliable, and fit for purpose. All states supported this view.
- Several states said simplicity, transparency and quality assurance were central to trust in, and understanding of, horizontal fiscal equalisation. They called for a greater focus on each of these.
- The Commission endorses many of the points raised by the states, particularly the importance of the consistent application of this principle across all assessments and the role of transparency. The Commission will consult states on a revised Quality Assurance Strategic Plan for the period 2025-2030.

Contemporaneity

- The contemporaneity principle remains appropriate. The 3-year lagged assessment period continues to provide balance between contemporaneity, predictability and stability.
- Most states supported this position. Western Australia said estimates of the year in progress could be used to reduce the data lag from 2 years to one and that this method could be used for volatile assessments. The ACT suggested that the use of forecast data in one of the assessment years could be examined.
- The Commission does not support the use of forecast or estimated data. It acknowledges that replacing historical data with forecasts could make assessments more contemporaneous, but would also likely reduce the reliability of the results. Should forecasts be unreliable there would be a need for an ex-post adjustment to the GST distribution to address inaccuracies. This would increase uncertainty.

Assessment guidelines

- The 2020 Review assessment guidelines remain appropriate, with the exception that materiality thresholds will be increased.

Materiality thresholds

- Following state feedback, the materiality thresholds will be increased to $40 per capita (for the assessment of a driver) and $12 per capita (for a data adjustment). This increase is broadly in line with the State and Local Government Final Consumption Expenditure chain price index. Most states supported this position. The Northern Territory did not. It does not support the use of materiality thresholds or discounts in-principle because they undermine horizontal fiscal equalisation.

Discounting assessments

- Discounting remains relevant and allows the Commission to capture states' fiscal capacities while recognising the limitations of data and methods in some circumstances. The 2020 Review discount levels will be retained.
- While most states supported discounting, several said that discounting involves judgment and can be seen as arbitrary. Western Australia supported expanding the use of discounting to address general uncertainty and policy neutrality.
- The Commission will explain the reason for any discount and ensure consistency of approach across assessments. During the review, the Commission will examine the rationale and level of discounts applied in its assessments. It will include this information in both the draft and final reports of the 2025 Review.

Introduction

1 On 21 April 2023, the Commission released a 2025 Review consultation paper outlining its preliminary views, and seeking state comments, on fiscal equalisation, supporting principles and assessment guidelines. Submissions were received from all states and are available on the Commission's website.

2 The Commission has carefully considered all state views. This paper presents the Commission's positions on the issues raised in the consultation paper and the other issues raised by states. These positions will provide guidance for the Commission's further work on reviewing assessment methods.

3 Some aspects of the application of the supporting principles will be considered when reviewing specific assessment methods. In addition, as a number of states have noted, some aspects raised in considering the supporting principles will be addressed in considering the case for flexibility to change methods between reviews in response to major shocks or reform initiatives. As such, 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 raised with the states and identified in the draft report to be released in June 2024.

Horizontal fiscal equalisation

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

5 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. This agreement 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 method reviews for the Commission to articulate its understanding of how the concept of horizontal fiscal equalisation was to be interpreted and applied.

6 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 2026-27. 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, which is the benchmark set by the legislation.

7 The Commission's preliminary view was that the approach to horizontal fiscal equalisation articulated in the 2020 Review remained appropriate for the first step in determining GST distributions, in keeping with the 2018 legislated changes.[1] In line

[1] Terms of reference ask the Commission to provide the relativities that would have applied if the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of the GST) Act 2018* had 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*.

with the conclusion in the 2020 Review, it 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.'

8 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]

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

State views

10 All states supported the Commission's preliminary view that the approach to horizontal fiscal equalisation articulated in the 2020 Review is the appropriate first step in determining GST distribution in accordance with the 2018 legislated arrangements.

11 New South Wales acknowledged that while the articulation of horizontal fiscal equalisation was the appropriate first step, it was inconsistent with the 2018 legislated arrangements. It said the Commission should reformulate its approach to be consistent with the 2018 legislated arrangements. It did not indicate how it should be reformulated. Victoria said that while horizontal fiscal equalisation should be the primary objective of the GST system, it would like to see a reweighting towards the supporting principles. Queensland supported the objective of horizontal fiscal equalisation, but considered horizontal fiscal equalisation was no longer achievable under the 2018 legislated arrangements. It noted that assessed relativities continue to play an important role under the legislated arrangements. Western Australia supported the existing horizontal fiscal equalisation objective, while noting it was only ever aspirational because it was not possible to calculate true horizontal fiscal equalisation.

12 South Australia said it supported GST revenue being distributed on the basis of a methodology that seeks to achieve full horizontal fiscal equalisation. It said the 2018 legislated arrangements move the distribution away from full equalisation. Tasmania supported full equalisation and said a permanent extension to the no-worse-off guarantee is needed.

13 The Northern Territory supported the 2020 Review definition of horizontal fiscal equalisation but sought recognition of the limitations in its application. It said equalisation, as currently implemented, gives states the fiscal capacity to deliver state-average services, but does not provide additional capacity to address persistent pre-existing structural disadvantage. While the Northern Territory did not seek to change the horizontal fiscal equalisation objective to provide that additional capacity, it said it was important that equalisation did not prevent additional investment, or offset funding aimed at addressing pre-existing structural

[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.

disadvantage. It sought consideration of changes to the Commission's framework for the treatment of Commonwealth payments to ensure the GST distribution does not impede the objectives of such funding.

Commission position

14 The Commission's view is to retain the approach to horizontal fiscal equalisation articulated in the 2020 Review as the first step in determining GST distributions in accordance with the 2018 legislated changes. This is in line with state views.

15 The Commission considers that its assessment methods should continue to accurately capture states' relative fiscal capacities to ensure it can produce relativities consistent with the equalisation benchmark linked to the fiscally stronger of New South Wales or Victoria, as well as providing the 'no worse off' relativities.[3]

16 The Commission has consistently stated that equalisation 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 will continue to follow the processes outlined in its assessment guidelines and will seek to make its judgments as consistent, transparent and understandable as possible. The Commission's approach to implementing fiscal equalisation involves minimising, as far as possible, differences in the fiscal capacities of states to provide services.

17 While the Northern Territory does not seek to amend the definition of horizontal fiscal equalisation, it is seeking to clarify the treatment of Commonwealth payments provided to a state to address pre-existing structural disadvantage. The Commission's consideration of the appropriateness of the framework for the treatment of Commonwealth payments, including payments intended to address pre-existing structural disadvantage, will be addressed in consultation with states in the Commonwealth payments assessment.

Supporting principles

18 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 relative fiscal capacities to diverge. By assessing these influences, the Commission seeks to estimate the GST share each state requires 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 were implemented, but rather reflect the average policy across states.

19 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.

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[3] Terms of reference ask the Commission to provide relativities that would have applied had the 2018 legislated arrangements not been enacted. These are known as the 'no worse off' relativities.

[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.

20 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. 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 supporting principles. Instead, it uses its judgment in each case to determine the most appropriate measure of states' relative fiscal capacities.

State views

21 While recognising that trade-offs between principles are often necessary, some states asked the Commission to provide greater clarity and consistency on how it weighed the horizontal fiscal equalisation objective and supporting principles in reaching its decisions on assessments, particularly where its decisions involved trade-offs between supporting principles.

'What states do'

22 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.

23 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 provide a service.[6]

24 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.

25 The 'what states do' principle ensures that Commission assessments reflect the full range of state expenditures and revenues.[9] Assessments should also reflect the material factors beyond an individual state's control that affect its costs of

[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 the minimum change from an equal per capita assessment of a revenue or expense that must occur for the Commission to recognise a driver. Materiality thresholds for the 2025 Review are considered in the section on Assessment Guidelines.

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

delivering state services and capacity to raise revenues. As the roles, functions, priorities and circumstances of states change, along with changes in the costs of delivering services or ability to raise revenues, so should the assessment of their relative fiscal capacities.

26 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 consultation paper.[10]

27 The Commission sought state views on whether the 'what states do' principle, with assessments based on the weighted average policy of all states, remained appropriate.

State views

28 All states supported the 'what states do' principle, with assessments being based on the weighted average policy of all states. However, many recognised the difficulty of determining an average policy when an assessment was dominated by one state. Some states also asked the Commission to provide greater clarity and consistency on how it weighed the primary objective of horizontal fiscal equalisation and supporting principles in reaching its decisions on assessments that involved a trade-off between supporting principles.

29 New South Wales broadly supported the 'what states do' principle and the weighted average policy approach. However, it said in some cases using the weighted average as a proxy for the average policy of states could be unrealistic and problematic. This was especially the case for revenues because the average approach was not representative of the average tax policy because it failed to account for the elasticity impacts a state would face if it levied the average tax rate. The extent to which this was a material problem depended on the specific revenue stream, as elasticities varied markedly across taxes. In the case of major tax reform, the failure to take account of elasticities could punish a state that deviated from average state policies. This could disincentivise reforms aimed at improving economic growth and productivity or improving the efficient delivery of government services.

30 Victoria supported the Commission making assessments based on 'what states do' and using the average weighted policy approach. Victoria was concerned there may be efficiency effects related to the 'what states do' principle. The current approach could have significant effects for some tax policy reforms, penalising states for undertaking the reform and may act as a disincentive to tax reform. However, in cases of significant reforms or economic shocks, Victoria supported providing the Commission with the flexibility to change its methods between reviews to better reflect what states do.

31 Queensland said that while the weighted average policy approach was appropriate for most assessments, there were exceptions. Approaches other than weighted average policy should be considered in cases where there are significant differences in policies or revenue bases between states. Western Australia said that the horizontal fiscal equalisation objective required an assessment of 'same' policies by the states, not 'average' policies. Nevertheless, it supported the use of 'what states do' as the general approach but noted that the concept of average state policy was problematic when one state dominated expenditure or revenue raising. In these

[10] 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.

circumstances, Western Australia said the Commission had flexibility in how it specified average policy – broadly or narrowly, based on the legal incidence or economic incidence of taxes.

32 South Australia said the principle was necessary to ensure all functions of state governments were considered and that changes over time in the scope of revenues and expenditure were reflected in Commission assessments. The weighted average policy approach also ensured assessments were based on the average of what states actually do, rather than judgments on what states could or should do. It acknowledged there could be challenges in a few isolated cases where the weighted average was dominated by a large state, but concluded there was no obviously superior approach. It said the Commission should not attempt to assess what states should do.

33 Tasmania supported the current approach of basing assessments on the average policies of all states. It believed this approach ensured the full range of state expenditures and revenues were captured in assessments. It said determining the average policy relied on the judgment of the Commission, particularly in cases where a tax was not imposed or a service was not delivered by all states.

34 The ACT said the 'what states do' principle was critical to the functioning of the equalisation system. It also considered the weighted average policy as generally the best available method for ensuring assessments comply with this principle. It noted there may be compromises in cases of a dominant state, but these cases should be considered on an assessment-by-assessment basis, rather than changing the existing approach.

35 The Northern Territory considered the average approach as the appropriate starting point for most assessments. However, assessments based on the weighted average policy are not always able to assess aspects of pre-existing structural disadvantage in a non-standard state. It said the Commission should consider improvements to how averages are measured.

Commission position

36 The Commission's position is that the 'what states do' principle remains appropriate. This is broadly supported by the states. The Commission will continue to base its assessments on the weighted average policy of all states. This approach avoids the need for judgments about what states could, or should, do. The Commission also endorses the importance of clarity and transparency where its decisions and recommendations involve trade-offs between the supporting principles and the objective of fiscal equalisation.

37 In applying the 'what states do' supporting principle:

- assessments reflect the average range of services provided collectively by states and the average range of revenues raised
- the level of services and associated infrastructure states are funded to provide, and the revenue raising efforts they are presumed to make, are an average of those actually provided or made
- the range of drivers reflects the material factors beyond a state's control affecting service delivery costs and revenue raising capacities.

38 New South Wales and Victoria's concerns that the GST distribution arrangements can be a disincentive for some tax reforms is covered in the consultation paper on stamp duty on conveyances. It will also be part of the consultations with the states

on the case for flexibility to change methods between reviews, including where major policy reforms are enacted between reviews.[11]

39 The issue of determining the average policy when one state dominates expenditure or revenue raising is covered in the consultation paper on mining.

40 The Northern Territory's views on pre-existing structural disadvantage were discussed in the previous section and will be addressed in consultation with states on the Commonwealth payments assessment. The Commission will seek further information from the Northern Territory on the improvements it thinks should be made to the measurement of averages.

41 Issues around the possible trade-offs between the 'what states do' and policy neutrality principles are discussed in the next section.

Policy neutrality

42 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.

43 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).

44 An exception arises where a revenue base is concentrated in one state, 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 if the dominant state changes its royalty rate. This issue will be explored as part of consultation on the mining revenue assessment.

45 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.

46 Another concern around the policy neutrality principle 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 such effects. Making an adjustment in such circumstances would ensure the Commission's assessments 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.

47 The Commission sought state views on whether the policy neutrality principle remained appropriate, recognising that 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.

[11] Steinhauser, R., Sinning, M. and Sobeck, K. 2018, *State tax elasticities of revenue bases*.

State views

48 All states supported the policy neutrality supporting principle as being appropriate.

49 Western Australia believed policy neutrality was not being achieved. It said there were 2 main ways policy neutrality could be contravened, which would result in a state being able to influence an assessment. The first was when a state dominated a revenue source or expense function and so had a disproportionate influence on the average. Western Australia said this issue was best addressed through global revenue assessments. The second situation was where a state could influence its revenue base or service population, which Western Australia said happened when the Commission used observed revenue bases. Averaging state policies in this situation would mean the assessment would no longer reflect the same effort, contravening the equalisation principle. It said these situations warranted an additional principle (policy consistency).

50 New South Wales said achieving policy neutrality can be problematic because there was an unavoidable tension between policy neutrality and 'what states do'. In particular, there were instances where a state's policy choices will result in it losing significant GST revenue. These effects were pronounced where a state dominated a tax base or sought to make efficiency generating tax reforms. New South Wales said it will explore these issues in a future paper.

51 Victoria and the Northern Territory generally supported the principle of policy neutrality but emphasised it was a supporting principle, and horizontal fiscal equalisation was the primary objective. Both states acknowledged that achieving policy neutrality may not always be possible and recommended that the issue be addressed on a case-by-case basis.

52 Queensland said policy neutrality remained an important supporting principle across all assessments, with increased significance in certain situations, such as the mining assessment. In these situations, Queensland suggested that greater consideration be given to alternative approaches to achieving policy neutrality. South Australia said the policy neutrality principle should be retained, although it noted there were concerns with its application when some states raise or account for significantly more revenue or expenditure than their population share. However, South Australia said there was no evidence that the current approach to horizontal fiscal equalisation distorted government decision making.

53 Tasmania agreed that further consideration should be given to policy neutrality in circumstances such as dominant state issues and some instances of tax reform. However, any adjustments should not detract from the achievement of horizontal fiscal equalisation or add an additional layer of complexity. Any adjustments should be considered in the full context of the 2018 legislated arrangements.

54 The ACT said the current policy neutrality approach to revenue assessments did not capture second order effects of tax reforms. It noted that as the Commission used weighted average state effective tax rates in its revenue assessments, any policy induced variations from this average could imply variations in the size of underlying tax bases. These effects will likely vary between different tax bases and could be a disincentive for tax reforms, particularly if the reform shifts tax from a relatively elastic to inelastic tax base. These effects could also be experienced in expenditure policy. The ACT said tax elasticity adjustments would be a practical method to address these issues and suggested the Commission reconsider its consultancy on tax reform and elasticity.

Commission position

55 The Commission's position is that the policy neutrality principle remains appropriate. It is a supporting principle and horizontal fiscal equalisation remains the primary objective. This is broadly supported by all states.

56 The Commission recognises that in a small number of cases it will need to use its judgment where supporting principles are in conflict. For example, there may be cases where it needs to balance the trade-off between 'what states do' and policy neutrality. This includes cases where a revenue base is concentrated in one state, as is the case with iron ore, and where states adopt very different policies, for example where certain mining activities are banned in some states. The Commission will consult on possible approaches to address these issues in its consultations on the mining assessment and on other assessments, if the need to balance trade-offs between supporting principles arises.

57 Regarding the application of policy neutrality, the Commission has consistently stated that it will work with states to ensure its methods are not an impediment to state tax reform. The Commission will consult the states on how to deal with significant tax reforms, including as part of consultations on the case for flexibility to change methods between reviews.

58 The Commission does not agree that the use of observed tax bases means some states are more able to influence revenue assessments than others. The Commission uses observed tax bases because such bases accurately reflect differences in the level of taxable activity between states. However, where the Commission concludes the observed tax bases for a particular revenue are too policy influenced, it does not use them.

Practicality

59 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'.

60 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.

61 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.

62 The Commission's preliminary view was that the practicality supporting principle remained relevant to ensuring assessment methods are simple, reliable and fit for purpose.

State views

63 All states support the practicality principle.

64 New South Wales said it is important that the Commission's methods be simple and reliable as this supports transparency of the system.

65 Given the complexity of the Commission's assessments, Victoria suggested that simplicity be elevated and considered more prominently across all assessments. It also suggested that the Commission be clearer in communicating the uncertainties and judgments involved in its assessments. Queensland also said further clarity was needed on how this principle was applied across assessments and recommended a continued focus on quality assurance as part of the 2025 Review.

66 Western Australia noted there was much judgment in the application of the practicality principle. It said transparency and quality assurance could be improved by sharing all the data underlying methods with states.

67 South Australia said the practicality principle recognised that there are trade-offs between simplicity, data reliability and fitness for purpose and the Commission should consult with states when facing data issues.

68 Tasmania supported the practicality principle but suggested measures to improve the practicality of assessments be balanced against the higher order objective of achieving horizontal fiscal equalisation. The ACT agreed that the horizontal fiscal equalisation objective remained the primary consideration and that methods should only be simplified if that simplification does not detract from accurately measuring state fiscal capacities.

69 The Northern Territory said the Commission should only use the 'fit for purpose' test for genuine data issues and suggested that the application of this principle must remain flexible and allow case-by-case responses to a variety of data issues.

Commission position

70 The Commission's position is that the practicality supporting principle remains appropriate for ensuring assessments use sound and reliable data and methods. It also remains appropriate for ensuring assessments are as simple as possible while also reflecting the major influences on state expenses and revenues. This supporting principle is consistent with terms of reference that ask the Commission to deliver quality assured relativities based on assessments that are simple, robust, fit for purpose, reliable and make the best use of available data.

71 The Commission endorses many of the points raised by the states, particularly the importance of the consistent application of the principle across all assessments and the role of transparency. The Commission recognises that the outcome of its assessments is an approximation of horizontal fiscal equalisation. It also recognises that the danger of false precision needs to be avoided. Nevertheless, the objective of calculating assessed relativities is to minimise, as far as possible, differences in the fiscal capacities of the states to deliver services. The Commission will continue to share with the states, where possible, the data underlying its assessments.

72 Quality assurance is an important component of the practicality principle. The Commission will consult states on a revised Quality Assurance Strategic Plan for the period 2025–2030.

Contemporaneity

73 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 are 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.

74 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.[12] 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.

75 The Commission's preliminary view was that the 3-year lagged moving average continues to provide an appropriate balance between contemporaneity, predictability and smoothing the impact of fiscal shocks. In the consultation paper, the Commission sought state views on whether the length of the assessment period should be changed.

State views

76 All states broadly supported the current method of contemporaneity, noting that the 3-year lagged average approach will achieve equalisation over time. There were differing views on the use of forecasts or estimates for one of the assessment years.

77 New South Wales said the current approach strikes an appropriate balance between contemporaneity and budget stability and predictability. It did not support the introduction of projections or forecasts to reduce the lag. New South Wales noted that the experience of the COVID-19 pandemic raised issues with the contemporaneity principle, but it considered this to be an extreme outlier event and does not support changing the principle in response. It noted that this was an issue that could be covered in the consideration of the case for flexibility to change methods in response to major events.

78 Queensland said the 3-year lagged approach was an appropriate balance between capturing recent trends and reducing the volatility from using a single year. It did not support changes to reduce the assessment period. It opposed the use of forecasts as they would introduce errors into assessments and lead to inaccurate GST distributions.

79 Western Australia noted that while the principle described fully contemporaneous assessments, the Commission used the criteria of predictability and stability to effectively support equalisation over time. It said the use of a lagged 3-year averaging was appropriate if the Commission was seeking equalisation over time. It asked whether forecasts (with ex-post adjustments) could provide more reliable

[12] 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.

results than historical data. It said estimates of the year in progress could be used to reduce the data lag from 2 years to one and that this method could be used for volatile assessments, such as commodities in mining. Western Australia provided calculations to the Commission and other states on how this method would work.

80 The ACT broadly supported the 3-year lagged average approach but suggested that the use of forecast data in one of the assessment years could be examined. Referencing an earlier proposal from Western Australia, the ACT suggested that the current balancing adjustment mechanism to account for inaccuracies in estimated GST receipts and populations could be leveraged to account for inaccuracies when using forecast data.

81 Victoria, South Australia, Tasmania and the Northern Territory did not support a shorter assessment period or the use of forecasts. These states said that such changes would most likely add volatility and reduce the reliability of assessments. South Australia noted the key benefit of the 3-year lagged average was the stability it provided through the use of actual revenue and expenditure data and smoothing the effects of volatility and large one-off revenue or expenditure shocks. Victoria considered the principle of contemporaneity to be less critical than the other principles.

Commission position

82 The Commission's position is that the contemporaneity principle remains appropriate, and the 3-year lagged moving average continues to provide an appropriate balance between contemporaneity, predictability and smoothing the impact of fiscal shocks. All states broadly supported the 3-year lagged average approach to contemporaneity.

83 The Commission has not supported the use of forecasts because it would require an ex-post adjustment to address inaccuracies in those forecasts. This would add an additional layer to the equalisation process with the Commission updating its relativities when final data become available. In previous reviews, states have generally opposed proposals involving ex-post adjustments.

84 Western Australia's proposal to use estimates of the year in progress to reduce the lag from 2 years to one includes an ex-post adjustment. The ACT suggests the current balancing adjustment mechanism could be leveraged to accommodate the ex-post adjustment. This would still require the Commission to update its relativities when final data are available in sufficient time for them to be included in the balancing adjustment mechanism.

85 The Commission accepts replacing historical data with forecasts would make its assessments more up-to-date, but whether it would improve the reliability of the results would depend on the reliability of the forecasts. The Commission has not used forecasts, or estimates, because of the uncertainty over their reliability and to avoid the complexity and uncertainty of an ex-post adjustment to address any inaccuracies in forecast data. The Commission's view is that it should not use forecast data.

Additional supporting principles

86 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.

87 The Commission's preliminary position for the 2025 Review was that, while aspects of the existing supporting principles could benefit from some elaboration, there had been no developments that called into question the appropriateness of the 4 existing supporting principles, the need for weighting or a need to introduce any new principles.

State views

88 New South Wales, Victoria, Queensland, South Australia, Tasmania, the ACT and the Northern Territory did not support introducing new supporting principles.

89 New South Wales believed that the current arrangements discourage efficiency enhancing reforms, especially major tax reforms.

90 Queensland supported the continuation of the current set of principles and noted that a consistent framework around the principles would offer greater certainty to assessments. South Australia said any proposal to introduce new principles must be supported by robust evidence that there was a key element of horizontal fiscal equalisation that was not currently addressed by the existing principles and could not be addressed by adjusting the existing principles.

91 Tasmania endorsed the Commission using its judgment when applying its supporting principles.

92 Western Australia proposed introducing 2 new principles:

- A policy consistency principle. This principle would require the Commission to calculate revenue bases and expense drivers which reflect the same policies across states. It would require the Commission to take account of any policy that could affect the size of these bases and drivers.
- A conservatism principle. This principle would require the Commission to err on the side of a smaller GST redistribution in the face of uncertainty by moving towards equal per capita.

93 Western Australia said the horizontal fiscal equalisation principle required the Commission to develop assessments that reflected the same policies across states. However, it acknowledged it was not possible to identify and adjust for all policies. Western Australia said it was particularly difficult to identify same policies when one state dominated a revenue base or when states had differing revenue base mixes and tailored their policies to those mixes. Western Australia suggested the Commission advise the extent to which it has not been possible to develop assessments that reflect same policies by highlighting the degree of uncertainty in its relativities.

94 South Australia, the ACT and the Northern Territory opposed the policy consistency principle. The ACT said it saw no compelling case for the adoption of a policy consistency principle, noting that the existing principle of policy neutrality already guided the Commission to make assessments of fiscal capacities that, as far as possible, eliminated policy differences between the states. South Australia and the Northern Territory said a policy consistency principle was unlikely to be workable in practice.

95 Western Australia noted there were many sources of uncertainty in the Commission's assessments and while the Commission discounted for some sources of uncertainty, it did not discount for others. It supports expanding the reasons for discounting for uncertainty (discussed below) or alternatively the use of a new principle (conservatism) to discount a wider range of assessments where there is uncertainty.

96 South Australia, the ACT and the Northern Territory also opposed the introduction of a new conservatism principle. South Australia said the Commission's discounting framework was appropriate. South Australia supported the consistent application of discounts in assessments where the Commission had concerns about data or methods, but it did not support proposals to widen the discounting of assessed relativities. The ACT noted that there was inherent uncertainty in all assessments and the Commission's current methods and recommendations reflected best estimates of horizontal fiscal equalisation given methodological and data constraints. It also said there was no reason why the Commission should inherently favour a GST distribution closer to equal per capita than one that is further from equal per capita. The Northern Territory said uncertainty was not a valid reason for assuming that a distribution closer to equal per capita is the appropriate basis to achieve horizontal fiscal equalisation. It said there was no conceptual or practical basis for the concept and its application would likely result in an under-estimation of horizontal fiscal equalisation.

Commission position

97 The Commission notes that significant experience, expertise and effort have gone into developing, refining and improving the supporting principles since they were introduced. In particular, the 2020 Review involved extensive consultation on, and consideration of, the supporting principles.[13]

98 The Commission's view is that there are no developments that suggest the need to introduce any new principles. This is the view of all but one state.

99 The Commission does not support the introduction of a 'policy consistency' principle. While there will inevitably be a range of different policies affecting a state's revenue capacity, it would be impractical to identify, and make reliable adjustments for, every difference. It would also be inconsistent with the current horizontal fiscal equalisation principle, which requires the identification of only material differences. While Western Australia has proposed this new principle, it acknowledges the difficulty of identifying 'same' policies. The Commission considers that the current approach of calculating a weighted average tax rate for each state's tax base, across all states, is the most practical approach to assessing a state's own source revenue capacity (with some adjustment to the tax base as required and the application of the policy neutrality principle).

100 The Commission also does not see a case for introducing a conservatism principle. There is an element of uncertainty with all assessments, but it is not evident that such general uncertainty materially affects the assessment of state fiscal capacities. The Commission seeks to reduce differences in the fiscal capacity of the states in all assessments and the degree of uncertainty with an assessment will depend on case-by-case circumstances. The Commission's approach to discounting assessments is the appropriate way to deal with uncertainty over data or methods. This is discussed below in the section on assessment guidelines.

101 The Commission remains of the view that its supporting principles are subsidiary to the primary objective of horizontal fiscal equalisation in measuring states' relative fiscal capacities. In addition, it considers that, wherever possible, methods should be chosen having regard to all of the supporting principles.

102 The Commission has not changed its position that there should not be an explicit weighting or hierarchy of the supporting principles.

[13] 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.

Assessment guidelines

103 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.

104 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 this process is transparent.

105 Attachment A outlines the proposed assessment guidelines for the 2025 Review. The guidelines set out the criteria for deciding when to include a driver of GST needs in the Commission's assessments and when a discount is to be applied. They are the same guidelines as used for the 2020 Review, except they incorporate increased materiality thresholds.

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

State views

107 Victoria, Queensland, Western Australia, South Australia and Tasmania supported the continued use of the 2020 Review guidelines. New South Wales, the ACT and the Northern Territory raised questions about materiality thresholds, discounting and the timeliness and use of data. State comments on materiality thresholds and discounting are covered below.

108 While supporting the guidelines, Victoria said it was seeking a more transparent decision-making process regarding how any proposed or recommended method change meets each element of the assessment guidelines. It said quality assurance and transparency could be improved through a peer review and periodic external review of calculations and documenting the reasons for Commission decisions.

109 The ACT broadly supported the assessment guidelines but suggested 2 improvements. As much as possible, the data used by the Commission should reflect the contemporary circumstances of the states. It suggested the Commission amend the guidelines to include a reference to the timeliness of data in the definition of fitness for purpose. In addition, the ACT said the guidelines should reflect that the Commission may use data that are not compliant with the assessment guidelines if they are the best available data. The ACT suggested amending the guidelines to reflect that the Commission will endeavour to use the best available data if a fully compliant source was not available.

110 The Northern Territory did not support the use of materiality thresholds or discounts in-principle because they undermined horizontal fiscal equalisation. However, it acknowledged the need to maintain balance between the horizontal fiscal equalisation objective and simplicity. Accordingly, the Northern Territory would accept the current assessment guidelines if its in-principle position was not accepted.

Commission position

111 The Commission's view is that the 2020 Review assessment guidelines remain appropriate, with the exception of the level of materiality thresholds. The Commission will continue to improve its communication, including around the application of the assessment guidelines and documenting the reasons for its decisions. It will also continue to undertake periodic external reviews of its calculations that underlie its assessments. It proposes to commission some external reviews as part of the 2025 Review.

112 The Commission's view is that it does not need to amend its definition of fitness for purpose to incorporate the timeliness of data because the contemporaneity principle provides sufficient guidance on the use of timely data. Similarly, it considers the existing guidelines provide it with the flexibility to use the best available data, with adjustments, if necessary, when data that fully comply with the guidelines are unavailable.

Materiality thresholds

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

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

115 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.

116 Data were adjusted where necessary to improve interstate comparability, but only if the adjustment redistributed more than $10 per capita for any state.

117 The Commission uses materiality thresholds when designing new assessment methods for a review. However, the assessment guidelines, including materiality thresholds, also apply where methods are changed in annual updates.

118 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. In addition, the Commission may assess a driver if it currently does not meet the materiality threshold but is expected to do so in future updates.

119 The Commission considered 2 options for basing an increase in the thresholds:

- the State and Local Government Final Consumption Expenditure chain price index — the approach used in the 2020 Review
- state expenditure per capita.

120 The Commission's preliminary view was that the thresholds should be increased broadly in line with state spending per capita. This would increase the threshold for assessing drivers to $45 per capita and the data adjustment threshold to $15 per capita.

State views

121 New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania supported increasing thresholds to maintain their value in real terms over time. They supported indexing the thresholds by State and Local Government Final Consumption Expenditure chain price index, as it was simpler, consistent with past practice, and maintained the value of thresholds real terms. The Northern Territory did not support indexation, but if the thresholds were to be indexed it also preferred the State and Local Government Final Consumption Expenditure chain price index. South Australia said the Commission's proposal to index by state expenditure per capita would imply a real increase in the value of the thresholds and there had not been any changes since the 2020 Review that would warrant a real increase. Victoria and Queensland also said the Commission's approach would raise the thresholds too high.

122 Western Australia noted that the thresholds proposed by the Commission were rounded to the nearest $5 per capita, which was appropriate for simplicity, but it suggested the Commission continue to apply its indexation to the same base year so that rounding errors did not accumulate over time.

123 The ACT and the Northern Territory did not support materiality thresholds.

124 The ACT said the thresholds do not make the horizontal fiscal equalisation system simple and the decision where to set them was arbitrary. It thought they should be set deliberately by balancing the practicality benefits of thresholds against their detrimental effects on the achievement of horizontal fiscal equalisation. It did not consider indexation to be the appropriate way to determine that balance. It also noted that the current $35 per capita threshold can result in significant fiscal implications for states should an assessment fail the threshold. It proposed a new 2-part threshold. Under its proposal, an assessment method would be deemed to be material if:

- at least one state received or lost $35 per capita compared to an equal per capita — this is the current approach, or
- the total amount of GST being redistributed by the assessment was equal to or greater than the equivalent of $35 per capita for the most populous state.

125 The second condition would introduce a nominal threshold, which would be set with reference to the population size of the most populous state (the ACT proposed $35 per capita). If an assessment redistributed more than the threshold it would be deemed to be material, even if it did not redistribute more than $35 per capita for an individual state.

126 The Northern Territory said the use of thresholds departs from horizontal fiscal equalisation and contributes to inaccuracies over time. The Northern Territory also said that there were mathematical difficulties in applying materiality thresholds, such as the difference between a single change that is material in a single year or category, and the materiality of a compound effect of multiple changes.

127 Victoria said that the Commission should review the materiality of all drivers of needs and assessments.

Commission position

128 The Commission's position is to increase its materiality thresholds to $40 per capita (for the assessment of a driver) and $12 per capita (for a data adjustment). These increases are broadly in line with the State and Local Government Final Consumption Expenditure chain price index. This was the approach used in the 2020 Review and it is consistent with most state views that materiality thresholds should be increased to maintain their value in real terms over time.

129 The Commission notes Western Australia's concern that rounding errors can accumulate over time. It recalculated the thresholds using the same base year and they did not change. In addition, the Commission rounded down the data threshold.

130 The Commission also acknowledges the Northern Territory's concerns with using materiality thresholds. However, the Commission notes they are an important aspect of simplifying assessments and they are the means by which the Commission determines the material factors to comply with the horizontal fiscal equalisation objective. However, the Commission recognises that materiality thresholds cannot be applied mechanistically and that judgment is often required.

131 The ACT's proposal for a 2-part materiality threshold would introduce a new threshold based on the aggregate redistribution of an assessment. When the Commission first introduced materiality thresholds in the 2010 Review, it considered a state-based approach to thresholds (that is, a driver was material if it exceeded a per capita amount for any one state) was superior to thresholds based on the total amount redistributed. The Commission recognised that it was possible for an overall redistribution to be immaterial but the effect on one or more states to be material. The Commission is not inclined to adopt an overall redistribution threshold in this review. The number of cases where an assessment is material overall (but not for any state) are likely to be few and do not warrant the additional complexity of a 2-part threshold.

132 The Commission agrees with Victoria that the materiality of all factors and assessments should be reconsidered in a review. This is the approach the Commission took in the 2015 and 2020 Reviews. It will retest the materiality of all drivers of need and assessments as part of the 2025 Review.

Discounting assessments

133 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).

134 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.

135 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 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.

136 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.

137 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. 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.

138 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 inefficiency itself.

139 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.

140 The Commission will consider the consistency of its use of discounting across assessments towards the end of the review.

141 The Commission's preliminary position was 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 invited 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.

State views

142 Queensland, South Australia, Tasmania and the ACT supported the 2020 Review approach to discounting. Queensland and South Australia said there was a need for regular reviews of discounts, so that the discount reflects the degree of uncertainty and unreliability of the data and methods. The states identified certain assessments where they considered a higher level of discount should be applied.

143 New South Wales was concerned that discounting was arbitrary. It said the Commission applies a discount where it considers data to be unreliable, but discounting was only ever in one direction, towards equal per capita. Discounting could be moving the outcomes further away from true horizontal fiscal equalisation. New South Wales supports greater consistency in the use of discounts. It suggested that assessments that have a discount be given greater attention in order to

improve them. It also suggested the Commission increase its efforts to collect more reliable data from states with the aim of removing discounts over time.

144 Victoria did not consider discounting appropriate, transparent or fit for purpose. It sought greater clarity over the definition and application of discounts. It said that where a high discount is applied, there were concerns with the appropriateness of the data or method and as such, it raised the question whether an assessment should be made. Victoria noted that discounts were not applied to judgment-based estimates, whereas Victoria considered there was a greater case for using discounts in these situations.

145 Western Australia said the Commission should be using discounting more often. It supports the use of discounts in cases of general uncertainty and policy neutrality. It also suggested that an alternative to discounts to individual assessments would be a discount to the assessed relativities or a floor on relativities.

146 The Northern Territory is opposed in-principle to extensive discounting. It does not think general uncertainty and methodological difficulties always warrant a discounting approach.

Commission position

147 The Commission acknowledges that discounting involves judgment. However, discounting remains relevant and allows the Commission to capture states' fiscal capacities while recognising the limitations of data and methods in some circumstances. While the Commission will continue to consider discounts on a case-by-case basis in individual assessments, it will explain the reason for the discount and ensure consistency of approach across assessments. Before the completion of the 2025 Review, the Commission will examine the rationale and level of discounts applied in its assessments. This information will be in both the draft and final reports of the 2025 Review.

148 The Commission agrees with New South Wales' suggestion that it should increase efforts to collect more reliable data from states with the aim of removing the need for discounting.

149 As New South Wales noted, discounting moves assessments closer to equal per capita. The Commission considers this to be the only practical way to deal with situations where there is evidence that material differences exist between states in the level of use or unit costs, or both, in providing services or in their capacities to raise revenue, but there is some uncertainty over the reliability of the data or the method. In such situations, discounting the assessment method for this uncertainty will be more consistent in moving towards horizontal fiscal equalisation than not undertaking an assessment. However, if the level of uncertainty is too large, it agrees with Victoria that an assessment should not be made.

150 The Commission does not apply discounts to judgment-based estimates, because in determining those estimates it has already considered the degree of uncertainty involved. The Commission does not consider that discounting assessed relativities is an alternative to discounting individual assessments. When deciding on whether to apply a discount, the Commission takes into account the circumstances of the individual assessment. States' assessed relativities may not align with the circumstances of an individual assessment.

151 The Commission's position is to retain the 2020 Review discounting framework and the 2020 Review discount levels.

152 The Commission has not changed its view that discounts should be used for issues with data or methods. Discounts will not be applied in cases of general uncertainty or to address policy neutrality.

Attachment A: Assessment guidelines for the 2025 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 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 $12 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 $40 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)
- 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.