

GST distribution reforms

ACT Submission to the Productivity Commission Inquiry into the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018*

February 2026



Acknowledgement of Country

The Chief Minister, Treasury and Economic Development Directorate acknowledges the Ngunnawal people as traditional custodians of the ACT and recognise any other people or families with connection to the lands of the ACT and region.

We respect the Aboriginal and Torres Strait Islander people, particularly our Aboriginal and Torres Strait Islander staff, and their continuing culture and contribution they make to the Canberra region and the life of our city.

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Overview

The 2018 GST distribution reforms have impaired Australia's Horizontal Fiscal Equalisation (HFE) system. The intended purpose of HFE is to ensure that all States have capacity to provide services of an equivalent standard to all Australians, regardless of each State's revenue capacity. However, without the permanent extension of the Commonwealth-funded GST no-worse off guarantee (NWOG), States will bear the cost of subsidising Western Australia (WA)'s budget position. This is clear evidence of the unsuitability of the current system.

The 2018 GST reforms were expensive, complex and continue to undermine the purpose of HFE to address a temporary problem – the volatility of global commodity prices interacting with State revenues and the HFE system. Given these costs, there is little rationale to continue the changes. The HFE system as it is currently operating is not fulfilling its equalisation objectives, without additional funding support.

The ACT's submission to the inquiry focuses on the following themes:

- the current harm and risk of further harm to HFE from the current arrangements;
- the 2018 reforms are not fiscally sustainable; and
- opportunities to improve HFE.

The submission outlines why the 2018 reforms do not align with HFE principles, or the broader economic and fiscal context Australia faces. The ACT's recommendations include practical options to return the HFE system to its original intent – to support fiscal sustainability across all levels of government, to improve resource allocation and to avoid further exacerbating VFI.

Ensuring the HFE achieves its objectives also requires the best information. The ACT population has been continually undercounted which has significant implications for the ACT's GST distribution. Addressing this would strengthen the HFE system and ensure an equitable distribution, of both GST and other Commonwealth payments.

Horizontal Fiscal Equalisation

The Inquiry provides a timely opportunity to reconsider the 2018 reforms, including the impact the reforms have had and options to improve the GST system to better support HFE objectives and promote fiscal sustainability for the Commonwealth and the States.

HFE – purpose and benchmarks

The objective of HFE is to ensure that all states have capacity to provide services of an equivalent standard to all Australians, with respect to actual needs in each jurisdiction, and the relative revenue raising capacity of each State. Equalisation matters, because state governments are responsible for delivering most public services including our schools and hospitals.

There is no objective, external benchmark available to determine a ‘reasonable’ level of equalisation. Australia is among only a handful of advanced economies with a federated Government structure. Individual circumstances – historical, economic, and political – have a fundamental bearing on the financial aspects of each of these countries’ federations.

The pre-2018 HFE system reflected Australia’s unique circumstances – no other federation equalises expenditure needs to extent of Australia, undertaken by an independent body. It also delivered this funding in a way that respects the autonomy of States to make expenditure and revenue decisions. For this reason, the ACT considers that the reasonable level of HFE was that which prevailed prior to the 2018 legislative changes. An alternative model that operates on an

Equal per capita distribution (EPC) also creates challenges within the Federation and is inconsistent with the principles of HFE. As the PC’s final Inquiry Report on Horizontal Fiscal Equalisation in 2018 concisely observed ‘*EPC and HFE are mutually exclusive. This proposal [EPC] is thus at odds with the general endorsement of the concept of HFE*¹. The purpose of equalisation is to ensure a reasonable standard of service delivery. Equal per capita distribution of GST revenues does not achieve this purpose. For this reason, the PC found against the notion of EPC distribution in its last review.

Over the period 2021-22 to 2025-26, the Commonwealth provided \$405 million in NWOOG payments to the ACT – equivalent to around 5.8 per cent of total Commonwealth Special Purpose Payments to the ACT. In the absence of this funding, the ACT would have needed to reduce spending, increase taxes, or incur higher debt, relative to WA. This provides clear evidence of the significant erosion of the HFE system.

¹ page 224, *Horizontal Fiscal Equalisation*, Productivity Commission Final Inquiry Report, 2018

Revenue Volatility and HFE

Reducing revenue volatility stemming from sharp movements in HFE distribution was cited as one reason for the 2018 reforms. However, for all sources of revenue, States are required to manage volatility through their annual budget processes, including leveraging their balance sheets to manage differences in the timing of receipts and expenses. It is also the case that the circumstances that prompted WA's insistence on the reforms – concurrently declining commodity revenues, and GST allocations – were foreseen in advance.

The Commonwealth Grants Commission (CGC) has, at States' request, considered and at times implemented mechanisms to reduce the variance in GST redistribution – by altering the period over which States' circumstances are considered for the purpose of equalisation. This approach has advantages and shortcomings. The longer the period of assessment, the further away from any States' present circumstances the resulting GST distribution process in that particular year will be, yet by averaging over a longer period volatility will be reduced. The opposite is true for shorter assessment windows, but together both examples serve to illustrate the inescapability of the problem of balancing volatility and equalisation. In either case, revenue certainty cannot be fully guaranteed. The CGC's Methodology Review process also provides an appropriate mechanism to consider and implement relevant changes that might mitigate volatility, such as the period over which data for assessments are considered.

The CGC's Methodology Reviews themselves can also be a significant source of volatility in GST distribution. However, the ACT does not consider this to be a problem – this is the result of a rigorous and collaborative process to determine appropriate HFE in Australia. Volatility of GST revenue is not a sufficient reason to change the HFE system – it exists to respond to the need for equalisation.

The NWOOG has also insulated States from the true consequences to volatility, of the 2018 GST reforms. Without the NWOOG, under the current system all States other than WA would be subject to volatility in revenue streams, yet without sufficient GST revenue to meet their equalisation needs.

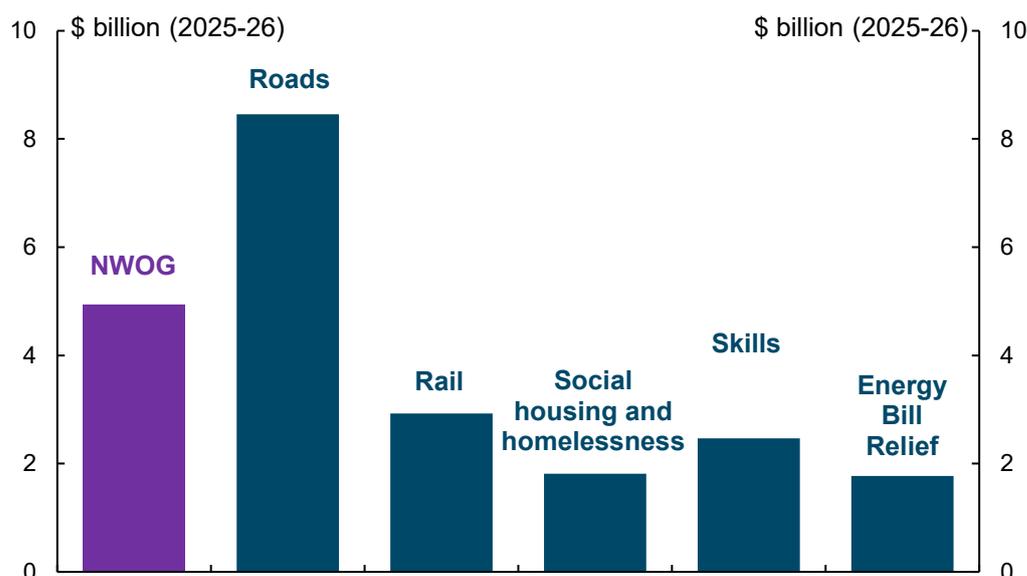
Impact of 2018 reforms on fiscal sustainability

The current HFE arrangements, including the NWOOG, are not sustainable for the Commonwealth. The size and duration of the NWOOG payments far exceed what was originally anticipated and is at a time of significant budget pressures for the Commonwealth and States. This is likely limiting the Commonwealth's ability to direct funding to other priorities. In comparison to the Commonwealth's other priorities, this diversion of resources is significant (Chart 1).

In finalising the reforms, it was the Commonwealth Government's expectation that the NWOOG would not be needed. This also establishes that the 2018 GST reforms were not intended to require other States to subsidise WA – yet removing the NWOOG will ensure this occurs. This is not sustainable for the States – it would lead to either reduced services, higher State taxes, higher State debts or some combination of all three.

States and Territories have been necessarily insulated from the fiscal consequences of these reforms by the NWOOG. The NWOOG means there is no evidence of the negative fiscal consequences of the 2018 reforms; however, States' fiscal positions would likely be significantly worse without the NWOOG – creating pressure for the Commonwealth to address VFI pressures. For the ACT, the NWOOG is estimated to be \$124 million in 2025-26. For this reason, if the Commonwealth judges there is a need to continue supporting WA's budget position, it should do so directly, and outside of the HFE system.

Chart 1 – Commonwealth NWOG expenditure vs. selected SPP categories



Source: Commonwealth Grants Commission, Commonwealth Budget Papers.

Implications of current HFE arrangements for reform

Arguments are often made that HFE can drive whether reforms are undertaken or not. However, evidence provided to the Review of HFE undertaken in conjunction with the 2018 reforms established that States generally did not consider the pre-2018 HFE system precluded decisions to undertake reform. Though, States acknowledged that the HFE system naturally has implications for revenue and expenditure decisions. In this context, the 2018 changes worsen States' incentives to undertake reform, and certainly do not encourage it.

The ACT has continued its own tax reform program, despite the introduction of the 2018 reforms to the HFE system. The Territory is the only jurisdiction to abolish insurance duty and continues to decrease stamp duty tax rates. This has increased the efficiency, fairness and stability of our tax system. General rates revenue has been progressively increased to offset the revenue forgone from reducing conveyance duty and abolishing insurance duty. The general rates system is now more progressive with lower income and wealth households paying a lower proportion of total general rates revenue. However, the ACT's experience shows that tax reform is challenging and requires a multi-year reform.

While the 2018 reforms have not affected the ACT's tax reform program, for other, larger jurisdictions the changes may have reduced incentives for reform, as large jurisdiction who chooses to undertake reform have more influence on 'average' policy and so would incur a reduction in its GST allocations. The current HFE system carries greater negative consequences, in this regard. Even if tax reform in a large jurisdiction is designed to be revenue neutral from an own-source revenue perspective, there is no guarantee that the net effect on GST flows would not be negative – this was also the case in the previous HFE system. However, this problem is exacerbated by the fact that in the absence of the NWOG, it is likely that such a jurisdiction would also absorb the cost of subsidising the WA budget position, despite the strength of WA's own-source revenues, at the same time.

The current HFE system also does not incentivise, in aggregate, efficient expenditure decisions. In contrast, the previous HFE system assessed each State's expenditure behaviours and relative needs impartially. These assessments were based on the principle of observing what States actually do. This is important because equalisation is done based on state circumstances and how each state chooses to meet those demands. In contrast, the current arrangements divert funding to WA for reasons other than the outcomes of expenditure and revenue assessments. That bilateral subsidy to WA that the NWOG effectively represents is not incentivising more efficient expenditure, compared with the previous HFE arrangements. The significant efficiency costs of subsidising WA in this way would be shifted onto most other States under the current system when the NWOG ceases. Both cases are an inefficient use of public expenditures, unconnected to actual service delivery.

Population and implications for HFE

The ACT has broader concerns about the adequacy of the HFE system, specifically the systemic undercounting of the ACT's population and its impact on the distribution of GST.

Errors in population estimates by the ABS resulted in the ACT receiving \$550 million less in GST payments than was entitled between 2016–17 to 2022–23. There is no reconciliation process for this. This persistent population underestimation directly reduces the ACT's share of the national GST pool and undermines the principle of HFE, and the consequences of these inaccuracies are significant.

This shortfall has placed a sustained and systemic burden on the ACT's finances, despite our continued provision of services to all ACT residents and the broader capital region, including the south-east New South Wales catchment.

Inaccurate estimates of net interstate migration (NIM) are the main reason for errors in the ABS' estimate of the ACT's estimated resident population (ERP). The March quarter 2025 ERP is the twelfth consecutive quarter of negative NIM for the ACT, far worse position than the 7 interspersed quarters of negative NIM in the 2016-2021 intercensal period.

Given the enduring financial disadvantage this creates, the ACT proposes two practical options:

- an explicit annual adjustment to the population data used by CGC in its yearly assessments to better reflect known discrepancies, or
- a post-Census balancing adjustment to reconcile ERP errors following each Census, in line with the existing process for reconciling GST advances and final entitlements.

These measures would help ensure a fairer distribution of GST revenue and reduce the scale of adjustments required after each Census. There is already precedent for such an approach — the Commonwealth currently applies annual adjustments for HFE transition payments under the 2018 GST reforms. It would also be timely for the Productivity Commission to consider the ACT's funding arrangements in this review, given our status as a City/State.

As the ACT has observed in its submission to the House of Representatives' Inquiry into Local Government Funding and Fiscal Sustainability, the National Capital Plan (NCP) and its inherited municipal requirements impose significant costs and obligations on the ACT. While the ACT receives some funding for municipal services, it is not clear that is sufficient to cover the full costs of meeting the ACT's status as a dual government and its NCP designation (See: <https://www.aph.gov.au/LocalGovernmentFunding>).

Alternative arrangements to the 2018 reforms

The ACT proposes four options to improve the integrity and sustainability of the HFE system, noting there is no reason to maintain the current HFE arrangements and the ACT's preferred option is to return to the pre-2018 system (Option 1). However, practical options to unwind current arrangements with ongoing Commonwealth support, or to distribute the necessary cost of doing so more fairly are set out below.

Option 1 – restore the HFE system to its pre-2018 structure (preferred)

The first-best solution is that the previous HFE system is restored, with a reversal of transition arrangements that brought the system to its current state. This would have ongoing fiscal consequences for the Commonwealth, over the short- to medium-term.

The transition back to the previous HFE system could occur over a sufficiently long transition period – 5 years would be appropriate with transition completed in the sixth year, consistent with the transition period for the introduction of the reforms. During this time, blending of relativities should occur in a similar fashion to the transition into the current state of the HFE system, to ensure a gradual fiscal adjustment. During this time, the Commonwealth should continue to fund the NWO, to insulate the States from the residual negative effects of the 2018 GST changes. The guarantee should cease at the conclusion of the transition period.

Alternatively, the Commonwealth could consider transitional bilateral payments for WA (funded outside the GST system), to smooth the impact of a reduction in its share of GST.

Option 2 – increasing fiscal capacity to fund a transition back to pre-2018 HFE

Instead of the Commonwealth funding the NWO in perpetuity, the cost of a transition to the pre-2018 HFE system could be met by other Commonwealth funding sources.

Any increased revenues should be quarantined from WA initially and be made available to WA in stages as the current HFE arrangements are unwound. The transition should mirror that proposed in Option 1. At the end of the transition, a wider revenue pool would be available to all States, under the pre-2018 HFE arrangements.

Any increase in revenue from other Commonwealth funding sources would cover the equivalent cost of the NWO, and could also help address broader fiscal pressures across the Federation. The Commonwealth should continue to fund the NWO until it has implemented long-term funding solutions, to ensure States are not penalised in the interim.

Option 3 – Fiscal rules for revenue equalisation

The ACT does not consider GST revenue volatility to conflict with HFE objectives. But, if managing volatility is desired, commodity-derived revenues could be distributed over a longer time horizon than 'normal' equalisation, subject to fiscal rules.

This approach would smooth the connection between significant movements in commodity prices on the HFE system, and States' actual expenditure needs. This approach would manage the vulnerabilities of the Australian economy, and States total revenues, to external commodity shocks.

Tension in the HFE system arose only during the relatively short period in which WA's own source revenues and GST relativity fell concurrently. A longstanding system of delayed distribution of GST revenues could have prevented this from occurring. For example, revenue equalisation over a 10-year horizon for commodity derived revenues, accompanied by access rules to prevent anomalous HFE consequences (i.e., concurrently falling own-source revenues and GST allocations) could achieve this, if revenue stability is judged important.

This should be undertaken with clear fiscal rules and GST grants would remain untied revenue for States. Deferred revenue allocation should occur only where total revenue equalisation more than exceeds equalisation for expenditure need in the ordinary assessment period. Extenuating factors, such as a situation where own-source revenues and GST relativities decline in tandem, could be a reason for early access to deferred distribution of GST. But this should only occur on the basis that future allocations to the accessing jurisdiction's deferred entitlements are correspondingly reduced. This arrangement could only work in the absence of a relativity floor.

It would be reasonable to transition to this option over a period of several years, if implemented. States, in consultation with the CGC, are best placed to determine the mechanism to allocate 'excess' revenue. Because this system would be feasible only under the pre-2018 HFE arrangements, a transitional model like options 1 and 2 should be adopted.

Option 4 – Commonwealth/State bilateral equalisation

If the HFE system remains impaired, addressing vertical fiscal imbalance becomes more challenging. The only viable solution in this case is that the Commonwealth bilaterally fund States' expenditure needs that are not met through the HFE system. To enable this, the Commonwealth could use CGC assessments based on the pre-2018 HFE system to establish expenditure 'need'. However, in this scenario, there is a risk that over time bilateral arrangements will not meet equalisation objectives. The existing mechanisms of the CGC provide an accepted and reasonable baseline for States' funding needs – though, the obvious solution would be to restore the HFE system to its unimpaired functionality, which is the ACT's preferred option.

Under this option, there is also a risk that funding for states will be subject to complex negotiations that consider factors beyond equalisation needs. It would also increase administrative complexity and costs for the Commonwealth. As it stands, there is opportunity to improve the functionality of this aspect of intergovernmental funding in the Federation. The Commonwealth expects that when entering into a funding agreement with States, that its contributions are tied to outcomes. However, in many cases these reporting outcomes are not jointly determined between States and the Commonwealth. Input control of this nature undermines States' accountability to their populations. This is not an ideal arrangement, particularly in cases where the Commonwealth is a minority funding partner. As a solution to this problem, the ACT recently proposed to the Economic Reform Roundtable, that intergovernmental funding agreements be subject to a joint assessment akin to a regulatory impact statement, which accounts for all parties' policy objectives, as well as reasonable measurement of outcomes or intent.