

NSW Government Initial Submission to the Productivity Commission Inquiry into the 2018 GST distribution reforms

20 March 2026

Acknowledgement of Country

We acknowledge that Aboriginal and Torres Strait Islander peoples are the First Peoples and Traditional Custodians of Australia, and the oldest continuing culture in human history.

We pay respect to Elders past and present and commit to respecting the lands we walk on, and the communities we walk with.

We celebrate the deep and enduring connection of Aboriginal and Torres Strait Islander peoples to Country and acknowledge their continuing custodianship of the land, seas and sky.

We acknowledge the ongoing stewardship of Aboriginal and Torres Strait Islander peoples, and the important contribution they make to our communities and economies.

We reflect on the continuing impact of government policies and practices, and recognise our responsibility to work together with and for Aboriginal and Torres Strait Islander peoples, families and communities, towards improved economic, social and cultural outcomes.

Artwork:

Regeneration by Josie Rose



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Executive Summary

Horizontal Fiscal Equalisation (HFE) has long been a feature of the Australian Federation. Under HFE, Commonwealth general purpose grants to the states and territories (states) facilitate each state providing a comparable standard of public services and infrastructure by making a comparable revenue effort and operating at a comparable level of efficiency. Underpinning HFE is the objective of achieving equity for the average citizen in each state from the activities of state governments.

Following concerns expressed by WA after 2010 regarding its rapidly declining share of Goods and Services Tax (GST) grants linked to the mining investment boom and the volatility of state GST relativities more generally, the Commonwealth legislated changes to HFE arrangements in 2018. The objective of the 2018 legislative changes was to ensure WA received a 'fair share' of GST grants and reduce the volatility of GST relativities more generally. To achieve this, several changes were made to HFE arrangements:

- The use of the fiscally stronger of NSW or Vic as the benchmark HFE state from 2026-27. Previously, HFE was based on the fiscally strongest state which, in recent years, had been WA.
- The introduction of a relativity safety net floor for all states of 0.7 commencing in 2022-23 rising to 0.75 from 2024-25.
- The 'topping up' of the GST pool by the Commonwealth in perpetuity.

In addition to these changes, the Commonwealth provided a time limited guarantee that no state would be worse off under the new arrangements (the No Worse Off Guarantee).

NSW believes the objectives of the 2018 legislative changes have not been achieved and that the current system of distribution is overly complex and increasingly unfair.

- WA has received a disproportionate share of Commonwealth general purpose grants allowing it to retain the windfall revenues from the mining boom. This permits it to offer a higher standard of public services and infrastructure compared with other states without the need to levy comparable levels of taxation.
- The volatility of GST relativities has not reduced, except for WA, because of the No Worse Off Guarantee.

Furthermore, the changes to HFE introduced since 2018 have come at a significant cost to the Federal Budget which is expected to be \$28.8 billion in the period to 2025-26 for no measurable national economic benefit. The opportunity cost of this expenditure is likely to be considerable in the current tight fiscal environment faced by all governments except WA.

Addressing the underlying distortions that resulted in the 2018 changes to HFE is critical to ensuring the viability of the ongoing arrangements for the distribution of GST grants. The current system is also likely to come at a cost to the productive efficiency of the Australian economy. Improvements to the operation of HFE that reduce its impact on state decision-making and improve productivity within the Australian economy should be considered.

Further, HFE gives states the capacity to adopt national average policies but does not mandate that these policies are implemented. While the deviation of individual state policies from the national average is consistent with states tailoring their policies to local preferences, in some cases this policy deviation may be considered excessive and not in the national interest. Consistent with the principle of state sovereignty, the Australian Government could consider reward payments to shift state policies more towards the national average. Such an approach is likely to see improvements in the effectiveness of government spending and therefore enhance productivity.

While resolving the ongoing HFE arrangements has the potential to improve fiscal sustainability, all governments face significant pressures on their finances from the aging of the population, rising community expectations and the impacts of climate change. Without structural changes to public finances all governments will face unsustainable debt burdens in the medium term.

Key Recommendations

NSW's preferred approach is the phased introduction of an equal per capita (EPC) distribution of GST grants which would remove the complexity of the current system and result in a higher level of transparency. It would also eliminate any possible drag from the current system on the productive capacity of the Australian economy. An EPC distribution with top-ups from outside the GST pool for the fiscally weakest states would achieve a reasonable level of equalisation.

While NSW prefers an EPC distribution of GST grants, we recognise the need for a broad national consensus for change. Given this, an alternative model that returns to the pre-2018 HFE model from 2030-31 with several modifications is also canvassed in this submission. These modifications are intended to address the factors which drove changes to HFE in 2018 as well as reduce the negative impact of HFE on the productivity of the Australian economy.

- The introduction of a relativities safety net floor of 0.5 funded by the Australian Government (noting this would be more fiscally sustainable for the Australian Government than the current arrangements).
- Early advice of likely changes to relativities, including through the provision by the Commonwealth Grants Commission (CGC) of four-year relativity forecasts.
- Improving the contemporaneity of GST distributions through the earlier application of updated relativities.
- Changes to CGC revenue assessments where a dominant state in a revenue category exists.
- The introduction of elasticity adjustments for key state taxes.

NSW welcomes the opportunity to participate in the review of one of the key fiscal underpinnings of the Australian federation and looks forward to engaging with the Productivity Commission (PC) in the coming months.

1 Introduction

The Australian Government legislated changes to the arrangements for distributing GST between the states through the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (the 2018 legislative changes). Under this legislation, the PC is required to review the efficiency and effectiveness of the 2018 legislative changes and assess whether they are acting as intended. NSW welcomes the opportunity to comment on the PC's Inquiry into the 2018 GST distribution reforms (the Inquiry) and, more generally on how HFE is implemented in Australia by the CGC.

Section 2 of this submission discusses what might be considered reasonable HFE in an Australian context. The submission notes that an EPC distribution of GST achieves the objectives of simplicity, practicality and transparency. This distribution would then be 'topped up' with grants to achieve a reasonable level of HFE.

Section 3 of this submission discusses the failure of the 2018 legislative changes to ensure the residents of all states are treated equitably or to reduce the volatility of GST shares, whilst coming at a substantial cost to the Federal Budget.

Section 4 discusses possible modifications to the current system to promote productivity and to facilitate better state budget management.

Section 5 argues that all governments across Australia face a challenging fiscal environment over the coming decades. Any changes to the arrangements for the distribution of GST revenue should therefore be fiscally sustainable for both the Australian Government and states.

Attachment A responds to the specific information requests sought by the PC and points to where our substantive comments on these issues can be found within this submission.

Attachment B contains analysis on the impact of HFE on state revenue policies.

2 Trade-offs in the implementation of HFE

The Australian federation is characterised by a high degree of vertical fiscal imbalance (VFI) which sees the Australian Government collect around 81 per cent of total taxation revenues while the states and local governments are responsible for around 46 per cent of expenditure. As a result of VFI, the Australian Government is required to transfer significant financial resources to the states.

Australia has a long-standing practice of undertaking broad ranging HFE involving both the expenditure and revenue sides of state budgets. Under HFE, the distribution of Australian Government general purpose grants is intended to facilitate states providing a comparable standard of public services and infrastructure by making a comparable revenue effort and operating at a comparable level of efficiency. Given this, HFE provides states the capacity to replicate service provision and taxation arrangements applying in countries with a unitary system of government where a common level of services and taxes apply nationally.

HFE results in fiscally stronger states receiving lower per capita GST transfers from the Australian Government while fiscally weaker states receive higher per capita GST transfers. Prior to 2018-19, GST grants were distributed to all states under a comprehensive model of HFE that involved equalisation to the fiscally strongest state. The 2018 legislative changes moved away from the principle of HFE to provide a fiscal advantage to WA.¹

Australia is one of many federations undertaking HFE between sub-national jurisdictions. There are a wide range of approaches to HFE practiced internationally reflecting their unique economic, social, political and historical circumstances. As practiced in Australia, HFE is more extensive than in other countries. For instance, Canada applies HFE only in respect to the own source revenues of provinces.

The extent of HFE pursued in Australia requires consideration of the trade-offs between achieving equity and promoting national economic efficiency. What constitutes a 'reasonable' level of HFE is therefore a matter of perspective. Fiscally weaker states desire comprehensive HFE to allow their citizens to be able to receive the same standard of services as in fiscally stronger states. By contrast, fiscally strong states are concerned that comprehensive HFE drains their finances of funds that could be used to provide a higher standard of services and lower taxes, which may support national economic and productivity growth that benefits all Australians.

Full HFE in Australia involves a considerable level of complexity and therefore it lacks ease of explanation or transparency. Pursuing reasonable HFE and reducing its complexity could involve restricting HFE to fewer service areas and revenue raising activities of government. On the other hand, reasonable HFE could involve its expansion to take into account other factors not currently captured adequately, such as the additional costs associated with servicing Australia's global cities and the costs borne by states associated with migration. These factors currently weigh heavily on the ability of states to underwrite improvements in the productive capacity of the Australian economy.

¹ From 2018-19, WA was effectively removed from HFE and given additional general purpose grants, a special arrangement.

NSW will undertake further analysis of how these issues impact national productivity as additional input to the PC's deliberations in due course.

As part of the Inquiry, the PC will need to also consider the implications of the often-large gap between what states are assessed as needing to spend and what states actually spend in several functional areas. This issue is likely to have implications for both the efficacy of HFE and the productive efficiency of the economy.

What are the benefits of comprehensive HFE?

While HFE is applied to a range of expenditures and revenues of each state, the principles of equity can only readily be applied to individuals. Given this, HFE can be considered to attempt to achieve equity between the 'average citizen' in each state.²

HFE facilitates the average citizen in each state having access to a comparable standard of public services and infrastructure and a comparable level of taxation. That is, the distribution of GST grants enables the government of a fiscally weaker state such as SA to provide the average citizen in that state access to a comparable standard of school and hospital services as those offered in a fiscally stronger state such as NSW. It recognises factors affecting state fiscal capacity such as demographics, geography, natural resources and other economic factors. As such, HFE can be seen as a cohesive nation building force.

Estimates by Independent Economics in 2012 show there are positive welfare benefits to the national economy from Australia's equalisation system equivalent to \$295 million in 2009-10 terms.³ These benefits increased to \$521 million in 2015-16 as equalisation became more significant with the mining boom adding to equalisation transfers (SA Department of the Premier and Cabinet, 2012, 2015).

What are the costs of comprehensive HFE?

Impact on Internal Migration

As demonstrated by the CGC assessments, some states are on average higher service delivery cost locations due to location-specific factors.⁴ While the academic literature argues that a benefit of HFE is that it removes the incentive for interstate migration,⁵ it also reduces the incentive for persons to migrate from higher to lower cost service delivery locations resulting in higher overall government service costs. This is because HFE, as practiced in Australia, provides states with a greater proportion of persons living in high-cost locations with additional funding and therefore the capacity to deliver state government services and infrastructure in these high-cost locations.

² More accurately, HFE attempts to achieve equity between citizens in similar circumstances across states.

³ This is the benefit from the Australian equalisation system compared to a situation in which all equalisation adjustments, except on account of Indigeneity, were abandoned.

⁴ Location-specific factors exclude demand factors driving differences in costs between jurisdictions.

⁵ HFE is argued to remove differences in state government generated net fiscal benefits.

Impact of HFE on state policy decisions

Over the past 40 years, many arguments have been made that the CGC's methodology can affect revenue and expenditure decisions made by state governments. This occurs where a policy decision by government results in a change in the GST received by that state. An example of this would be an increase in WA iron ore royalties which would see that state eventually lose 88 per cent of any additional revenue raised through reductions in GST distributions.⁶

NSW believes the potential for HFE to distort state policy decisions that increase the efficiency of the state economy and deliver productivity benefits more broadly should not be ignored. Section 4 of this submission outlines our suggested approach to minimising the potential distortionary effects of HFE on state government policy decisions.

Complexity and lack of transparency in determining GST relativities

As has been widely argued, implementation by the CGC of HFE is overly complex resulting in a lack of transparency and imposing significant administrative costs both federally and for states. The reasonableness of any model of HFE needs to balance the achievement of HFE outcomes against ensuring transparency, broad public understanding and support of the system and the costs involved.

Is the CGC's methodology too complex?

Assessing whether excessive complexity exists in the application of Australia's HFE system requires complexity to be judged against the significance of the objective to be achieved and the efficacy of alternative arrangements. HFE determines the distribution of over \$100 billion of GST grants. If HFE on both the expenditure and revenues sides of state budgets is to be achieved for the distribution of such a large sum of money, some complexity would seem to naturally arise.

An EPC distribution would be simple to understand and administer. It would also not require any data-intensive assessments of states' revenue raising capacities or costs of service and infrastructure delivery. Instead, the distribution of GST grants would be simply based on population data and the size of the GST pool. This distribution could then be 'topped up' with grants to achieve a reasonable level of HFE.

The CGC processes encourage greater levels of complexity in the drive to achieve 'perfect HFE'. Offsetting this is the CGC's decision to impose a materiality threshold on additional factors being taken into account in its assessment methodology. Ultimately, there is likely to be a trade-off between complexity and better achieving HFE. An increase in the CGC's materiality threshold could be a means of rebalancing between these two forces.

How transparent is the CGC's methodology?

An overly complex HFE system can adversely affect both the understanding of the system more broadly and the way in which decisions are made. It is difficult to achieve transparency and accountability if the HFE system is so complex that only a handful of people understand it. Poor

⁶ See Table 2 in section 4.

transparency, combined with a high degree of complexity and subjective decision-making means credibility and confidence in the CGC and HFE is undermined.

The CGC goes to considerable lengths to publicly explain its methodology. Unfortunately, the complexity of its methodology is such that it is still not well understood without investing considerable time and resources. Distributions which see increasingly widening gaps in GST payments made to otherwise comparable states (such as NSW and Vic) further undermine the perception of fairness in the current system.

What steps have been taken to reduce complexity and improve transparency?

Both the 2012 GST Distribution Review and the 2018 PC Review made recommendations around improving the simplicity of HFE. However, in 2018 the PC noted that greater assessment simplicity may compromise the achievement of full HFE, and that limited understanding of the system largely reflects its complexity. The PC proposed that a better understanding of HFE and CGC processes could be achieved through the CGC undertaking a greater public education role.

Following the 2018 PC Review, changes to the CGC's methodology to simplify its assessments were made as part of its 2020 Methodology Review. This involved among other things an increase in the materiality threshold against which additional levels of complexity are judged. The CGC regularly reviews this threshold and last increased it to \$40 per capita for any state as part of the 2025 Methodology Review.⁷

It should be noted that the 2018 legislation changes have added considerable complexity to the final stages of calculating relativities. The interaction of the equalisation benchmark, relativity floor, GST pool top-ups and blended relativities over the six-year transition period has introduced significant complexity into the system and are poorly understood by the general public.

An EPC distribution of GST achieves simplicity, predictability and transparency

NSW considers that an EPC distribution of GST grants is the best way to achieve outcomes that are simple, predictable and transparent. Under an EPC distribution, each state would receive a share of the total pool of GST revenue equal to their share of the national population.

The simplicity and transparency of an EPC system would increase confidence in the GST distribution system. Basing the calculation on publicly available and timely data would remove the need for subjective judgements by the CGC and the ability for states to game the system. The current equalisation task is complex, resource intensive and subject to data challenges. The amount of CGC and state administrative resources dedicated to an EPC system would be greatly reduced.

An EPC model would remove any possible disincentives for states to undertake efficiency-enhancing revenue and expenditure reforms. By increasing states' responsibility for improving their

⁷ In the case of NSW, this materiality threshold is equivalent to around \$350 million.

own fiscal capacities, it would encourage states to consider ways to improve their own tax bases and achieve greater levels of efficiency and better outcomes in service delivery.

Distributing GST grants on an EPC basis would also produce more stable outcomes, as the population of a state does not vary significantly on an annual basis. This would allow more fiscal certainty for state governments, noting that GST represents a major source of untied revenue for states. Moreover, an EPC distribution would be contemporaneous. This would remove the pro-cyclical nature of the current system, allowing states to appropriately manage their budgets in response to changing circumstances. Section 4 of this submission discusses this issue further.

An EPC approach accompanied by top-up funding for fiscally weaker states would ensure that a reasonable level of HFE is achieved. Top-up funding would be provided by the Australian Government from outside the GST pool. Table 1 sets out the distributional impacts of an EPC distribution of GST grants (prior to any adjustments), should it have been applied in 2025-26.

Table 1: Comparison of EPC and full HFE distribution of GST grants, 2025-26 \$ per capita

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
HFE	3,230	3,928	2,910	636	5,051	6,590	4,305	18,322	3,414
EPC	3,414	3,414	3,414	3,414	3,414	3,414	3,414	3,414	3,414
Difference	+184	-514	+504	+2,788	-1,637	-3,176	-891	-14,908	Nil

Source: NSW Treasury estimates

NSW recognises that an EPC distribution of GST grants without top-ups would have the most significant impact on the budget of the NT. The Australian Government could fund special grants to the NT from outside of the GST pool. The NT is an outlier jurisdiction whose fiscal capacity is affected by its remoteness and the Indigenous share of its population. These special grants from the Australian Government would recognise the differing financial circumstances that the NT faces. Top-up funding would also need to be considered for SA and Tas due to their weaker economic circumstances.

An EPC distribution of GST grants could be achieved by either a five- or ten-year transition path commencing in 2030-31, following the expiration of the No Worse Off Guarantee in 2029-30. Under both options, GST relativities could be calculated using a weighted average of the relativities applying under current arrangements (without the No Worse Off Guarantee) and an EPC distribution in a similar manner to the six-year transition for the 2018 legislative changes.

Alternative consensus model for reasonable HFE

NSW recognises that achieving sufficient national consensus on a significant change to GST distribution arrangements is likely to be difficult.

In recognition of the preference expressed by other jurisdictions to restore 'pre-2018' arrangements, NSW proposes the following alternative arrangements for the distribution of GST grants commencing from 2030-31 could be considered, including several important modifications:

- The restoration of HFE as applied prior to 2018-19 with GST relativities recommended by the CGC.

- The introduction of a safety net relativity floor for all states set at 0.5 rather than the current floor of 0.75.
- Funding of the new relativity safety net floor by the Australian Government.

We believe this alternative model balances the need to promote Australia as a country that values its citizens wherever they live but also recognises that the citizens of states have a right to receive a defined, minimum distribution from the GST pool.

Going forward, NSW believes the proposed new relativity floor is likely to be activated only in rare circumstances and thus will be considerably less costly to the Federal Budget than the existing arrangements. However, the proposed relativity floor will provide reassurance to all states that they will not be at risk of the extreme outcomes faced by WA over the past 10 years. A relativity floor of 0.5 also ensures there is a fair distribution to all states of any windfall revenue flowing to only one state associated with future economic uncertainties.

It is worth noting that in such exceptional circumstances, most likely arising from significant mining sector windfalls, the Australian Government will receive fiscal benefit in the form of increased company tax and potentially personal income tax receipts. While others are better placed to quantify these impacts, they are highly unlikely to be sufficient to offset the fiscal burden imposed on the Australian Government by the 2018 deal. They are likely, however, to provide capacity for the Australian Government to support a reasonable consensus option in a way that is not available to the other states.

The need for a transition to this model of HFE would depend on the fiscal circumstance of WA in 2030-31. Should WA's underlying HFE relativity rise above the current 0.75 safety net floor, no transition would be needed. On the other hand, if WA's relativity is materially below 0.75, transitional payments to WA funded by the Australian Government could be considered.

Differences between HFE based funding and actual expenditures

As outlined above, HFE provides states the capacity to deliver a comparable standard of public services and infrastructure by making a comparable revenue effort and operating at a comparable level of efficiency.

While HFE provides the capacity to deliver comparable services, states are free to set their own policies consistent with local preferences. In most cases, differences between state policies are not material. However, in some cases, the difference between assessed and actual expenditure calls into question the rationale underpinning the distribution of GST grants with this also having potential national implications.

The PC should consider whether differences in the assessed and actual expenditures of states result in a loss in national productivity and whether the Australian Government should consider providing National Competition Policy style reward payments in these circumstances. Such an approach is likely to see improvements in the effectiveness of government spending and therefore enhance national productivity.

3 Failure of the 2018 legislative changes

Prior to 2018-19, the distribution of GST grants in Australia was designed to allow each state to provide a comparable standard of public services and infrastructure by making a comparable revenue effort and operating at a comparable level of efficiency. Historically, this has resulted in NSW receiving less than its equal per capita share of Australian Government funding due to its more diverse and stronger economic base.

The mining boom commencing in the mid-2000s saw a strong increase in WA iron ore royalties and significant strengthening in its finances. This resulted in WA's relativity falling by the mid-2010s to levels unprecedented in the history of HFE in Australia and claims that WA was being treated unfairly under HFE. The rapid reduction in the WA relativity also resulted in claims that state shares of GST had become too volatile and that this was creating significant budget management issues for states.

In response to the concerns expressed by WA with the fairness of its GST share, the Australian Government commissioned the PC to review HFE arrangements (the 2018 PC Review). The 2018 PC Review examined whether the existing HFE model adequately reflected differences in states' individual fiscal circumstances and whether it created disincentives to enhance revenue raising or efficiencies in spending.

Following the 2018 PC Review, the Australian Government formally introduced changes to HFE arrangements from 2021-22 that differed from the PC's recommendations. These changes have materialised as a significant fiscal advantage for WA.

The 2018 legislative changes to HFE and associated top-up funding to states introduced by the Australian Government have weakened the achievement of HFE. While the 2018 legislative changes have delivered favourable fiscal outcomes for WA, they have resulted in significant inequity for residents in other parts of Australia.

The inequities created by the 2018 legislative changes will be further exacerbated if the No Worse Off Guarantee provided by the Australian Government is not extended beyond 2029-30, as this will see the 2018 legislative changes funded by states other than WA.

Finally, the 2018 legislative changes have imposed significant cost on the Federal Budget with little measurable national economic benefit.⁸

⁸ Since 2018, economic growth in WA has been similar to the national average.

What changes to GST were introduced in 2018?

The key changes introduced in the 2018 legislation were:

- The use of the fiscally stronger of NSW or Vic as the benchmark HFE state from 2026-27. Previously, HFE was based on the fiscally strongest state which, in recent years, had been WA due to the substantial increase in its mining royalties. Under the current approach, WA retains any fiscal strength greater than either the stronger of NSW or Vic rather than sharing its higher fiscal capacity with all states. In effect, WA receives a higher share of Australian Government funding than would occur under normal HFE.
- The introduction of a relativity safety net floor for all states of 0.7 commencing in 2022-23 rising to 0.75 from 2024-25.
- The 'topping up' of the GST pool by the Australian Government in perpetuity.

To ensure no state had an effective relativity below 0.7 (and 4.66024 for the NT), the Australian Government provided additional funding between 2018-19 and 2021-22 of \$5.2 billion of which \$4.9 billion was provided to WA. As a transitional measure, the Australian Government also guaranteed that no state would be worse off under the new arrangements. Between 2018-19 and 2025-26, it is estimated that the changes to HFE arrangements along with transitional top up payments to the states will cost the Federal Budget \$28.8 billion.

Chart 1 shows annual GST relativities, as calculated by the CGC, since the introduction of the GST in July 2000, after removing the impact of the 2018 legislative changes. The data indicate:

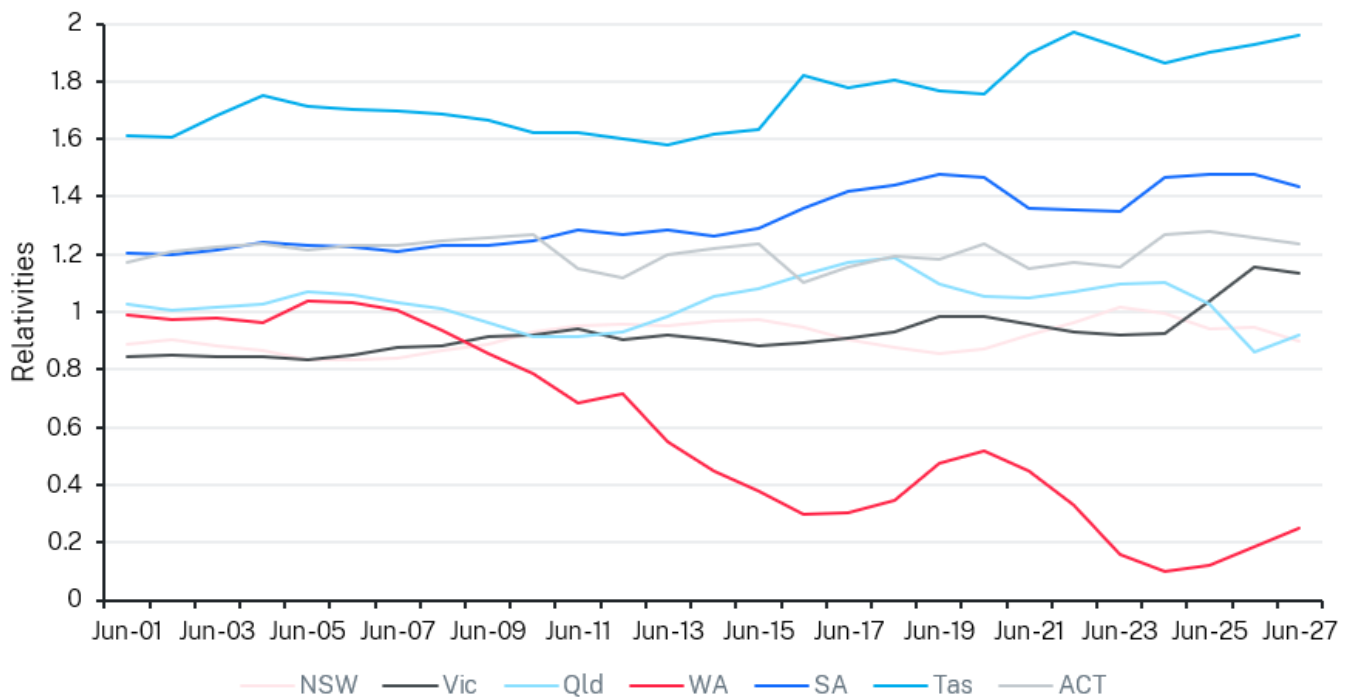
- A significant downward trend in the relativity of WA commencing from around the beginning of the mining investment boom which is associated with increased revenue from iron ore royalties.
- An upward trend in the relativities of Vic, SA and Tas.
- Significant volatility in the relativity of WA.

Note that changes in the relative fiscal strength of one state impacts on the relativities of all states. For example, the decline in the relativity of WA has resulted in an increase in the average relativity of other states.⁹

Chart 1 excludes the NT, which had a relativity of 5.24 in 2026-27. This exceptionally high relativity highlights that the NT's fiscal circumstances are structurally different from other states requiring a substantial level of fiscal equalisation.

⁹ Under the CGC's methodology, the population weighted sum of state relativities is equal to 1.

Chart 1: Assessed GST relativities (excluding NT)



Source: Commonwealth Grants Commission

The 2018 legislative changes undermine the principle of HFE and provided a fiscal advantage to WA

The Australian Government has a long history in providing grants to assist fiscally weaker states dating back to Federation. Over time, the distribution of general purpose funding has evolved into the current comprehensive HFE arrangements that now underpin the distribution of GST grants.

Since the early 1980s and up until 2018-19, the distribution of Australian Government general purpose grants to the states¹⁰ was underpinned by the objective of achieving comprehensive HFE.¹¹ Under the *Intergovernmental Agreement of Federal Financial Relation 2009*, the Australian Government was required to distribute GST payments among the states in accordance with the principle of HFE.

In the period from 2018-19 to 2021-22, the Australian Government provided ad hoc general purpose top up grants to WA and the NT outside the HFE arrangements to support a higher relativity for those states. However, from 2021-22, the 2018 legislative changes formally shifted from distributing general purpose grants (GST grants and top up grants) based on achieving full HFE. This will see

¹⁰ Australian Government general purpose grants between 2000-01 and 2017-18 represented the distribution of GST revenues. Since 2018-19, additional general purpose grants have been provided by the Australian Government to effectively support the relativities of most states.

¹¹ The NT was included within HFE from the late 1980s while the ACT was included in HFE in the early 1990s.

WA fiscally advantaged on an ongoing basis if recent structural changes to its fiscal position continue.

While many federations have equalisation arrangements, Australia is one of the few federations to pursue full or comprehensive HFE. The 2018 legislative changes moved Australia away from full HFE and opened a level of fiscal disparity between states, which appears to be becoming more entrenched over time. This represents a move towards the system that prevails in the United States, where no dedicated federal program designed to directly reduce fiscal disparities between states exists.¹² While the extent of HFE as practised in Australia has been a matter of some contention, full HFE is a long-standing practice and any permanent departure from full HFE will likely require some form of national consensus.

The current fiscal advantage provided to WA results from the 2018 legislative changes largely excluding the revenue windfall associated with mineral wealth in the north of the state from relativity considerations. These benefits are largely an artifact of historical border arrangements and the current resources cycle. WA was a beneficiary of HFE for around 100 years with Australian Government special grants commencing in 1910-11, and changing world circumstances may well see WA become a HFE beneficiary in future years.

The WA Government has received an additional \$28.5 billion in GST revenue and transitional payments in the period to 2025-26 because of the changes to HFE arrangements implemented since 2018-19.

The 2018 legislative changes have provided direct support for WA's credit rating which in turn has helped support comparatively lower costs of borrowing for the state. WA remains one of the few jurisdictions globally, and the only Australian state, to maintain a triple-A credit rating from both Moody's and S&P Global.

Have the 2018 arrangements reduced the volatility of GST relativities?

Reducing the volatility of GST relativities was a key justification for the introduction of changes to HFE arrangements following the 2018 PC Review. The 2018 legislative changes and No Worse Off Guarantee have effectively provided all states except WA with the same degree of GST volatility as would have occurred prior to 2018.

Much of the volatility in relativities in recent years has arisen due to volatility in WA finances caused by significant annual changes in iron ore royalties.¹³ The introduction of a relativity safety net floor when activated for WA should reduce the volatility of relativities for all states. Under the CGC's methodology, the populated weighted sum of state relativities is equal to 1 and reduced relativity volatility for one state is mirrored by reduced relativity volatility for other states.

¹² There are some Federal Government programs where the eligibility criteria effectively result in some partial HFE.

¹³ Table 4 in Section 4 shows the magnitude of revenue volatility for WA compared with other states.

Section 4 discusses possible changes to HFE arrangements to better manage volatility and better align the timing of changes in GST relativities with changes in the underlying fiscal circumstances of states.

4 Improving the operation of the HFE system

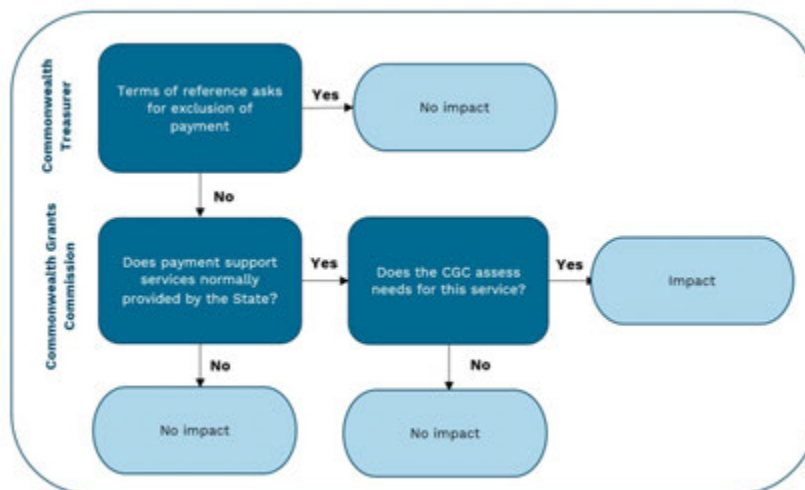
While HFE as practised in Australia is sophisticated by world standards, improvements can be made to the way it operates. These changes would improve HFE outcomes, including its responsiveness to changing circumstances, address issues of GST grant volatility and uncertainty and support state reforms and efficient service delivery.

Treatment of Specific Purpose Payments

As outlined earlier, HFE in Australia attempts to ensure that each state can provide a comparable standard of public services and infrastructure by making a comparable effort and operating at a comparable level of efficiency. Given this, an effective HFE model for the distribution of GST grants needs to consider the impact of differences in the distribution of specific purpose payments (SPPs) where these payments are used to fund state services or infrastructure. In such circumstances, states that receive a higher per capita share of SPPs will have a lesser per capita need for GST funding to deliver these services or infrastructure.

The CGC has adopted the following decision framework for assessing whether SPPs should impact the distribution of GST grants.

Figure 1: Commonwealth Grants Commission decision framework for the treatment of SPPs



Source: Commonwealth Grants Commission, 2022a

Under its Terms of Reference, the Australian Treasurer may instruct the CGC to ensure that a nominated SPP does not impact the distribution of GST grants between the states. That is, the Australian Treasurer requires the CGC to quarantine the nominated SPP from its assessments.

The Australian Treasurer is not required to provide reasons for quarantining an SPP in the Terms of Reference, however quarantining generally arises in the following circumstances:

- Where a state is undertaking a function on behalf of the Australian Government.

- Where a state is undertaking a project of national significance on behalf of Australia as a whole (for example, hosting the Olympics).
- Where an Australian Government agency successfully argues the SPP has been distributed on a 'needs basis' and this distribution should not be overridden by HFE arrangements.
- Where the Australian Government, as part of its negotiations with certain states, agrees to quarantine a SPP as an added incentive to facilitating a deal with that state.

States have a vested interest in seeing a SPP quarantined from HFE where that state receives a higher per capita share than its assessed needs as determined by the CGC. In the first two cases outlined above, quarantining SPPs through the Terms of Reference appears appropriate. However, in the last two circumstances we believe quarantining is likely to be inappropriate.

Historically, NSW has opposed quarantining SPPs from HFE through the Terms of Reference for several reasons:

- The assessment of expenditure needs by the CGC should be transparent and comprehensive and likely to be more in line with the actual needs of states based on independent data. On the other hand, the interstate distribution of an SPP sought by an Australian Government agency may reflect other policy objectives.
- The Australian Government is incentivised to agree to a generous deal that quarantines a SPP from HFE for the smaller states where the cost to the Federal Budget is relatively low. Given such circumstances, quarantining of SPPs is generally not in the financial interest of NSW (and other large states).

Quarantining of SPPs through the Terms of Reference undermines the achievement of HFE and should only occur in extraordinary circumstances. To ensure this occurs, the PC should recommend that the Australian Treasurer be required to provide reasons for the quarantining of any SPPs as part of the publicly released Terms of Reference for the CGC.

While not formally quarantined from HFE, the treatment of other SPPs by the CGC can also effectively see them quarantined from HFE. This arises where:

- The SPP does not support services or infrastructure normally provided by states.
- The SPP is associated with an expenditure category where the CGC does not assess differential expenditure needs.

NSW supports quarantining SPPs for services and infrastructure not normally provided by states, however we are concerned with the treatment of SPPs where the CGC does not assess differential expenditure needs. In practice, these payments fall into two categories:

- SPPs supporting state expenditure where differential expenditure needs are expected to exist, but no feasible methodology to assess expenditure needs has been determined. An example of this would be any SPP currently associated with environmental protection.
- SPPs supporting state expenditure where no differential expenditure needs are thought to exist.

In both cases, we believe that, on balance, HFE is more likely to be achieved by the CGC if these SPPs are not effectively quarantined from HFE.

More broadly, NSW is concerned with the exclusion of some expenditure and revenues from the CGC assessments as it results in significant differences between CGC data and other published sources, such as that provided by the Australian Bureau of Statistics (ABS). We believe such differences create confusion, are unnecessary and potentially allow data errors to arise. With this in mind, we believe a better approach to HFE would be for the CGC data to closely match aggregate published ABS data regardless of whether the CGC undertakes a differential assessment of the expenditure. In this way, the quality of both data sets is likely to improve.

Reducing the impact of HFE on state policy decisions

As outlined in Section 2, it has been suggested that HFE as practised in Australia can impact state policy decisions by:

- Reducing the incentive for states to improve the efficiency of service delivery.
- Distorting the spending and revenue raising priorities of states, including the ability of states to undertake major tax reform.

Impact on state service delivery efficiency

States have different average per capita service delivery expenditure for various reasons including:

- Demographic factors: Some states such as Tas and SA have on average an older population which increases health costs but reduces school education expenditure. Also, the share of Indigenous Australians in some states is higher, raising the average cost of service delivery.
- Location specific factors: Some states are more decentralised than others resulting in higher average unit costs as service delivery is generally more costly outside of metropolitan areas.
- Differing levels of technical efficiency.

NSW Treasury modelling indicates that changes in technical efficiency of states can impact the distribution of GST. For example, a deterioration in the technical efficiency of a state with assessed expenditure needs results in higher GST distributions to that state. However, importantly, any change in the GST received by an inefficient state is minor relative to the additional direct cost borne by the inefficient state.

NSW believes that it is highly unlikely that CGC processes have any significant impact on the desire of states to deliver services in the most efficient manner possible. As a matter of budget practice, it is highly unlikely that any line agency would recognise and rely on receiving any GST feedback from treasuries associated with changes in their level of service delivery efficiency. However, it is worth recognising that where states may be achieving a relatively higher level of service delivery efficiency, they may perceive a lack of appropriate recognition for this endeavour.

Impact on state expenditure priorities

In the past it has been suggested that HFE can distort the service delivery mix adopted by states. In theory, a state with a higher-than-average per capita assessed service delivery cost due to demographic or location specific factors can raise their share of GST by increasing expenditure in that functional area. This is because higher expenditure in an area where a state has a service

delivery disadvantage increases the absolute size of this per capita disadvantage, which the distribution of GST is designed to offset.

In practice, the benefit of increasing or decreasing expenditure to maximise GST is minimal and is greatly outweighed by the policy implications. Furthermore, the extent of any changes in GST distributions will depend on the size of the gap between a state's share of assessed expenditure and its national population share. In most expenditure functions, this gap is small and therefore any theoretical redistribution of GST is also small.

In summary, while the above gaming behaviours are theoretically possible, the policy and financial implications are such that they are unlikely to occur in practice.

However, we would note that there is often some ambiguity associated with the administrative allocation of expenditure to functions. Where this is the case, states have a vested interest in allocating expenditure to categories where their GST will be maximised. NSW is not aware that any state adopts such a practice, but some additional quality assurance regarding the functional allocation of expenditure should be considered.

Impact on state revenue policies

While changing the expenditure mix to maximise GST distributions is unlikely, the impact of HFE on state revenue policy is likely to be more significant. This is because the divergence between the distribution of revenue bases and population is often much greater. Three areas where this is particularly an issue are land tax, stamp duty on conveyances and various sub-components of the mining revenue assessment. The variation between the distribution of the assessed revenue base across states and a state's population share is shown in Attachment B along with the extent to which the state uses the tax base relative to the national average.

Land Tax and Stamp Duty on Contracts and Conveyances

As shown in Appendix B, the CGC estimates that NSW holds 47.8 per cent of the national land tax base which is 16.5 per cent higher than its share of Australia's population. This difference reflects NSW's assessed revenue raising advantage in land tax. On average NSW's average tax rate is only 81.6 per cent of the national average.

The very significant theoretical advantage for NSW for both land tax and stamp duty on contracts and conveyances is shown in Appendix B has several significant policy implications:

- NSW could increase its GST revenue by reducing its land tax revenue effort and increasing its reliance on stamp duty on conveyances.
- Other states, except Vic, could maximise their GST revenues by imposing higher tax rates on land and property transfers at the expense of NSW and Vic. In the case of Vic, the imposition of higher land and property transfer taxes slightly reduces its GST revenues but has a significant negative impact on NSW GST distributions.¹⁴

¹⁴ This requires the assumption that there is no impact of the higher tax rates on the measured size of Vic's tax base.

Further, we would point to the impact of the absence of elasticity adjustments within the CGC assessment methodology. As shown in Appendix B, average tax rates on land and property transfers are lower-than-average for NSW but significantly higher than average in Vic. As widely recognised in economic literature, taxes have an impact on the measured size of a tax base.

The absence of elasticity adjustments represents a serious flaw in the CGC's revenue assessment methodology which has significant implications for tax policy development.¹⁵ For example, in the case of land tax, the CGC's assessment of the NSW revenue base is over estimated relative to other states due to:

- Significantly higher tax rates in Vic suppressing its CGC measured tax base.
- Significantly lower-than-average tax rates in NSW inflating its CGC measured tax base.

The negative GST impacts associated with possible tax reform in NSW are significantly magnified because the CGC overestimates the relative size of the NSW land tax base by not taking into account revenue elasticity adjustments.

Mining Royalties

The potential impact of HFE on state mining revenue policy has been the subject of considerable debate. In particular, the extent to which a state should benefit from a change in revenue policy after allowing for the flow on GST impacts. For example, in the case of iron ore royalties, should WA increase its revenue effort, 88 per cent of the additional revenue raised will be eventually redistributed through HFE to other states.

Table 2 illustrates the impact of a hypothetical \$100 million increase in WA's iron ore royalties on GST distributions after allowing for the inherent lags in CGC's assessment methodology and ignoring the current relativities safety net floor for that state.

Table 2: Net revenue impact of an increase in WA's iron ore royalties

\$million	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32
<i>WA Impact</i>						
Additional Royalties Raised	100	100	100	100	100	100
Change in GST Revenues*	0	0	-29.3	-58.7	-88.0	-88.0
Net WA Revenue Change	100	100	70.7	41.3	12.0	12.0
<i>Other states Impacts</i>						
Increase in GST Revenues	0	0	29.3	58.7	88.0	88.0

* Additional revenue begins to impact GST distributions with a two-year lag.

Source: NSW Treasury

Table 2 highlights the potential for iron ore revenue policy in WA to be influenced by HFE redistributing 88 per cent of the additional revenue raised to other states. It should be noted that the potential for similar policy distortions could arise for some other metals and minerals, such as gold, lithium, nickel, copper and coal.

¹⁵ This matter was discussed in detail in NSW submissions to the 2025 Methodology Review by the CGC.

The CGC has considered several times various approaches to reduce the potential for HFE to distort state revenue policy decisions. In proposing these options, it is necessary to:

- Define the circumstances under which dominance exists in a specific revenue category requiring a modification to the existing HFE model.
- Define the nature of the modification to the existing CGC approach to assessing revenue required under HFE due to the dominance of one state within a revenue category.

In respect to the first issue, it is reasonable to define dominance as a situation where a revenue policy decision results in an ongoing budget impact of less than 50 per cent of the gross revenue associated with the policy change. This will arise when a state's share of a nominated tax base exceeds its population share by more than 50 per cent.

The CGC has identified several approaches to modify HFE where a dominant state in a revenue category exists and the state undertakes a policy change:

- Assessing equal per capita part of the additional revenue raised by a dominant state.
- Discounting mineral assessments with a dominant state issue.
- Using external standards in mineral assessments with a dominant state issue.
- Fully or partially aggregating the CGC's current mineral-by-mineral assessment.
- Assessing revenue raising capacity using profitability rather than production.
- Phasing into its assessments any changes in revenue due to changes in state policy.

NSW believes that the key to reducing the potential HFE impact on state revenue policy decisions where a dominant state exists is to extend the period over which the revenue impact of the policy change flows through to GST distributions.

Our proposed approach is illustrated in Table 3 using a hypothetical scenario based on WA being a dominant state with 98 per cent of a mining revenue base and representing 11 per cent of Australia's population.¹⁶ It shows that under existing HFE principles, the full GST impact of a policy change occurs after a lag of four years. NSW proposes that this period be extended to six years by phasing in the revenue impact of a policy change by a dominant state over five years.

Under this proposal, changes in commodity prices would continue to impact HFE assessments, with any change in revenue from a policy adjustment flowing through more slowly. The potential for any distortionary impact from HFE is therefore significantly reduced. We believe our proposal represents a pragmatic solution to the dominant state issue which does not cause too much damage to the principle of HFE.

¹⁶ These assumptions equate to the position WA finds itself in with iron ore royalties.

Table 3: Proposed phasing in of a revenue policy change where a dominant state exists

\$millions	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33	2033-34
<i>Existing CGC Approach</i>								
Additional Revenue raised								
- HFE Assessed	100	100	100	100	100	100	100	100
- EPC Assessed	0	0	0	0	0	0	0	0
Impact on GST Revenues	0	0	-29.3	-58.7	-88.0	-88.0	-88.0	-88.0
WA Net Revenue from Policy Change	100.0	100.0	70.7	41.3	12.0	12.0	12.0	12.0
<i>Proposed Approach</i>								
Additional Revenue raised								
- HFE Assessed	20	40	60	80	100	100	100	100
- EPC Assessed	80	60	40	20	0	0	0	0
Impact on GST Revenues	0.0	0.0	-5.9	-23.5	-52.8	-70.4	-88.0	-88.0
WA Net Revenue from Policy Change	100.0	100.0	94.1	76.5	47.2	29.6	12.0	12.0
GST benefit from proposed change in CGC assessment methodology								
	0.0	0.0	23.4	35.2	35.2	17.6	0.0	0.0

Source: Commonwealth Grants Commission and NSW Treasury

In summary, we believe there is a plausible case HFE, as currently practised in Australia, may affect the revenue policy decisions of state governments. To minimise this risk, we propose:

- The introduction of elasticity adjustments for differences in tax rates where these are significant in respect to state revenues.
- Phasing in the revenue impact of state policy changes where this policy change is introduced by a dominant state.

Managing volatility in GST distributions

Over time the relative fiscal circumstances of states change due to:

- Expenditure or investment needs of states. This can occur due to changes in relative demographics, such as population share, socio-economic characteristics and population location (especially following publication of new census data).
- Revenue raising capacity of states. This can arise predominantly because of property market or commodity price cycles.
- The distribution of Australian Government SPPs.
- Changes in the methodology used by the CGC to determine the fiscal capacity of states.¹⁷

Few would argue that these changes in fiscal circumstances should not be reflected promptly in the distribution of GST grants. However, in recent years the volatility of GST relativities has been perceived to be excessive.

In a perfect world, GST relativities in a financial year would reflect the fiscal circumstances of states in the same financial year. That is, changes in the relative fiscal circumstances of a state from year to year would be offset by changes in that state's share of GST grants. Under such an arrangement, the overall relative fiscal circumstances of states would be expected to remain relatively stable. From this perspective, year-to-year changes in GST relativities should be seen as an essential design feature of a comprehensive HFE model.

Changes in GST distributions are problematic for state budgets when:

- The changes to the distribution of GST grants are significant and come as a surprise late in the budgeting process.
- The time lags embedded in HFE see changes in GST distribution being pro-cyclical.

NSW proposes a range of possible operational changes that would help resolve these issues.

Earlier advice on likely changes to GST relativities

Currently, relativities for the coming financial year are advised to states in late February based on a three-year moving average of data up to June of the previous financial year. That is, the relativities applying in 2026-27 will be based on data for 2022-23, 2023-24 and 2024-25. Earlier advice of likely changes in GST relativities would therefore allow for improved budget management.

NSW Treasury has analysed the sources of volatility in GST distributions based on published CGC data that utilised methodology from the 2020 Methodology Review.¹⁸ Our analysis indicates that a

¹⁷ Changes in Commonwealth Grants Commission methodology are generally on a five-yearly cycle with the last methodology review reporting in 2025 with the recommended relativities being implemented in 2026-27.

¹⁸ Data was taken up to 2022-23 to ensure comparability of volatility prior to method changes introduced in the 2025 Methodology Review.

major source of volatility arises from the revenue side of the CGC's calculations as shown in Table 4. Revenue volatility is particularly a challenge for WA, Qld and the NT.

Table 4: Sources of annual volatility in GST distribution – Absolute Values Per Capita

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<i>Expenses and Investment less Australian Government Payments</i>								
2017-18	89	96	12	305	357	141	202	501
2018-19	83	79	26	448	16	140	65	256
2019-20	101	118	125	133	363	17	86	129
2020-21	234	193	184	147	131.9	138	3	605
2021-22	41	13	225	351	136	79	7	1,884
2022-23	149	210	63	205	143	505	682	805
Average Absolute Value	116	118	106	265	191	170	174	697
<i>Revenue</i>								
2017-18	5	69	59	32	23	2	141	85
2018-19	114	36	51	315	64	131	112	298
2019-20	124	19	112	556	125	187	85	457
2020-21	60	182	421	1,275	193	292	125	349
2021-22	207	251	652	760	551	465	203	262
2022-23	145	401	556	153	360	371	258	561
Average Absolute Value	109	160	308	515	219	241	154	335
Revenue to expense Ratio	0.94	1.35	2.91	1.94	1.15	1.42	0.88	0.48

Note: Each row represents the contribution to the change in the GST requirement for each jurisdiction calculated by the CGC. For example, in 2022-23 data year, changes in the revenue raising capacity of NSW contributed to a \$146 per capita reduction in its GST requirement for that data year compared with 2021-22. Data taken up to 2022-23 to ensure comparability of volatility prior to method changes introduced in the 2025 Methodology Review.

Source: Various Commonwealth Grants Commission Reports.

The results shown in Table 4 are not surprising as the expenditure side of the CGC calculations tend to reflect longer term structural changes in state expenditure needs. In contrast, many of the CGC revenue assessments reflect market volatility arising from short term economic cycles, particularly in property and commodity markets.

All states have GST relativity forecasting models. The accuracy of these forecasting models could be improved by the earlier provision to the states of key data by the CGC.

Revenue data are provided by the states to the CGC in October and could be made available to the states around that time for input to their GST forecasting models. This would allow states to update their GST revenue forecasts for inclusion in half-year reviews and provide a firmer base for budget deliberations.

Consideration should also be given to early provision to states of other key data elements of the CGC relativities model, including revisions to past published data and SPPs which can also be a source of considerable volatility in GST relativities.

Improving the contemporaneity of GST relativities

As outlined above, states can face budget difficulties where the time lag in CGC assessments results in relativities applying in a financial year that do not reflect a state's fiscal circumstances in that year. Given economic cycles, there have been many instances in the past where states have seen a temporary revenue boom fade at the same time as their GST distributions fall due to the average three-year lag in the CGC's assessments. Improving the contemporaneity of GST relativities and/or providing earlier advice on changes to GST relativities would help states manage GST volatility and their budgets. Shortening the current average three-year gap between the application year and the data on which relativities were calculated will go some way to resolving this issue.

Consideration could be given to shortening the current time lag to an average of two years. Under a revised model, preliminary relativities for the current financial year would be based on the existing arrangements (that is, current relativities for 2026-27 are based on data for 2022-23, 2023-24 and 2024-25), with the final relativities for 2026-27 updated to using the three latest years of data (that is, 2023-24, 2024-25 and 2025-26) following the Treasurer's acceptance of the CGC's report in March. This is illustrated in the following example in Table 5 for relativities applying in 2026-27.

Table 5: Comparison of current and proposed revised GST arrangements

GST Application Year	Current Arrangements	Proposed New Arrangements	
	Data Years	Preliminary Data Years	Final Data Years
2026-27	2022-23	2022-23	2023-24
	2023-24	2023-24	2024-25
	2024-25	2024-25	2025-26

Source: NSW Treasury

Adopting the revised approach would shorten the fiscal time lag faced by states from three years to two years improving the contemporaneity of GST distributions. Offsetting this would of course be increased uncertainty at budget time of GST distributions for the coming financial year.

Delayed application of GST relativities

An alternative approach to managing uncertainty would be to delay the application of updated relativities by a further year. Under this approach, relativities announced in March 2027 would be implemented in 2028-29 rather than 2027-28.

While this approach provides greater budget formulation certainty and provides a longer period for states to adjust to future changes in GST distributions, it extends the current average three-year gap between the application year for relativities and the data on which it is based. This approach to reducing GST relativity uncertainty sees a worsening in the contemporaneity of HFE.

On balance, NSW does not favour this approach.

5-year relativities

Over recent history, the CGC has used both three and five-year data periods for the calculation of GST relativities. Most recently, the CGC moved from a five-year to a three-year data period following the 2010 Methodology Review. While a five-year data period would reduce the volatility of GST

relativities, this would be at the expense of contemporaneity with relativities being an average of four years out of date rather than three years at present.

NSW does not support this reduction in the contemporaneity of GST relativities as it increases the risk that GST distributions in a year have little relevance to the finances of states in that year.

Forecasting GST relativities

The CGC makes annual recommendations to the Australian Government on how GST revenue should be distributed among the states. Currently, the CGC only recommends GST relativities for the upcoming financial year. The CGC has previously noted that forecasts of a state's GST share beyond one year would be highly uncertain, as they would depend on expectations about revenue and expenses, non-contemporaneous data and assumptions about the movements of all these factors across all states.

While it is true that the task involves a high degree of uncertainty, states face an arguably greater degree of uncertainty when forecasting GST relativities to inform their budget processes. This is because changes in GST relativities are driven by changes in the relative fiscal capacities of all states. While an individual state can reasonably forecast its own revenue and expenditure drivers, it is limited in the data it can access to prepare these forecasts for all other states.

The CGC should provide four-year GST relativity forecasts every six months, rather than the current approach of providing a single-year forecast once every year. These forecasts could be accompanied by necessary caveats setting out the high degree of uncertainty and noting that forecasts are intended to give an indication of direction and magnitude of changes only.

The CGC is better placed than states to forecast relativities, given its access to state financial and other data it receives to inform its calculations, including where states or other data custodians have imposed confidentiality restrictions on underlying data. NSW recognises that the CGC has a small, specialised workforce, that may face resourcing constraints in taking on this additional responsibility.

5 Fiscally sustainable future

As widely accepted, public finances in Australia will come under increasing pressure and in the absence of significant policy adjustments, government debt will grow to unsustainable levels. Given this, policy measures will need to be put in place over the coming years and will involve a combination of adjustments to both revenue and expenditure. Improvements in the efficiency of government service delivery will be insufficient to close the widening projected fiscal gap in both state and Australian Government finances. The effective management of these policy changes will have a significant impact on the future prosperity of Australia.

The distribution of GST grants impacts fiscal sustainability, with the current arrangements materially advantaging WA at the expense of other states. The fiscal sustainability of the Australian Government has also been undermined by the costs of the 2018 arrangements.

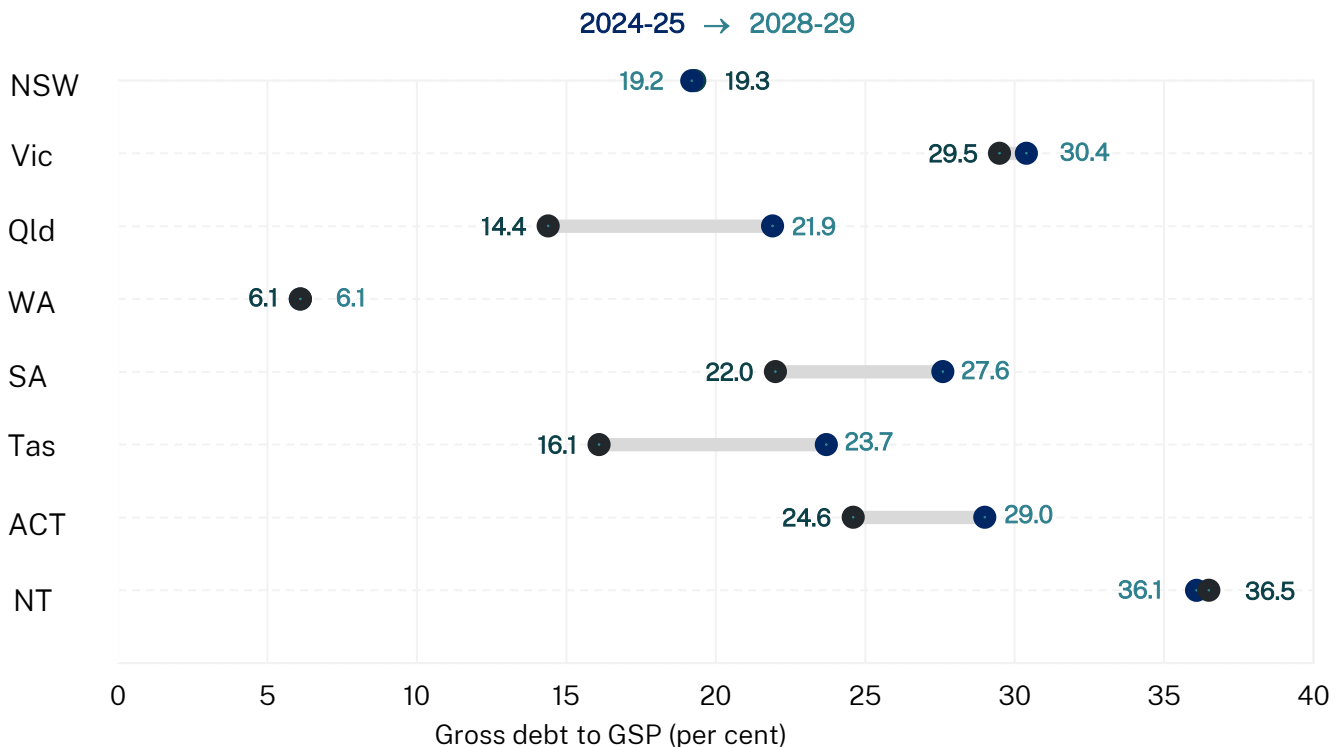
All Australian Governments face long-term spending pressures

The 2023 Australian Intergenerational Report (IGR) projects slower economic growth will place pressure on the federal tax base at a time of rising costs, creating a long-term fiscal challenge for the Australian Government.

Structural pressures on the Federal Budget will inevitably have flow on implications for payments to the states.

Many states are also facing fiscal pressures. As highlighted in Chart 2, QLD, SA, Tas and the ACT are all expecting significant increases in their gross debt to Gross State Product (GSP) ratios over the forward estimates.

Chart 2: General government gross debt to GSP



Source: Australian State and Territory 2025-26 Half-Yearly Budget Reviews or equivalent (Vic, Qld, WA, SA, NT, ACT and NSW), 2025-26 Budget Papers (Tas); Australian Bureau of Statistics (ABS) and NSW Treasury.

The 2021-22 NSW IGR projected the fiscal gap to reach 2.6 per cent of GSP by 2061, which would see net debt levels reaching 100 per cent of GSP.¹⁹ The mismatch between expenditure and revenue raised is expected to remain over the next 40 years, creating an ongoing reliance on debt and increasing interest costs.

The long-term fiscal outlook signals a growing risk to NSW's fiscal sustainability. This is defined as its ability to maintain provision of essential services and to implement its spending, tax, and related policies without a substantial risk of insolvency, or failure to meet financial obligations. An ageing population, rising community expectations and climate impacts are expected to place continuous upward pressure on the cost of essential services.

- **Ageing population:** By 2061 a significantly larger share of the NSW population will be aged 65 and over, raising the old-age dependency ratio, placing pressure on the working-age population and public finances. This will see an unavoidable increase in demand for health services with greater patient complexity and rising input costs.
- **Community expectations:** Growing community expectations for higher-quality public services place upward pressure on service delivery costs. For example, spending on disability, including contributions to the NDIS and Foundational Supports is expected to increase as new policy

¹⁹ The long-term projections for NSW presented in this section are based on data published in the 2021-22 NSW IGR. Updated figures will be provided in the upcoming 2026-27 NSW IGR, scheduled for release by June 2026.

agreements come into force over the next decade. Community expectations in this area continue to rise.

- **Climate change impacts:** More frequent and severe natural disasters are expected to see economic costs to NSW increase to between \$15.8 and \$17.2 billion per annum on average by 2061 (real 2019-20 dollars), while the NSW contribution to Disaster Recovery Funding Arrangements alone is projected to increase more than threefold over the same period (NSW IGR, 2021).

These drivers interact and compound the current structural gap, resulting in an expenditure trajectory that outpaces revenue.

NSW revenue raising capacity remains limited

Under the Constitution, the Australian Government has access to a range of broad-based efficient taxes, including income and consumption taxes. Meanwhile, states are responsible for delivering many essential public services, including health, education, and policing.

Historically this mismatch between Australian Government and state expenditure responsibilities and the allocation of taxes under the Constitution has been managed through significant Australian Government transfers to other levels of government. As a result, grants from the Australian Government, including GST, represent a large source of revenue to NSW, making up approximately 40 per cent of total state revenue in 2024-25. While tied funding agreements support NSW to deliver essential services, the nature of the agreements can reduce NSW's flexibility to respond to long-run expense pressures.

The 2021-22 NSW IGR projected that NSW tax revenues as a share of total state revenues will remain largely unchanged over the period to 2061, making up just under 40 per cent of total revenue. NSW's taxation revenue is inherently limited and is heavily reliant on inefficient and volatile taxes such as transfer duty. Section 2 outlines how current CGC processes make reform of state taxes more difficult.

Impact of the 2018 deal

The costs associated with the 2018 arrangements in the period to 2029-30 represent a significant fiscal burden to the Australian Government at a time of fiscal pressure. In the period to 2025-26, the cost of the 2018 arrangements to the Federal Budget are expected to total \$28.8 billion. In addition to this, significant additional costs are expected to arise over the next four years associated with the No Worse Off Guarantee provided to the states. While these costs are unknown at this time, they will be determined by trends in the underlying relativity calculated by the CGC for WA. The stronger the underlying WA relativity, the greater the cost to the Federal Budget will be in the period to 2029-30.

Should the 2018 arrangements continue after 2029-30 without the No Worse Off Guarantee, the Federal Budget will see savings at the expense of state budgets who will fully bear the cost of the GST relativity floor. These savings for the Australian Government will again be determined by the underlying relativity of WA in 2030-31. Currently, NSW forecasts of the underlying WA relativity see

these savings as relatively minor. However, should these savings be significant, this would mean the negative fiscal impact on states other than WA will be significant.

The 2018 legislative changes have limited the Australian Government's capacity to allocate funding to areas of identified policy need, including through tied funding arrangements to the states for core service delivery areas such as health and education. At the same time, Australia's healthcare system is increasingly experiencing higher demand associated with population ageing, greater disease complexity and ongoing workforce pressures.

Attachment A: Productivity Commission's information requests

Information request 1

How have the 2018 legislative changes impacted the fiscal positions of states and territories?

- Have other Commonwealth payments to states and territories been affected?
- Has Commonwealth, state, or territory revenue, service and infrastructure provision been supported or impeded by the changes?
- What would happen to Commonwealth, state and territory revenue, services and infrastructure if the No Worse Off Guarantee ceased?

Should other Commonwealth payments to the states, such as specific purpose payments and other general revenue assistance, be included in the Commonwealth Grants Commission's assessments?

- Should some of these payments be excluded? If so, which payments should be excluded and why?
- When the states ask for a payment to be excluded, what criteria do they use to determine if an exemption should be sought?

Is additional guidance needed on which Commonwealth payments should be excluded?

- Is additional guidance is required, what form should it take?

Response

The additional cost of the 2018 arrangements to the Federal Budget are expected to total \$28.8 billion in the period to 2025-26.

Should the No Worse Off Guarantee not be extended past 2029-30, the cost of the 2018 legislative changes will shift from the Australian Government to state governments. The impact on the finances of individual states will depend on the underlying HFE relativity of WA. If WA continues to be fiscally strong (that is, having a low assessed relativity), this will lead to a substantial negative impact on the finances of other states, and in particular fiscally weaker states.

Table A1 shows the fiscal impact on each state if the No Worse Off Guarantee had not applied in 2026-27.

Table A1: No Worse Off Guarantee estimates for 2026-27 (\$million)

NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
-2,125	-1,753	-826	0	-466	-140	-120	-64	-5,492

Source: Commonwealth Grants Commission

Should these fiscal impacts arise in 2030-31 when the current Guarantee ends, an indication of the scale of service cuts required to maintain the current budget results in NSW would be as follows:

- Around a 13,000 reduction in nurses in the NSW public hospital system (AIHW, 2026)
- Over a 14,000 reduction in NSW public school teachers (NSW Department of Education, 2024).

As outlined in Section 4, NSW believes HFE should encompass most SPPs provided to the states. Section 4 sets out reasoning to this issue.

Information request 2

Have the GST distribution arrangements since the 2018 legislative changes delivered a reasonable level of horizontal fiscal equalisation?

- How do you define a reasonable level of horizontal fiscal equalisation?
- Should the PC look to international approaches to determine what reasonable fiscal equalisation is in Australia, and why?

Response

In Section 2 of our submission, we discuss the concept of a 'reasonable level of HFE'. NSW favours an EPC distribution of GST grants with top-ups funded by the Australian Government to achieve a reasonable level of HFE.

NSW recognises that political consensus for moving to an EPC distribution of GST grants is not currently in place. Given this we propose the following HFE model commencing in 2030-31 could be considered as a potential point of consensus.

- The restoration of HFE as applied prior to 2018-19 with GST relativities recommended by the CGC.
- The introduction of a safety net relativity floor for all states set at 0.5 rather than the current floor of 0.75.
- Funding of the new relativity safety net floor by the Australian Government.

Information request 3

Do the 2018 GST distribution reforms strike the right balance between responding to changing circumstances and providing certainty around revenue?

- What changing economic and social circumstances are of most concern to states and territories?
- Do the GST distribution reforms support states to manage the fiscal impact of shocks such as natural disasters or economic disruptions?
- Have changing economic and social circumstances affected revenues, and the provision of state services and infrastructure?
- Has the impact of these changing economic and social circumstances been more or less significant than the changes in GST distribution on the states' finances?
- Have the GST distribution reforms decreased or increased the volatility of state finances?
- Can volatility in the states' GST shares be reduced, and if so how?
- How do the states manage volatility in their finances?
- Are there other sources of volatility in state finances?
- Have the GST distribution reforms impacted the ability of the states to undertake fiscal planning?

Response

The volatility of GST relativities was a fundamental driver behind the changes to HFE introduced in 2018. As outlined in Section 4 of our submission, volatility in state revenues is the main source of year-to-year changes in GST relativities. From a fiscal management perspective, volatility in state revenues becomes a much greater problem when changes to GST relativities become pro-cyclical due to the inherent lags in the CGC processes. This has been particularly the case for WA since 2010 due to the volatility of mining royalty revenue. This problem has also arisen in NSW to a lesser extent where property market cycles have seen considerable volatility in stamp duty revenues.

Natural disasters expenditure is treated by the CGC on an actual per capita basis. That is, higher natural disasters expenditure falling within national agreed guidelines in one state that is not reimbursed by the Australian Government results in an offsetting redistribution of GST funding. NSW believes this arrangement continues to be fit-for-purpose, although it continues to rely on effective and timely communication between federal and state agencies to support accurate forecasting of revenue and co-funded expenditure for budget planning purposes.

Historically, the CGC has been unable to revise its methods for determining state fiscal capacities outside of its five-yearly major review processes, unless authorised to do so by the Treasurer through the Terms of Reference for the annual update. This rigidity means the HFE system is not responsive to major changes in circumstances between reviews. This was clearly demonstrated over

the course of the COVID-19 pandemic, when states incurred significant health and business support expenditure in direct response to the pandemic.

The constraints placed by the CGC Terms of Reference between its methodology reviews resulted in significant unrecouped COVID-19 cost borne by NSW and Vic. While moving forward this position was rectified as part of the 2025 CGC's methodology Review, significant costs borne in 2020-21 remained outside HFE.

As outlined in Section 5, changes in economic and social circumstances are driving changes in the expenditures of state budgets with the aging of the populations seeing the need for higher health expenditures. These changes will see a growing fiscal gap in the NSW budget over the coming decades.

Section 4 of our submission discusses the issue of GST relativity volatility and proposes methodology changes to reduce its significant impact on state finances. We would note that the application of the No Worse Off Guarantee has seen the financial impacts of the 2018 arrangements impact only on WA. Following the current planned expiry of the No Worse Off Guarantee in 2029-30, significant fiscal impacts will arise for most states (see above). NSW expects that under such a scenario, the volatility of GST relativities will diminish mirroring the likely greater stability of the WA relativity.

Information request 4

- Do the current GST distribution arrangements impede states and territories pursuing service delivery or revenue raising reforms?
- What are the elements of the current arrangements that impede the pursuit of reforms?
- Should there be amendments to the current arrangements to remove impediments to reforms?
- Should there be amendments to the current arrangements to provide support for reforms?
- Have states and territories pursued service delivery or revenue raising reforms since the 2018 GST distribution reforms?

Response

Sections 2 and 4 outline our concern that the current CGC processes may inhibit policy action by states. We conclude that HFE is unlikely to impact on service delivery choices and technical efficiency. However, we are concerned with how HFE can distort revenue policy decisions through a feedback loop into GST distributions. Section 4 provides a suggested approach to mitigate these concerns.

Information request 5

Should alternative arrangements for GST distribution be adopted? What could alternative arrangements look like? Would alternative arrangements:

- result in a reasonable level of horizontal fiscal equalisation?
- provide stability and certainty to state and territory budgets?
- provide incentives to, or not impede, the pursuit of policy reforms that lead to higher prosperity and productivity?
- require additional funding from the Australian Government or other states? Could the proposal proceed without this additional funding?
- retain the independent basis for determining the fiscal needs of states?
- result in significant changes in Commonwealth transfers to states, in total and individually? If so, what are the likely transitional implications of the change?
- present any implementation challenges or risks?

Response

Section 2 of our submission discusses defining a reasonable level of HFE and concludes that a political consensus to move permanently from the substance of the pre- 2018 arrangements is unlikely. However, we believe that some reassurance needs to be provided that the relativity of states cannot fall below 0.5, at which time we believe the consensus to HFE begins to unravel.

Section 4 provides several suggested modifications to HFE to improve its operation and, in particular, to deal with the volatility of GST relativities and address possible effects on state policy deliberations. While additional funding from the Australian Government to the states is always welcome, our suggested HFE path forward outlined in Section 2 would reduce financial claims on the Federal Budget and restore the integrity of HFE.

Attachment B: Impact of HFE on state revenue policies

Table B1: Distribution of tax base compared with population in 2023-24

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<i>Land Tax</i>								
Share of Tax Base	47.8%	28.7%	11.5%	6.1%	3.9%	0.9%	0.7%	0.4%
Variance from population share*	-16.5%	-3.1%	9.0%	4.8%	3.0%	1.2%	1.0%	0.5%
Revenue Effort**	81.6%	135.9%	97.2%	75.2%	105.6%	112.3%	157.5%	0.0%
<i>Stamp Duty on Conveyances</i>								
Share of Tax Base	38.7%	23.9%	19.7%	9.4%	5.0%	1.2%	1.6%	0.5%
Variance from population share*	-7.4%	1.7%	0.8%	1.5%	1.9%	0.9%	0.1%	0.4%
Revenue Effort**	97.8%	116.9%	87.4%	99.3%	94.9%	100.4%	69.1%	122.4%
<i>Mining – Iron Ore</i>								
Share of Revenue Base	0.0%	0.0%	0.0%	98.8%	0.8%	0.3%	0.0%	0.0%
Variance from population share*	31.3%	25.6%	20.5%	-87.9%	6.1%	1.8%	1.7%	0.9%
Revenue Effort**	NA							
<i>Mining – Coal</i>								
Share of Revenue Base	36.8%	1.0%	61.6%	0.5%	0.0%	0.0%	0.0%	0.0%
Variance from population share*	-5.5%	24.6%	-41.1%	10.4%	6.9%	2.1%	1.7%	0.9%
Revenue Effort**	61.7%	100.0%***	118.1%	121.0%	NA	224.7%	NA	NA

* Measured as the difference between states population share and states share of total assessed tax base. A negative value reflects state advantage in raising this revenue.

** Revenue effort measures the extent to which a state's tax rates are higher than average. Estimates above 100 per cent indicate a state imposes a higher-than-average tax rate on the measured tax base.

*** The CGC assesses Victoria's actual and assessed revenue to be the same for coal.

Source: Commonwealth Grants Commission Working papers, Simulator, Resource Victoria Annual Statistical Report and State Budget Papers and NSW Treasury.

Glossary

ABS	Australian Bureau of Statistics
ACT	Australian Capital Territory
CGC	Commonwealth Grants Commission
EPC	Equal Per Capita
GSP	Gross State Product
GST	Goods and Service Tax
HFE	Horizontal Fiscal Equalisation
IGR	Intergenerational Report
NSW	New South Wales
NT	Northern Territory
PC	Productivity Commission
Qld	Queensland
SA	South Australia
SPP	Specific Purpose Payments
Tas	Tasmania
VFI	Vertical Fiscal Imbalance
Vic	Victoria
WA	Western Australia

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