Understanding Australia’s system of fiscal transfers

This paper provides a brief introduction to Australia’s system of fiscal transfers. It details the intergovernmental fiscal imbalances that give rise to these transfers, outlines the history of Australia’s horizontal fiscal equalisation (HFE) system and describes how HFE is implemented in practice.

1. The Australian Government has a greater fiscal capacity than the states

Australia has separate and overlapping levels of government, with different responsibilities assigned to different levels. The Constitution largely determines the division of policy responsibilities between the Australian Government and state and territory governments (hereafter ‘states’) (Parliament of Australia 2025). Some Australian Government responsibilities – like social security and defence – have large direct fiscal costs, while others – such as macroeconomic stabilisation or trade policy – do not. States have significant expenditure responsibilities, including health, education and public safety. This is in line with the principle of subsidiarity, under which responsibility for a particular function should, where practicable, reside with the lowest level of government capable of delivering it effectively (PC 2006, p. 27).

Over the last decade, the Australian Government raised roughly 3 times more own-source revenue than the states combined (PC estimates using ABS 2026), including through personal income tax, company income tax and the GST. In contrast, states have access to a comparatively limited range of tax bases and rely more heavily on relatively less efficient taxes (PBO 2024, pp. 24–26). This imbalance in taxing power was first established at Federation, when the states ceded the right to impose customs and excise duties to the Australian Government (PC 2018, p. 8). Since then, this disparity has further increased, facilitated by key events like the Australian Government taking over sole responsibility for levying income tax in 1942 and the removal of some state revenue streams in exchange for introducing the GST in 2000. Additionally, significant High Court rulings – including *Ha v New South Wales* (1997), which found that licence fees on tobacco, alcohol and fuel constituted excise duties and therefore were the exclusive domain of the Australian Government, and *Vanderstock v Victoria* (2023), which found that Victoria’s electric vehicle road user charge was unconstitutional – have further limited state revenue-raising capacity (section 5).

As a result of these revenue and expense imbalances, Australia experiences vertical fiscal imbalance (VFI): the Australian Government raises more revenue than it needs to provide the services it is responsible for, while states raise less revenue than they need to fund their policy responsibilities. Due to the constitutional and historical reasons discussed above, Australia experiences a higher degree of VFI compared to many similar federations in the OECD (CGC 2022, p. 1). Furthermore, the extent of VFI varies over time in line with legal rulings.

2. Some states have greater fiscal capacities than others

Australia also experiences horizontal fiscal imbalance (HFI): some states can raise revenue more easily or provide services more efficiently than others because of structural factors, such as resource endowments and the demographic composition of their populations (figure 1).

HFI can be seen when examining the own-source revenue raised by different states. In 2024–25, Western Australia raised about $10,000 per capita in own-source revenue, while Tasmania raised less than $5,500 per capita (PC estimates using ABS 2026). Mining royalties are a key – but not the only – driver of differences in state own-source revenue. A state's ability to generate revenue from mining royalties is largely dependent on its resource endowments – a structural factor beyond its direct control. However, policy decisions to allow and facilitate extraction and to set royalty rates also affect the amount of revenue a state raises.

Figure 1 – States have different revenue-raising capacities

State own-source revenue sources per capita, 2024–25

Property-related taxes are the sum of stamp duty and land tax revenue. Other revenue includes gambling taxes, motor vehicle taxes, non-royalty property income, other taxes, and municipal rates (for the Australian Capital Territory). The Australian Capital Territory is not directly comparable as its other revenue includes local government revenue sources, such as municipal rates.

Source: PC estimates using ABS (2026).

Differences in expenses between states also contribute to HFI. For example, the Northern Territory has significantly higher expenses per capita compared to other jurisdictions. This can be attributed to the demographic and geographic composition of the population. For example, 26% of the Northern Territory's population identifies as Aboriginal and/or Torres Strait Islander (compared with 3% of the total Australian population) and 39% live in remote or very remote areas (compared with 2% of the total Australian population) (ABS 2022; PC estimates using ABS 2025).

3. Fiscal transfers in Australia aim to address both vertical and horizontal fiscal imbalances

Australia's federal financial relations system recognises and, to some extent, accounts for both VFI and HFI. The Constitution gives the Australian Government the ability to provide states with financial assistance under terms and conditions set by the Australian Government.[1] Accordingly, the Australian Government provides significant grants to states each year to assist them in undertaking their policy responsibilities. In 2024–25, the total value of these grants was $195 billion, equivalent to approximately 27% of total Australian Government revenue and 49% of total state revenue (PC estimates using ABS 2026; Commonwealth of Australia 2025). These grants supplement the revenue states raise from their own sources to better align governments' revenues with their service delivery responsibilities. They also ensure the benefits of decentralised governance are retained (CGC 2020, p. 2).

Grants from the Australian Government to the states take 2 main forms: tied and untied grants. Tied grants are payments to states that must be used for pre-agreed purposes in policy areas where the states are primarily responsible for service delivery (such as health, education or infrastructure) (Commonwealth of Australia 2025, p. 60). In 2024–25, the Australian Government provided about $97.4 billion in tied grants to states, accounting for half of total grants (PC estimates using Commonwealth of Australia 2025).

The Australian Government also provides untied grants, which states are free to spend according to their own budget priorities (Commonwealth of Australia 2025, p. 64). Most untied funding is delivered through the distribution of the GST pool,[2] which is collected by the Australian Government and passed on to the states. In 2024–25, states received $97.3 billion in untied funding, of which $91.2 billion, or 94%, was GST payments (PC estimates using Commonwealth of Australia 2025, p. 64).

The Australian Government uses the GST pool to address HFI (while also reducing VFI)

The GST pool is distributed to the states with the explicit intent of delivering HFE. HFE involves the transfer of financial resources to and between subnational governments with the aim of mitigating regional differences in fiscal capacity (Dougherty and Forman 2021, p. 5). It seeks to address HFI by equalising the fiscal capacities of states to give them the opportunity to provide public services of a similar standard, if they made the same effort to raise own-source revenue and operated at the average level of efficiency (CGC 2025b, p. 231). These are concepts of *assessed* revenue and spending, which differ from *actual* revenue and spending (section 6).

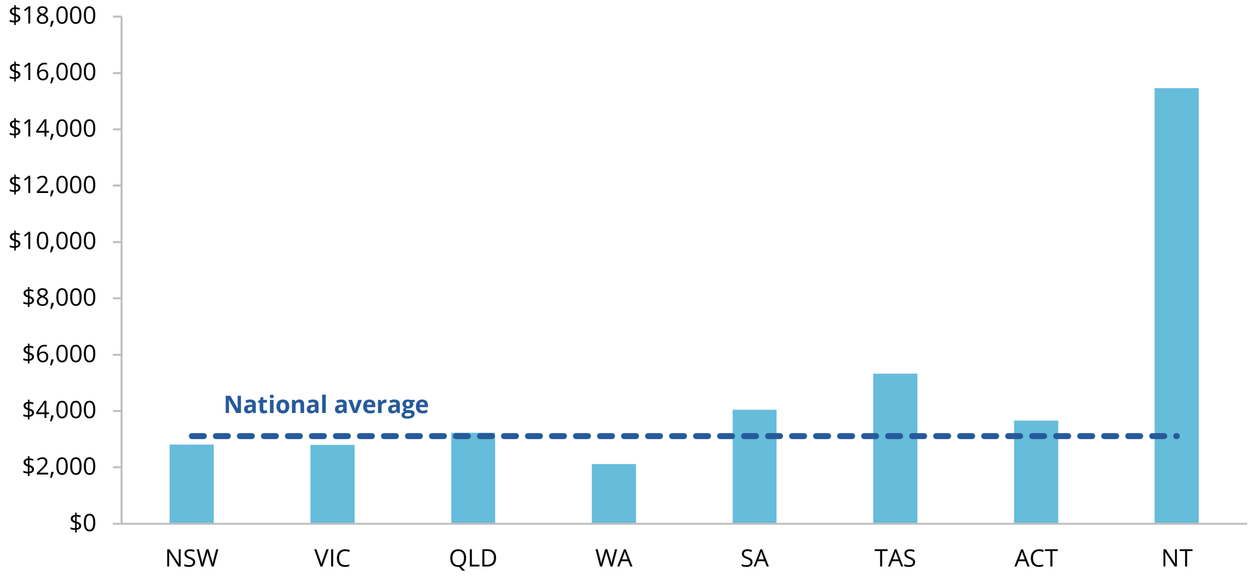
In practice, states with a relatively lower assessed fiscal capacity – because of higher assessed net costs of delivering services and/or lower assessed net capacity to raise revenue – receive more GST payments per capita than states with a relatively greater fiscal capacity (figure 2).

[1] s. 96.

[2] Other sources of untied funding include payments to Western Australia for mining activities in the North West Shelf, and to the Australian Capital Territory for the provision of municipal services (Commonwealth of Australia 2024, pp. 126–127).

Figure 2 – States with greater fiscal capacities receive a lower share of the GST pool

Average GST payment per capita, 2000–01 to 2024–25, constant prices 2024–25 basis



GST payments do not include other general revenue assistance (including payments under the No Worse Off Guarantee or transitional GST top-up arrangements).

Source: PC estimates using Commonwealth of Australia (2025 and various other years).

For example, the scale of Western Australia's resource endowment creates a substantial assessed revenue advantage compared to some other states (CGC 2026a, p. 34). Similarly, New South Wales has stronger property sales and land values compared to other states, which increases the assessed revenue New South Wales can raise from property transactions (CGC 2026a, p. 34). These factors contribute to an increased fiscal capacity in these states and, therefore, relatively lower GST payments per capita.

On the other hand, assessed service delivery costs are higher in the Northern Territory and Tasmania due to remoteness and the higher reliance of their residents on public services. For example, in 2024–25, the Commonwealth Grants Commission (CGC) assessed that providing housing services in the Northern Territory costs more than 7 times the national per capita average, justice more than 3 times, and welfare and roads more than double (PC estimates using CGC 2026b). In the same year, the CGC also assessed that Tasmania had higher costs of providing public services than the national per capita average in more than half of the sectors where expense needs are assessed (CGC 2026b). In the absence of commensurate revenue advantages in these states, these higher assessed expenditures have decreased their respective fiscal capacities and increased their relative GST payments per capita.

Changes in state circumstances can cause variations in GST payments. For example, significant increases in metallurgical coal prices contributed to Queensland's increased assessed coal royalty revenue in 2022–23, which (after accounting for the lag in CGC assessments) brought their per capita GST payment substantially beneath the national average (CGC 2024, pp. 11, 34). In contrast, Victoria is expected to receive GST payments above the national per capita average in 2025–26, primarily because of higher assessed expenditures on health and business support during the COVID-19 pandemic (CGC 2025a, p. 46).

The Australian Government further addresses VFI through non-GST funding

The distribution of the GST pool alone is insufficient to align state revenues with the extent of their policy responsibilities. The Australian Government and the states therefore negotiate other grants to support, incentivise or reward the delivery of particular services, projects or reforms by the states (box 1). A state's fiscal capacity – and its consequent share of the GST pool – does not necessarily indicate how much it receives in non-GST payments (figure 3).

Box 1 – The Australian Government uses several instruments outside of the GST distribution system to deliver funding to the states

The intergovernmental agreement on federal financial relations (IGAFFR) establishes the agreement mechanisms through which the Australian Government can provide funding to the states. Broadly, there are 2 types of funding agreements: National Federation Funding Agreements (NFFAs) and Federation Funding Agreement Schedules (FFA Schedules) (Australian Government Department of the Treasury 2022c, p. 2).[a]

NFFAs

NFFAs are ongoing funding agreements with bespoke terms and substantial policy content (Australian Government Department of the Treasury 2022c, p. 2). These agreements underpin intergovernmental cooperation to deliver services and achieve beneficial outcomes in key sectors. NFFAs currently exist for health, schools, skills, mental health and suicide prevention, social housing and homelessness, justice, and foundational supports (Australian Government Department of the Treasury 2026).

As intended by the IGAFFR, the Australian Government and all states are parties to all NFFAs, which are negotiated on a multilateral basis (Australian Government Department of the Treasury 2022b, p. 1). Outside GST payments, NFFAs in health and education are the 2 most valuable Commonwealth payments to all states (figure 4).

FFA Schedules

FFA Schedules are a flexible funding instrument which the Australian Government can use to deliver fixed-term funding to the states to facilitate reforms, reward jurisdictions for delivering nationally significant reforms, or support the delivery of a specific project or output (Australian Government Department of the Treasury 2022b, p. 3). Most, but not all, funding provided through FFA Schedules is provided through tied grants.

Though FFA Schedules are intended to be between all governments, not all FFA Schedules include all states. This is because not all FFA Schedules are relevant to all states – for example, Tasmania, Western Australia and the Northern Territory are not parties to agreements concerning water reform in the Murray–Darling Basin (Australian Government Department of the Treasury 2024a) – and because states are not obliged to become parties to agreements if they do not find the terms sufficiently advantageous.

In practice, there is great diversity among FFA Schedules in terms of subject matter, duration, value and state participation. Some are highly specialised and have a relatively low dollar value. For example, in 2015–16, New South Wales was the only state party to a FFA schedule which granted a payment of

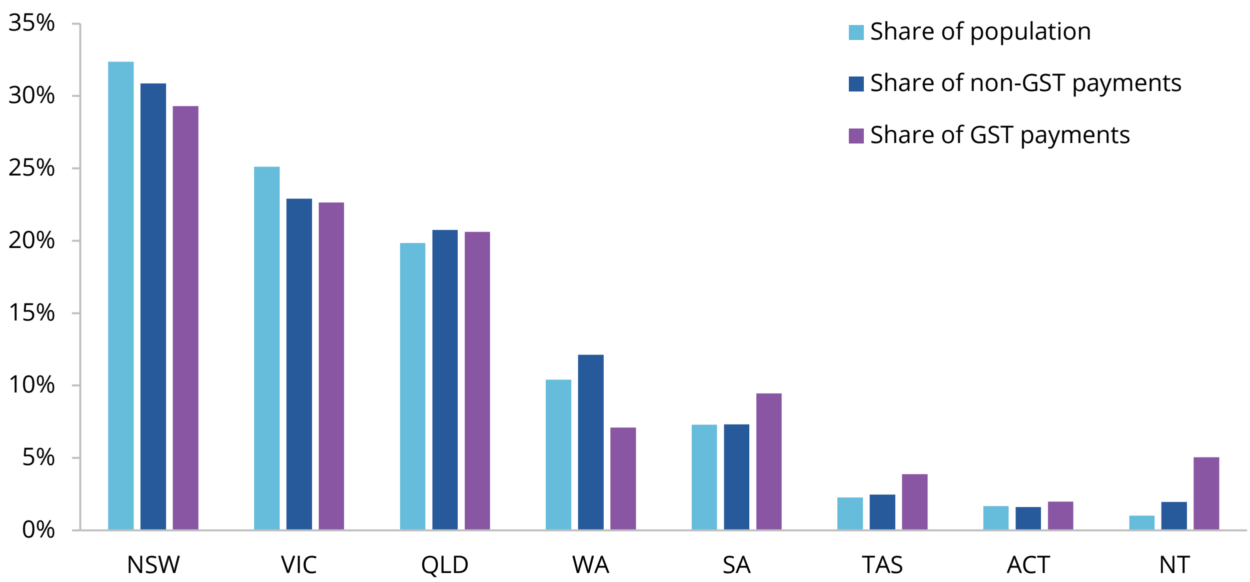
Box 1 – The Australian Government uses several instruments outside of the GST distribution system to deliver funding to the states

$200,000 for the National School for Travelling Show Children (Commonwealth of Australia 2016, p. 70; Pyne and Piccoli 2015). Other agreements are broader and involve higher spending. For example, over the last 15 years, all states have received a share of approximately $80 million distributed under the 5 iterations of the National Bowel Cancer Screening Program FFA schedule (Australian Government Department of the Treasury 2024b; Commonwealth of Australia 2025 and previous versions). In 2024–25, there were approximately 190 active FFA Schedules covering policies and projects in a range of sectors, including (among others) health, education, skills, community services, infrastructure, housing and environment (PC estimates using Commonwealth of Australia 2025).

a. FFA schedules previously operated through national partnership agreements. FFA Schedules are attached to the 5 sectoral Federation Funding Agreements – which provide the framework for specific sector-based agreements – but have the same effective functions as national partnership agreements (Australian Government Department of the Treasury 2022a, p. 1).

Figure 3 – HFE governs the distribution of the GST pool, but not other Commonwealth payments

Average share of population, non-GST Commonwealth payments and GST payments by state, 2000–01 to 2024–25



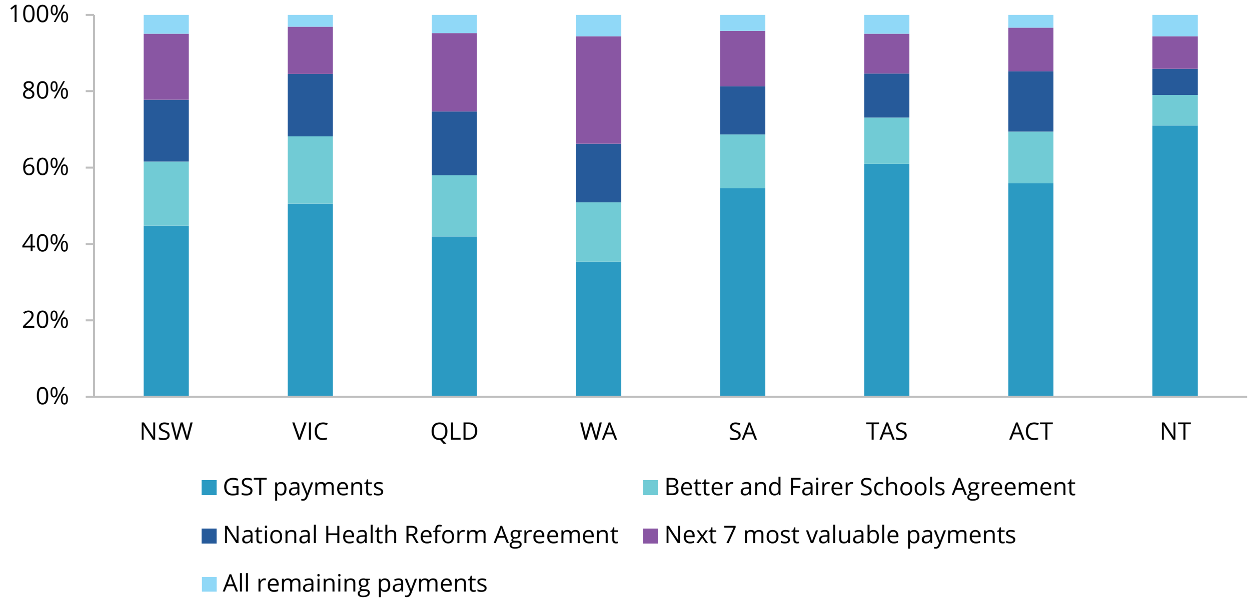
Payments under the No Worse Off Guarantee are included in non-GST payments.

Source: PC estimates using Commonwealth of Australia (2025 and various other years).

In 2024–25, there were 200 different active funding agreements between the Australian Government and the states, and each state benefited from between 76 and 114 agreements. Despite the large number of agreements, many transfer relatively small amounts of money. GST payments and National Federation Funding Agreements (NFFAs) in health (National Health Reform Agreement) and education (Better and Fairer Schools Agreement) are the most valuable for all states. In 2024–25, these agreements collectively accounted for between about 75% and 85% of total grant revenue in every state except Western Australia (figure 4).[3] In the same year, the 10 most valuable funding agreements in each state accounted for about 95% of the total value of grants from the Australian Government.

Figure 4 – The majority of Commonwealth payments are contained within a small number of funding agreements

Share of Commonwealth payments contained in funding agreements, 2024–25



Source: PC estimates using Commonwealth of Australia (2025).

4. The theoretical basis of HFE

HFE '*has long been an important and internationally notable feature of Australian federalism*' (Fenna and Phillimore 2025, p. 701) and promotes the fair and non-preferential treatment of all states by the Australian Government. Without HFE, the standard of services which states could provide would be impacted by structural factors like the demographic make-up of the population or resource endowments.

Australia chooses to undertake HFE for several reasons

HFE supports equality of opportunity

HFE supports equality of opportunity by reducing differences in states' fiscal capacities that result from structural factors outside of a state's control. Equality and the principle of a 'fair go' are widely recognised and accepted as cultural and political values in Australia (Braun 2006, p. 12; Fenwick and Silva 2026, p. 5;

[3] Western Australia is the only state which receives substantial Commonwealth payments from royalty arrangements relating to mining activity in the North West Shelf. This decreases the share of Western Australia's total grant revenue obtained through NFFAs relative to other states.

Howard 2023, pp. 210–211) and HFE aligns with these values by providing support to states so the quality of public services that citizens receive are less dependent on the state in which they live.[4]

Comparable levels of services between states are important for equality of opportunity, as the quality of services delivered by states, such as health and education, contribute to economic and social outcomes (OECD 2015, p. 80, 2025, pp. 1, 7–12). Education, for example, can act as an equaliser between individuals by improving lifetime earnings (Leigh 2025).

Many inquiry participants were supportive of equality of opportunity as an important reason for undertaking HFE.[5]

HFE acts as a fiscal stabiliser in a federation where states do not have their own exchange rate or monetary policy

States' year-to-year fiscal capacities are impacted by business cycles and economic shocks, but unlike the Australian Government, states cannot use monetary policy or exchange rates to smooth their business cycles (PC 2018, p. 132). Federal tax-transfer systems can help to smooth states' revenues and act as a fiscal stabiliser (Asdrubali et al. 1996, pp. 1082, 1092). For example, federal transfers like GST payments can help to cushion state budgets from declines in own-source revenue or increases in expenditure during localised downturns. A state experiencing a negative economic shock will receive a greater share of the GST pool as its revenue-raising capacity falls or its drivers of expenditure rise (relative to those of other states) (Smart 2004, pp. 197–198). Conversely, a state which experiences a positive economic shock that causes its revenue-raising capacity to increase (relative to that of other states) will receive a smaller share of the GST pool as it would require less support to provide services of a similar standard to other states.

HFE theoretically supports national cohesion

HFE can support national cohesion by giving states the fiscal capacity to provide services and associated infrastructure of a similar standard. This has broad positive implications for social cohesion as access to high-quality public services can reduce the negative consequences of income and wealth inequality and foster upward mobility (OECD 2010, p. 184, 2015, p. 80, 2025, pp. 1, 7–12; Verbist et al. 2012, pp. 62–63). This finding was supported by several participants in this inquiry, who also noted the role HFE plays in promoting national cohesion.[6]

Australia's HFE system also ensures the fair and non-preferential treatment of states by the Australian Government as the distribution of the GST pool is based on independent recommendations from the CGC. This promotes national cohesion by limiting the ability of the Australian Government to favour certain states and ensures the GST pool is distributed according to fiscal need.

However, the implementation of HFE can be contentious and there is often tension regarding how it is applied in practice. There was increased dissatisfaction with the HFE system during the mining boom of

[4] Saul Eslake, sub. 3, p. 2; Tasmanian Government, sub. 48, p. 2; City of Melbourne, sub. 47, p. 2; Northern Territory Department of Treasury and Finance, sub. 39, p. 34; Victorian Government, sub. 59, p. 1; Queensland Government, sub. 62, p. 3; Rob Fairs MP, sub. 15, p. 1.

[5] Victorian Government, sub. 59, p. 22; Queensland Government, sub. 62, p. 3; Tasmanian Government, sub. 48, att., p. 1; NSW Government, sub. 61, p. 8.

[6] Rob Fairs MP, sub. 15, p. 2; Brendan McCarthy, sub. 29, p. 2; John Purcell, sub. 44, p. 38; Queensland Government, sub. 62, pp. 21, 26.

the 2010s, and debate about the HFE system has continued following the introduction of the 2018 reforms (Fenna and Phillimore 2025, pp. 701–702). However, observable dissatisfaction with the HFE system does not necessarily mean that the pursuit of HFE has negative implications for national cohesion.

Without HFE, states' fiscal capacities would likely diverge because of structural factors outside their control. This would mean some states would be able to consistently provide superior services to what others are able to (not because of better fiscal management but because of the innate advantages their economy possesses), which in itself, could plausibly lead to tension amongst residents living in different states. While interstate migration could in theory mitigate some of this divergence, it could also be a driver of divergence under certain circumstances. Australia's Federation could become harder to sustain, as significant divergence between states' fiscal capacities would likely undermine support for the Federation among residents of states with lower fiscal capacities.

HFE may impact the efficient distribution of productive resources across Australia

There are different schools of thought on the extent to which HFE can have a material impact on the efficient distribution of resources across Australia.

The first is that equalisation removes incentives for people to migrate based on the fiscal benefits a state can offer (such as lower taxes or better-quality public services). This facilitates the efficient movement of labour and capital, as people choosing to move will do so for genuine economic opportunities rather than because of the fiscal benefits that can come from living in one particular state (Chris Murphy, sub. 45, p. 24; Buchanan 1950, p. 589; Murphy 2018, p. 9). Both the Tasmanian Government (sub. 48, pp. 16, 24, 54) and the Government of South Australia (sub. 13, pp. 4, 9) noted that full HFE is important in avoiding an inefficient distribution of labour and capital. This view is supported by Murphy's (2018, p. 32) findings that the removal of the existing HFE system would lead to shifts in economic activity between states that are caused by differences in fiscal benefits rather than genuine economic opportunities, causing small state economies with large fiscal disadvantages, such as the Northern Territory, to experience a downward spiral in population.

An alternative school of thought is that equalisation disincentivises people and capital from moving to more productive areas by subsidising services in jurisdictions with lower fiscal capacities (Garnaut and Fitzgerald 2002, p. 134). This view was advanced by the New South Wales Government, which argued that HFE reduces the incentive for people to migrate from higher to lower cost service delivery locations, resulting in higher overall government service costs (sub. 61, p. 8). Additionally, it has been argued that equalisation may slow down regional convergence as states with lower fiscal capacities are not required to become more competitive or incentivised to overcome their fiscal disadvantages (OECD 2013, p. 111).

Arguments in favour of and against HFE promoting an efficient allocation of resources across states are plausible in theory, but there is limited empirical evidence in the Australian context that definitively supports one of these effects over the other. The counterfactual is difficult to specify, and both observed HFE outcomes and interstate migration decisions and patterns are endogenous. *Prima facie*, this lack of clear empirical evidence *might* suggest that the effect of HFE on the distribution of productive resources in Australia – be this positive or negative – may not be particularly strong.

5. The evolution of HFE in Australia

The role of the CGC

The CGC is an independent agency responsible for providing recommendations to the Australian Government on the allocation of the GST pool among states. Australia is distinct in having an independent and specialist agency with this purpose (CGC 2023, p. 3).

Since its establishment in 1933, the CGC has provided advice to the Australian Government on how to bring the fiscal capacities of states closer together to ensure they can provide a similar standard of services to their citizens (CGC 2023, p. 3). While its methods and exact role have evolved alongside Australia's broader federal financial relations system, its focus on delivering HFE has remained largely unchanged (box 2). The CGC defines the objective of HFE as '*each state [having] the fiscal capacity to provide services and associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency*' (CGC 2025b, p. 231).

Box 2 – A short history of the CGC and Australia's HFE system

Since it was established in 1933, the Commonwealth Grants Commission (CGC) has been an enduring feature of Australia's horizontal fiscal equalisation (HFE) system. Its role has adjusted over time as Australia's federal financial relations system has evolved, but its core objective has remained the same.

1901 to 1933: Post-federation and pre-CGC era

At Federation, the Australian Government was granted authority to collect customs and excise duties while states remained responsible for delivering most government services (CGC 2023, p. 4). This established vertical fiscal imbalance (VFI) as a defining feature of Australia's Federation and necessitated a system for managing federal financial relations to ensure states had sufficient revenue to deliver the public services expected of them (PC 2018, p. 68).

Various ad-hoc schemes for revenue-sharing between the Australian Government and states were established during the 30 years following Federation, including equal per capita grants and additional 'special grants' for states with lower fiscal capacities (CGC 2023, p. 4). During the 1920s, the process for determining special grants led to frequent disputes between the Australian Government and states with lower fiscal capacities. States' discontent was exacerbated by the financial hardship caused by the onset of the Great Depression (CGC 2023, p. 4).

In 1933, Western Australia voted in favour of leaving the Federation due to economic grievances associated with federating, which were then intensified by the Great Depression (Fenna and Phillimore 2025, p. 706). The result of the secession referendum was ultimately rejected by the British Parliament, but it demonstrated the degree of discontent with the revenue-sharing system of the time. Fenna and Phillimore (2025, p. 6) have argued that Western Australia's vote in favour of seceding was a '*major instigating factor*' in the establishment of the CGC in 1933. However, separate to Western Australia's secession referendum, there was also broad recognition of the need to have an ongoing body to advise on fiscal federalism matters (Williams 2015, p. 108).

Box 2 – A short history of the CGC and Australia's HFE system

The CGC was established in 1933 with the hope that an independent institution responsible for providing impartial advice on special grants would help to mitigate conflict between the Australian Government and the states (CGC 2023, p. 4).

1930s to 1970s: The 'claimant state' era

During the 1930s and 1940s, states were able to apply for special grants if they needed additional assistance from the Australian Government. Special grants were intended to allow states to function at a standard not appreciably lower than that of other states, provided they made reasonable efforts to achieve these standards (CGC 2023, p. 5). The CGC was responsible for assessing states' needs against this benchmark and judged Western Australia, Tasmania and South Australia to be 'claimant states' in need of additional financial support (Williams 2012, p. 147).[a]

VFI increased significantly in 1942 when the Australian Government took over sole responsibility for levying income tax (Williams 2012, p. 146). States were compensated for this loss of revenue by tax reimbursement grants similar to the revenue they had foregone, and they could also apply to the CGC for further compensation (CGC 2023, p. 5). Tax reimbursement grants were replaced by financial assistance grants in 1959 which remained the basis of revenue assistance until the mid-1970s (PC 2018, p. 69). Payments for specific purposes were also introduced in the late 1960s as a means of influencing state service delivery and infrastructure (CGC 2023, p. 5).

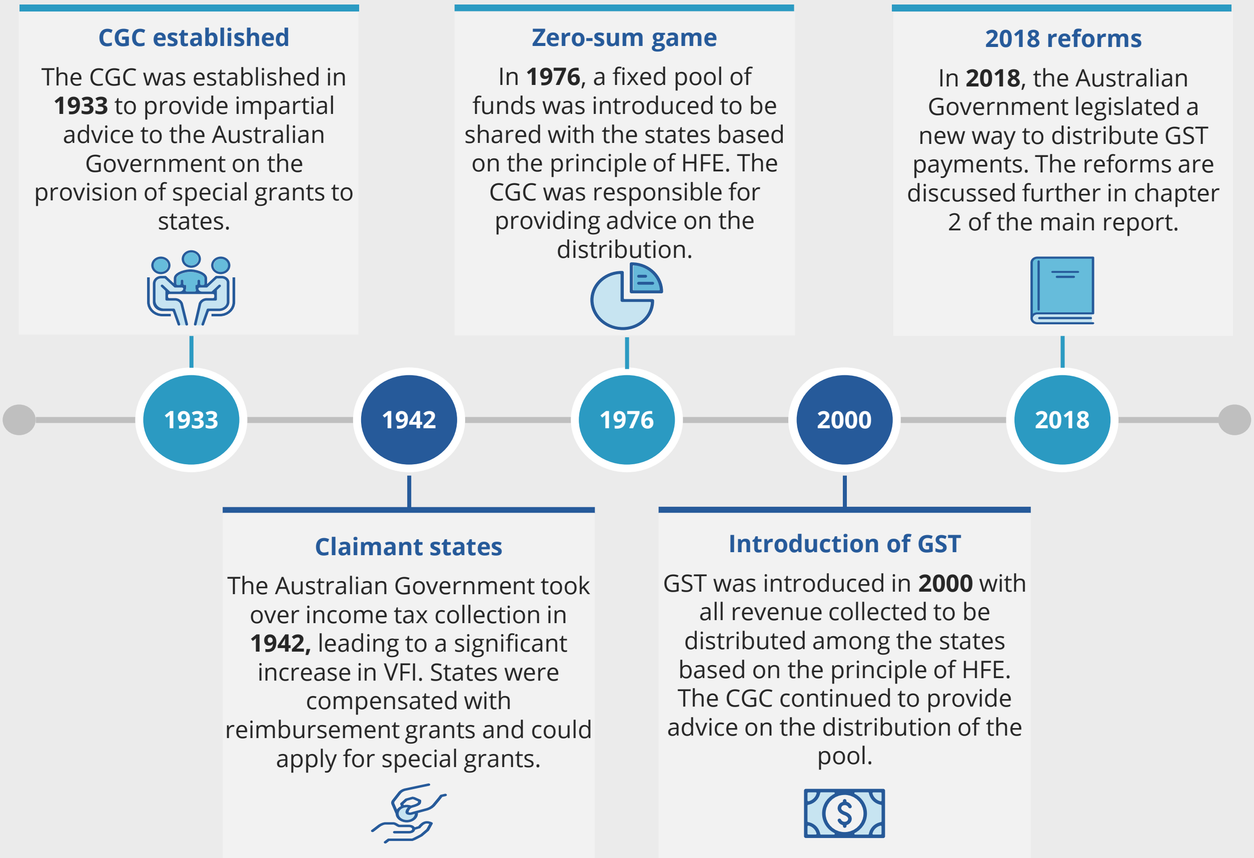
1976 to 2018: The 'constant-sum' game era

In 1976, the Australian Government's approach to supporting states shifted away from a claimant model, with the Australian Government instead providing a dedicated pool of funds to be shared between the states in line with the principle of HFE (PC 2018, p. 74). The role of the CGC expanded in 1978 when it became responsible for determining the relativities which would guide this distribution (Williams 2012, p. 146).

The pool of funds – which was fixed in any given year – introduced a 'constant-sum game' into HFE arrangements, whereby an amount given to one state meant the same amount was foregone by the other states (PC 2018, p. 75). Prior to 1978, the CGC's decisions on special grants for claimant states had no bearing on the fiscal capacities of non-claimant states, but the shift to a constant-sum allocation transformed the CGC from '*being a peripheral to a major player in federal-state relations*' (Williams 2012, p. 147).

Although its assessment methods have evolved over time, the CGC's overarching approach to calculating relativities remained largely unchanged until the 2018 reforms (PC 2018, p. 76). State revenue-raising capacities and service delivery costs are assessed on a yearly basis and a methodology review is conducted every 5 years.

Box 2 – A short history of the CGC and Australia's HFE system



a. The Northern Territory and the Australian Capital Territory did not join the HFE system until 1988 and 1993 respectively (PC 2018, p. 69).

The introduction of the GST in 2000 changed Australia's HFE system

Tax reform and the introduction of the GST

The GST was implemented in 2000 as part of the Howard Government's *A New Tax System* legislative package. The introduction of the GST occurred in the context of broader reform to Australia's tax system. In 1998, the Howard Government released *Tax Reform: not a new tax, a new tax system*, which outlined a plan for tax reform, including reductions in personal income tax rates and the introduction of the GST to replace the wholesale sales tax (Costello 1998, pp. 15, 77). The wholesale sales tax was considered an inefficient indirect tax with a narrow base and multiple, complex classification rates, while the GST was designed to be a more efficient indirect tax with a broader base (Costello 1998, p. 71).

It was legislated that revenue from the GST would be shared with the states based on the principle of HFE, on the condition that states abolished several other inefficient taxes, including financial institutions duty, bed taxes, and bank account debits tax (Commonwealth of Australia 1999, p. 3; Costello 1998, pp. 83–84). This was intended to '*remove the reliance of the States on Commonwealth payments and distorting taxes*' and provide states with a more reliable source of revenue (Costello 1998, p. 77).

The High Court's ruling in *Ha v New South Wales* in 1997 was also an important factor in the introduction of the GST, as it provided a '*political window for reform*' (Tilley 2021, p. 5; Twomey 2014, p. 17). The ruling undermined existing state tax bases and exacerbated the states' dependence on Commonwealth payments (Fenwick and Stewart 2025, p. 95; Twomey 2014, pp. 18–19). The GST was framed as a solution to this problem because, although it was to be collected and administered by the Australian Government, it would be provided to the states as untied revenue.

The GST became part of Australia's HFE system

From the 1970s, the Australian Government had provided a dedicated pool of funds to be shared between the states in line with the principle of HFE. This shifted the HFE system to a constant-sum game, whereby an amount given to one state meant the same amount was foregone by the other states (box 2). The size of the dedicated pool of funds was determined by tax-sharing arrangements, which were subject to negotiations between the Australian Government and the states (Williams 2012, p. 147).

The introduction of the GST created a nexus, linking the HFE system to a single revenue source. The HFE system remained a constant-sum game, as it had been since the 1970s. However, tying the pool to GST receipts shifted the emphasis to how the pool was to be allocated between states, rather than a negotiation about the size of the pool (PC 2018, p. 78).

Although the GST is collected and administered by the Australian Government, it is often perceived as being a state tax. This is partly due to the framing of the GST when it was introduced (Twomey 2014, pp. 17–18). It was reported as a state tax rather than an Australian Government tax until the 2007–08 Budget (Commonwealth of Australia 2008, p. 5-26). Although GST payments to states are a grant themselves, the GST was also marketed as reducing the states' reliance on Commonwealth grants (Costello 1998, p. 77).

The framing of the GST as a state tax has led to states feeling a sense of entitlement to the GST collected within their state, which has been amplified by the misconception that relativities represent the number of 'cents per dollar' of GST collected that is returned to a state.[7] However, the GST is an Australian Government tax which is shared with the states based on the principle of HFE.

6. Implementing HFE in practice

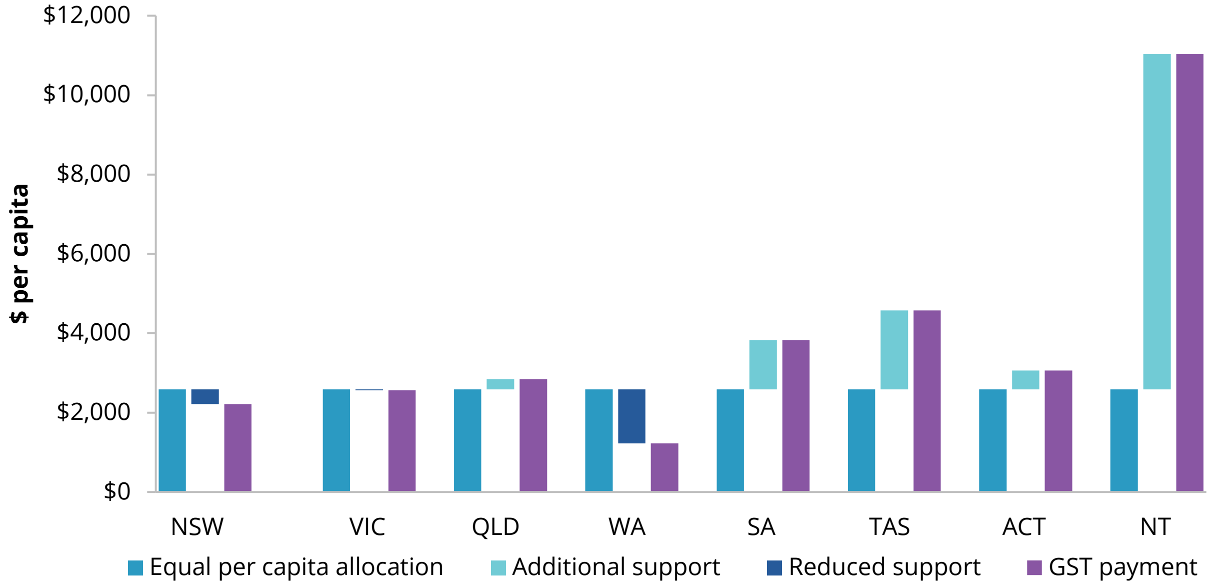
The CGC provides advice on the distribution of the GST pool based on the objective of achieving HFE. The distribution is governed by legislation and the annual terms of reference issued by the Treasurer (CGC, sub. 34, p. 2).

The CGC determines the national average policy – this is the benchmark. If each state operated at the national average policy, the GST pool would be distributed on an equal per capita basis. In other words, each state would receive the same amount in GST payments per capita.

As states do not have the same ability to raise revenue and provide services, the CGC then assesses each state's relative fiscal capacity and determines the level of support each state requires to be able to provide services and infrastructure of a similar standard. Each state's GST requirement reflects the equal per capita allocation, plus or minus the level of support they are assessed to need (figure 5). The more similar states' assessed fiscal capacities are, the closer the distribution of the GST pool is to an equal per capita allocation.

[7] This and several other common misconceptions about the HFE system are addressed in chapter 1.

Figure 5 – The CGC considers the level of support each state requires



The data relates to the distribution of the GST pool in 2018–19 as this was the last financial year before the 2018 reforms came into effect.

Source: PC estimates using Commonwealth of Australia (2019).

Australia implements equalisation in a more comprehensive way than similar federations, assessing revenue, expenditure and investment capacities, compared to using revenue-only assessments (CGC, sub. 34, p. 2; CGC 2022, p. 20; chapter 3). A state's fiscal capacity is determined by its assessed budget, which consists of its assessed revenue – the revenue it could raise if it followed average policy – and its assessed expenses – the amount it would need to spend to deliver a similar standard of services to other states (figure 6). The CGC also generally accounts for payments for specific purposes (PSPs) received by a state from the Australian Government. This is because PSPs impact a state's relative fiscal capacity as they are often used to fund services and invest in infrastructure. However, not all PSPs are included in the CGC's assessments. This is discussed further in chapter 5.

The CGC then examines the differences between states' revenue-raising capacities and their costs of providing services to determine their relative fiscal capacities. On the revenue side, key differences include the value of property, the value of resource endowments and the level of economic activity. Differences in expenses largely arise from differences in the socio-demographic make-up of states' populations. For example, states with a greater proportion of their population living in regional and remote areas or a higher average age will have relatively higher service delivery costs.

The CGC assumes a state applies national average policy to ensure its assessments capture states' underlying fiscal capacities rather than their *actual* policy decisions (box 3). This means a state's assessed revenue and expenditure will be different to what it actually raises and spends.

Figure 6 – The CGC considers several categories of state revenue and expenditure

Components of the CGC's assessment methodology

Revenue	Expenses
Payroll tax	Schools
Land tax	Post-secondary education
Stamp duty	Health
Mining taxes	Housing
Insurance taxes	Welfare
Motor vehicle taxes	Services to communities
Other revenue	Justice
Commonwealth payments	Roads
	Transport
	Services to industry
	Other expenses
	Depreciation
	Investment

Other revenue includes various revenue sources, including gambling taxes, user charges fees and fines, and interest and dividend income. Other expenses include general public services, natural disasters and capital grants to local governments, among other expenses.

Source: (PC 2018, p. 88).

Box 3 – The CGC's assessments are guided by 4 supporting principles

- **What states do –** the Commonwealth Grants Commission's (CGC's) methods should, as far as possible, reflect what states collectively do, and not make judgements about what they could or should do.
- **Policy neutrality –** a state's policy choices (for the revenue it raises or the services it provides) should not directly influence its GST payments. The CGC's assessments should not create incentives or disincentives to choose one policy over another.
- **Practicality –** assessments should be based on sound and reliable data and methods. Methods should be as simple as possible, while capturing the major influences on state revenues and expenses.
- **Contemporaneity –** to the extent reliable data will allow, the GST distribution in a year should reflect state circumstances in that year.

However, the CGC noted that these principles are secondary to the primary objective of pursuing horizontal fiscal equalisation.

Source: CGC (sub. 34, pp. 3–4).

After determining states' assessed revenues and expenses, each state's relativity is calculated based on a lagged 3-year average of assessed revenues and expenses.[8] A relativity reflects a state's share of the

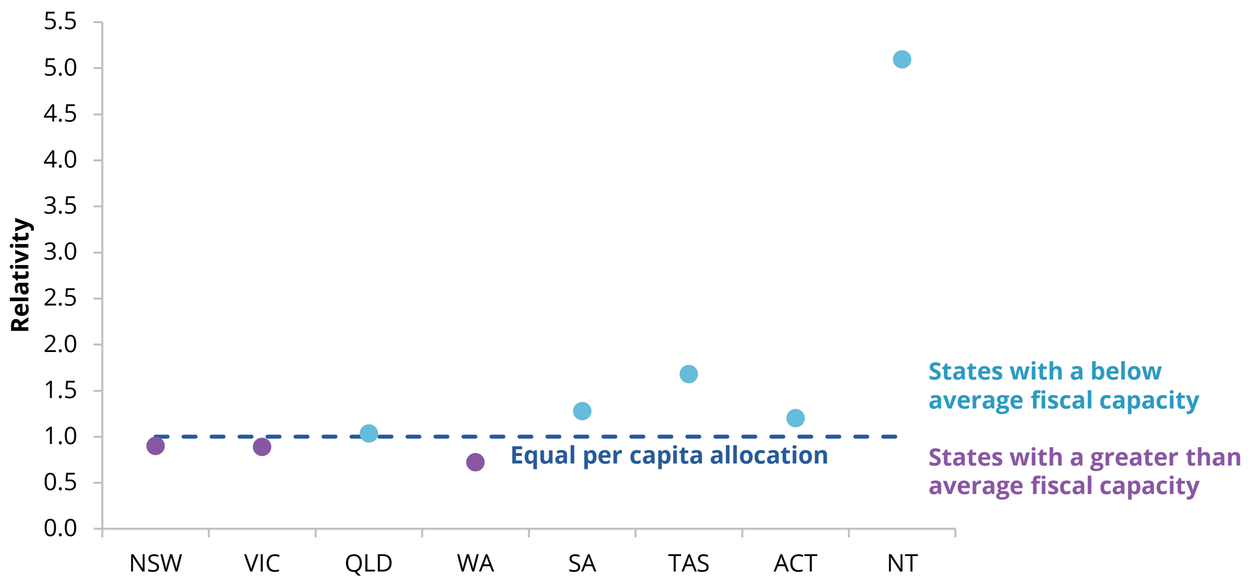
[8] The CGC uses a 3-year average to mitigate the effects of volatility on states' GST payments and uses lagged data because robust data for the assessment year is often not available at the time of the determination (CGC, sub. 34, p. 11).

GST pool relative to the national average per person GST, given its assessed fiscal capacity (CGC 2026c). In other words, relativities reflect a state's share of the GST pool relative to its share of the national population. For example, a state with a relativity of 1.05 would receive 105% of its population share of the GST pool. This is not equivalent to the percentage of GST returned to the state relative to the amount contributed, noting that it is not possible to calculate the amount of GST paid in each state with any level of confidence (chapter 1).

If all states were assessed to have equal fiscal capacities, each would have a relativity of 1. States with a greater-than-average fiscal capacity have a relativity of less than 1 and states with a below-average fiscal capacity have a relativity of greater than 1 (figure 7). Since relativities capture states' relative fiscal capacities, any given state's relativity can be influenced by factors that affect the capacity of other states, as well as factors which impact their own fiscal capacity (figure 8).

Figure 7 – The CGC determines the relative fiscal capacity of states

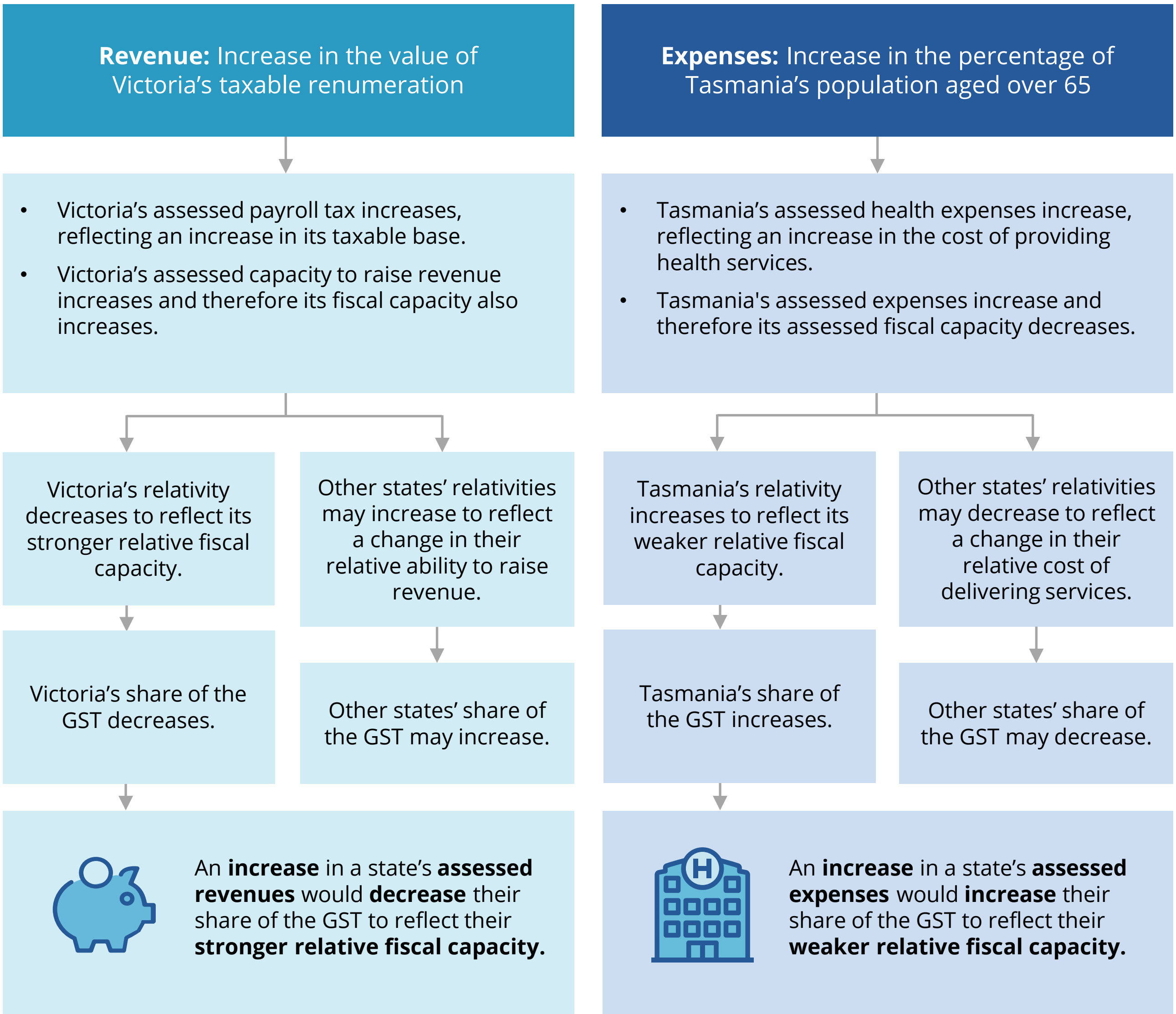
Average state relativities, 2000–01 to 2018–19



Average state relativities are shown for 2000–01 to 2018–19 only as 2018–19 was the last financial year before the 2018 reforms came into effect.

Source: PC estimates using CGC (2026a).

Figure 8 – Examples of HFE in practice



Examples are based on the pre-2018 HFE system. Following the 2018 reforms, the CGC's approach has additional steps which may impact a state's GST payments, but do not affect the calculation of their assessed relativities.

The 2018 reforms changed the way HFE is implemented

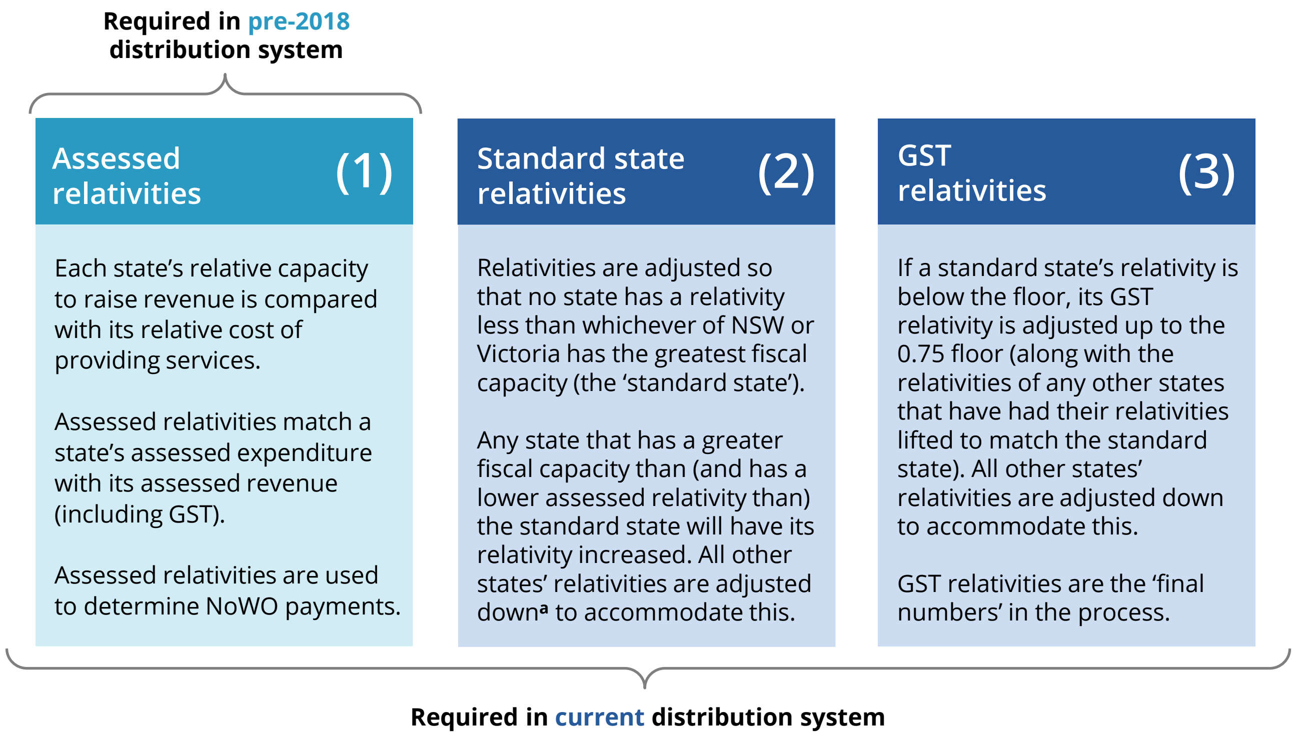
In 2018, the Australian Parliament passed the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) (the Act). Schedule 1 of the Act made 4 substantial changes to how HFE is implemented in Australia by introducing:

- a new **fiscal equalisation standard** (with transitional arrangements) – set at the relativity of whichever of New South Wales or Victoria has the greater fiscal capacity
- a GST **relativity floor** – set at 0.70 in 2022–23, then increased to 0.75 from 2024–25
- a GST **pool boost** – perpetual yearly top-ups of the GST pool by the Australian Government ($600 million from 2021–22, then $850 million from 2024–25, indexed to GST pool growth)
- a **No Worse Off (NoWO) guarantee** – ensuring that no state receives less under the current GST distribution system than it would have received under the pre-2018 system.

Together, these changes represent a significant change to how HFE is undertaken in Australia.

Following the 2018 reforms, the CGC now undertakes additional steps when calculating relativities (figure 9). These changes were implemented over a transition period from 2021–22 to 2025–26. During the transition period, each state's GST relativity was calculated using a weighted average of the relativities that would apply under the pre-2018 HFE system and current HFE system (Parliament of Australia 2018, pp. 15–16).

Figure 9 – The 2018 reforms introduced additional steps to the CGC's process



a. States' relativities are adjusted down on a population share basis.

Source: adapted from CGC (sub. 34, p. 22).

The 2018 reforms and their impacts are discussed in more detail in chapter 2 of the GST distribution reforms report.

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