

OFFICIAL

**SUBMISSION TO THE INTERIM REPORT OF THE
PRODUCTIVITY COMMISSION INQUIRY INTO GST
DISTRIBUTION REFORMS**

Submitted by

Clive Brooks

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1. OVERVIEW

The Productivity Commission (the Commission) has released the interim report of its inquiry into the 2018 GST distribution reforms. This submission provides commentary on some of the issues raised and analyses undertaken in the interim report.

The Commission expresses the changes to the HFE system in 2018 as ‘reforms’. A pedantic view would be that reform is the incorrect term to use as the changes introduced in 2018 did not result in an improvement in the HFE system¹. It is clear that the 2018 changes were introduced to serve a political purpose rather than to achieve good public policy. The only state to have benefited is Western Australia and the improvement to its fiscal capacity has been effectively funded by the Commonwealth.

Overall, the Commission’s findings and recommendations are broadly supported. However, there are some concepts, particularly ‘dominant-state effects’ which should be the subject of rigorous examination.

This submission works through the sections of the interim report providing comments and analyses where they are considered to add value. Unfortunately, any attempt to improve the findings and conclusions of the interim report is likely to be futile, given the Prime Minister’s comments. This makes it even more important that the Commission highlights the opportunity costs of the no worse off (NoWO) guarantee and the GST pool boost.

2. HFE IN AUSTRALIA

2.1 Dispelling Some Misconceptions About the HFE System

This is a quite valuable section of the interim report. It is quite important that the misconception that GST relativities represent ‘cents in the dollar’ of GST raised in a state is well and truly quashed. This characterisation of GST relativities has been frequently presented in the media. For those with a knowledge of the HFE system such a characterisation indicates a degree of ignorance within the media and a lack of an inclination to properly understand HFE. It is hoped that this mischaracterisation no longer appears in the media. If it does, those who are presenting it should be regarded as having no credibility.

There is one further misconception of the HFE system that the Commission could have addressed. This misconception is that the pre-2018 HFE method equalised states to the fiscal capacity of the fiscally strongest state. The Commonwealth’s response to the Commission’s 2018 inquiry into HFE stated ‘...HFE seeks to **‘fully equalise’** the fiscal capacity of all the States by bringing each of their fiscal capacities up to the standard that has been adopted by the CGC, which is to equalise to the fiscal capacity of the strongest State...’².

This statement is patently incorrect but was never challenged. The Explanatory Memorandum to the Bill that brought in the 2018 changes stated ‘transitioning the horizontal fiscal equalisation system from full equalisation (equalised to the strongest State or Territory) to reasonable equalisation (equalised to the stronger of New South Wales and Victoria)’³.

1 For instance, the Cambridge Dictionary give the meaning of reform as ‘to make an improvement, especially by changing ... the structure of something’.

2 Australian Government (2018), p. 6.

3 The Parliament of the Commonwealth of Australia, House of Representatives (2018), p. 3

This misconception was also raised in a number of submissions to the current inquiry (for instance, submissions 14, 15, 18, 19, 22, 49 and 56). It is hoped that the reason the Commission did not mention this misconception was not due to its embarrassment about making this claim throughout its HFE inquiry report⁴.

The Commission's Interim finding 1.1 that a lack of understanding of the HFE system has undermined the quality of public debate on the topic is supported. This finding is consistent with a finding of the 2012 GST Distribution Review⁵. The pertinent question is how to overcome this lack of understanding given some appears to be highly political.

2.2 The HFE System was under Pressure Prior to the 2018 Reforms

The Commission noted that the mining boom which commenced around 2010 had a noticeable impact on the HFE system, with Western Australia's GST relativities falling to levels that were not anticipated when the GST was introduced. It also noted that concerns were being raised about the possibility that HFE system provided a disincentive for states to undertake reform.

These issues and concerns were considered by the GST Distribution Review established in 2011. This review, while recommending some minor changes to the operation of the HFE system, did not recommend any change to the methodology used to determine HFE.

It could be argued that the Commission's 2018 HFE inquiry was the result of Western Australia's continual advocacy regarding its low GST relativity. What is being dealt with now is the fallout from that inquiry.

3. IMPACTS OF THE 2018 REFORMS

3.1 The Reform Package

The Commission noted that the reform package has four components:

- a new fiscal equalisation standard;
- a GST relativity;
- a GST pool boost; and
- a NoWO guarantee.

Although the intention of the 2018 legislation may have been to impose a new equalisation standard, this has not actually occurred. The method applied by the Commonwealth Grants Commission (CGC) uses the per capita relativity of either New South Wales or Victoria, whichever is the lower, as a relativity floor. The state per capita relativities are then rescaled so that the population weighted sum is unity. If necessary, the legislated relativity floor is then imposed. This method has resulted in the fiscally strongest state receiving a fiscal capacity in excess of that needed to provide services and infrastructure at the average level of what states collectively do, while the other states receive a lower fiscal capacity, to varying degrees. Such an outcome could not be regarded as achieving fiscal equalisation.

The intention of the 2018 legislation is set out in 16AB(2) the *Commonwealth Grants Commission Act 1973* (CGC Act) which states:

4 For instance, refer to Productivity Commission (2018), p. 2.

5 Finding 2.4 of Australian Government (2012), p. 9.

‘...the States, the Australian Capital Territory and the Northern Territory each have the fiscal capacity to provide services (including associated infrastructure) at a standard that is at least as high as the standard for whichever of New South Wales and Victoria has the higher standard’.

What might be the standard is not defined, so is not clear that the standard referred to in the CGC Act relates to the per capita relativity or some other measure. It is noted that the wording in the CGC Act has strong similarities to the CGC’s interpretation of HFE:

‘State governments should receive funding from the pool of GST such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency’.⁶

One interpretation of the CGC Act is that the assessment of expenses should be based on the per capita expenditure of either New South Wales or Victoria, depending on which is the highest, and the assessment of revenue be based on the tax rates of either New South Wales or Victoria, depending on which is the highest. This lack of clarity in the wording of the CGC Act indicates poor legislative drafting.

It is interesting to note that the NoWO guarantee was not originally part of the Commonwealth’s proposed changes to the HFE system. It was claimed (naively as it turned out) that the GST pool boost would be sufficient to ensure that no state would be fiscally worse off. It was only after intense advocacy by the (non-Western Australian) states that the NoWO guarantee was part of the legislative package. The amendment to the Federal *Financial Relations Act 2009* specified the NoWO guarantee would operate until 2026–27. The Commonwealth Treasurer has extended it until 2029–30, but its future after then is uncertain (although the Prime Minister has implied that it will continue)⁷.

As noted by the Commission, the cost of the NoWO guarantee to the Commonwealth has been largely driven by high iron ore prices and volumes. While the Commonwealth has received higher taxation receipts as a result, it is false analysis to state that this additional revenue justifies the expenditure on the NoWO guarantee. There is an opportunity cost associated with using the additional tax revenue to fund the NoWO guarantee rather than some other Commonwealth expenditure, particularly in an environment of budgetary restraint.

3.2 The 2018 Reforms Deliver a Lower Degree of HFE

It would have been interesting for the Commission to indicate the implication for the lower degree of HFE for the requirement of the Intergovernmental Agreement on Federal Financial Relations (IGAFFR) that GST payments be distributed among the states in accordance with the principle of HFE⁸.

For instance, does a lower degree of HFE go against the intent of the IGAFFR? The Commission discusses the IGAFFR later in its interim report and this submission will make some commentary at that stage.

3.3 Impacts on the GST Distribution System

The Commission noted that the new fiscal equalisation standard creates perverse outcomes that invert the logic of HFE. Such an outcome is not unexpected as the current HFE system has not

6 Commonwealth Grants Commission (2020), p. 36.

7 Prime Minister of Australia (2026a).

8 Council of Australian Governments (2011), Part 4.

changed how fiscal capacity is assessed. That is, the basis of assessment has not been changed to what New South Wales or Victoria does. It actually cannot do that because the measure of fiscal strength is based on the amount of GST required to deliver state government services at the same standard.

What the current system does is modifies the distribution of the GST pool, not by changing how fiscal needs are assessed, but by applying a floor (either the legislated floor or a floating floor based on the lower per capita relative out of New South Wales or Victoria). Given this determination of the distribution of the GST pool it is not surprising that perverse outcomes can arise.

It is unfortunate that those who developed the new HFE system did not apply more intellectual rigour to addressing the perceived shortcomings of the pre-2018 HFE system as the solutions would lie in the assessment methodology and not in how the GST pool is distributed.

3.4 The 2018 Reforms are Generally not Operating as Intended

The Commission's interim finding 2.2 that the 2018 reforms are not operating efficiently, effectively or as intended is not surprising. This would have been foreseen if the Commonwealth's response to the Commission's HFE inquiry had applied an intellectually rigorous examination to that inquiry's recommendations. The conclusion might be reached that Commonwealth's response was directed to a politically expedient outcome rather than to good public policy. The 2018 changes certainly quietened Western Australia's complaints about the HFE system.

4. THE PC'S ASSESSMENT OF THE CURRENT SYSTEM

4.1 HFE is Broadly Policy Neutral

The Commission's interim finding 3.2 was that the GST distribution system was and is broadly policy neutral, with some exceptions that are best managed through targeted responses.

Table 3.1 of the interim report indicates that the impacts on GST payments are small for tax-rate changes, apart from mining revenue. A closer examination of this analysis is warranted. It is difficult to tie in directly GST impacts to changes in revenue as it will take a minimum of two years before the increase in revenue will impact GST payments and the GST impact will depend on the size of the future GST pool, which is likely to be higher than the GST pool in the year of the tax rate change.

The main issue is the redistribution of fiscal capacity resulting from an increase in a tax rate. A way of presenting this would be to focus on what the CGC terms the 'GST requirement' for the assessment year in which the tax rate change occurs⁹. This measure would provide an indication of the extent the tax rate change affects the assessment of fiscal capacity, which should be the focus of the policy neutrality considerations.

The Commission notes that if the HFE system influences state government policy then it can have efficiency costs. However, as the Commission concedes, any potential effects are likely to be marginal, and that there can many factors influencing policy choices.

The Commission has changed its view since the 2018 HFE inquiry where some of the criticism made of the then current HFE system included the scope to discourage state policy for major tax reform and not allowing states to retain the dividends of their policy efforts. It is open to speculation as to

9 Refer, for example to Commonwealth Grants Commission (2026), Supporting Information, Table S7-1

whether the Commission had the same views then as it does now we would find us in the situation of needing to wind back the changes made to the HFE system.

4.2 Mining and Policy Neutrality

The Commission noted that the assessment of mining revenue provides challenges to the achievement of policy neutrality because mining activity is highly concentrated in a small number of states. This issue is couched in terms of a ‘dominant-state effect’.

Australia is quite geologically diverse with particular types of mineral resources tending to be located in distinct parts of the nation. The assessment of mining revenue requires careful consideration. The starting point should be whether the nation’s mineral resources belong to all Australian citizens or to the states that are fortunate to have mineral deposits within their borders. The answer to this will have implications for the assessment methodology.

If it is considered that nation’s mineral resources belong to all Australian citizens then the current assessment of mining revenue is appropriate. The revenues generated by the states that have a particular mineral resource are distributed, via the HFE system, to the other states. This way all Australian citizens benefit from the exploitation of the nation’s mineral resources.

Any modification to this assessment to enable a state to retain a greater proportion of its mining revenue will lessen HFE. It will enable resource rich states to increase their fiscal capacities. Over time this could result in the resource rich states being in a fiscal position to deliver higher quality services or lower taxes, creating a divide between these states and other states. A state having valuable mineral resources could be regarded as having ‘an outcome attributable to luck’ and so falling outside of equity considerations.

The Commission notes that if a state that is dominant in the production of a particular type of mineral were to increase its royalty rate then the state may incur a future reduction in GST revenue. This outcome is not necessarily undesirable as it means that the other states also benefit from the further exploitation of the nation’s mineral resources.

The Commission needs to consider carefully whether the dominant-state effect is the appropriate means of treating the assessment of mining revenue. While the current mining assessment methodology may not satisfy the policy neutrality supporting principle, it better achieves HFE which is the primary objective. Introducing an adjustment for the dominant-state effect may incorporate policy neutrality, but this will be at the expense of HFE¹⁰.

The current HFE system will only lessen the impact of a state increasing its mining revenue if that state has a lower per capita relativity than the lower of New South Wales or Victoria. The extent of this lessening of the impact has no direct relationship to what that state does. The adjustment depends on the impact the increased mining revenue has on the per capita relativities of New South Wales and Victoria. This is hardly a policy neutrality outcome.

4.3 The NoWO Guarantee Fiscal Impacts on the Commonwealth

The NoWO guarantee payments are now a growing cost to the Commonwealth budget. It is unfortunate that the Commonwealth did not provide a submission to the Commission as it would have been interesting to know the impact of the NoWO guarantee payments on the Commonwealth’s ability to make other payments to the states. As a result it is not clear the full extent that the 2018 changes have distorted HFE.

10 The Appendix discusses further the assessment methods used by the CGC.

As the Commission noted, there are opportunity costs associated with the NoWO guarantee payments. It gave the examples that the \$6.4 billion spent on the 2018 reforms in 2024–25 could deliver a more than \$450 tax cut for each Australian taxpayer, or fund an increase in JobSeeker payments to 90 per cent of the Age Pension. Perhaps the Western Australian Premier could explain to the nation why giving his state a fiscal capacity to deliver services to a greater extent than the rest of Australia serves the nation better than other potential uses of these funds.

5. ALTERNATIVE GST DISTRIBUTION ARRANGEMENTS

A number of alternative arrangements for HFE were presented to the Commission. Some of these were not dissimilar to proposals put to the 2012 GST Distribution Review. Finding 3.4 of that review was:

‘Whether any of the approaches examined ... would improve the HFE system is ultimately a matter of judgement.... On balance, the Panel has come to the conclusion that we can neither recommend very small changes that would deliver only symbolic benefits to the large States ..., nor are we prepared to recommend larger changes that would have major negative impacts on small States’¹¹.

After considering a number of alternative arrangements the Commission’s conclusion was that first-best response would be to return to the pre-2018 HFE system and address issues associated with the mining assessment and dominant-state effects. It is obvious that the Commission’s views about the pre-2018 HFE system have changed between the 2018 inquiry and the current inquiry. Perhaps the Commission now has a better understanding of the issues associated with HFE.

The Commission has made a hierarchy of three recommendations:

Interim recommendation 4.1: Australia should return towards the pre-2018 system but the Australian Treasurer should direct the CGC to address dominant-state effects.

The first part of this recommendation is strongly supported. The current HFE system represents poor public policy. Both this inquiry and the 2012 GST Distribution Review found that the pre-2018 HFE system was the best way to achieve HFE.

The second part regarding addressing the dominant state effects is not supported. As argued above the assessment of mining revenue, while not being policy neutral, does achieve HFE by ensuring that the benefits of exploiting the nation’s resources are distributed to all Australian citizens.

Perhaps the Commission has included the second part in recognition of the push back that will be received from Western Australia against a return to the pre-2018 HFE system.

Interim recommendation 4.2: If the Australian Government is not minded to pursue interim recommendation 4.1, Australia should return to a pre-2018 system and the Australian Government should make direct payments to states it considers are affected by dominant-state issues.

This recommendation could be viewed as the pre-2018 HFE system with the current pool boost and NoWO guarantee payments being made under a different guise to the mineral rich states. This recommendation is not supported. Unless there are clear criteria established for the direct payments they will lack transparency and accountability. The view might be gained that the Commonwealth is using these payments to ‘buy off’ the states that might resist a return to the pre-2018 HFE system.

11 Australian Government (2012), p. 56.

Interim recommendation 4.3: If the Australian Government does not pursue interim recommendation 4.1 or 4.2, it should make the minimum changes to address the critical issues in the current system.

The changes identified by the Commission are the removal of the standard state benchmark, the removal of the pool boost and making the NoWO guarantee permanent. Effectively this would be the pre-2018 HFE system with a GST relativity floor of 0.75 and NoWO guarantee payments to ensure that no state would receive less GST than they would under the pre-2018 HFE system. As this would result in the fiscally strongest state receiving a higher fiscal capacity than the other states, HFE would not be achieved and the requirement of the IGAFFR would not be met. As such, this recommendation is not supported.

6. AN EFFECTIVE FFR SYSTEM

One issue that the Commission could explore further is the codification of the principles of HFE, either in the CGC Act or the IGAFFR. The IGAFFR states that GST revenue should be distributed in accordance with the principle of HFE. However, the IGAFFR is silent on what are these principles. It had been left to the CGC to determine how HFE was to be implemented, both in terms of how fiscal capacity was to be assessed and how the GST pool was to be distributed.

Neither the 2012 GST Distribution Review nor the Commission's 2018 HFE inquiry recommended that the methodology for the assessment of fiscal capacity be changed. The 2018 legislative changes explicitly incorporated in the CGC Act how fiscal capacity was to be determined. However, as noted above, there was not necessarily any gain in clarity as it refers to a standard which is not defined.

In winding back the 2018 changes, 16AB(2) of the CGC Act could be amended to explicitly state the methodology that the CGC should use to assess the fiscal capacity of states. Alternatively, 16AB of the CGC Act could be completely abolished and the CGC methodology for the assessment of fiscal capacity be explicitly stated in the IGAFFR. Either of these measures would provide explicit confirmation of the CGC's assessment methodology. Currently the confirmation is only implicit.

The IGAFFR needs strengthening. The Commonwealth's initial response to the Commission's 2018 HFE inquiry proposed a GST distribution system that clearly did not distribute the GST pool according to the principles of HFE. The requirement of the IGAFFR was apparently irrelevant to the Commonwealth. While the NoWO guarantee made the current HFE system closer to meeting the principles of HFE, it still enabled one state to have a greater fiscal capacity than the other states.

7. CONCLUDING COMMENTS

The Commission has undertaken a thorough review of the post-2018 changes to the GST distribution system, assisted by a number of high quality submissions. There is no doubt that these changes have achieved virtually none of their objectives. This reinforces the perception that the changes were made purely to meet political objectives, rather than because they represented good public policy.

As the post-2018 changes were a failure that came at a high cost to the Commonwealth, the obvious solution is to repeal them. The pre-2018 HFE system met the requirements of the IGAFFR, an instrument that the Commonwealth and states appear not to treat as seriously as they should.

The outstanding issue to be resolved is the means by which state revenue from mining royalties is assessed. The Commission favours applying a dominant state consideration to their assessment. Such an approach requires careful consideration as it will enable resource rich states to have higher fiscal capacities than the other states. The appropriate way to view mineral resources is that they

belong to the nation as a whole and the returns from their exploitation should be shared with all citizens, not just those fortunate to live in a resource rich state.

It is worrying that comments made by the Prime Minister indicate that the Commonwealth will make a political response to the Commission's inquiry rather than one based on good public policy. These comments indicate that the Commonwealth will continue with the current HFE system, including the NoWO guarantee. The Prime Minister has indicated that the non-Western Australian states have nothing to complain about as the additional revenue received by Western Australia is funded by the Commonwealth¹². This comment ignores the opportunity cost of providing the funding to Western Australia. The Commission is encouraged to highlight the opportunity costs involved.

The Prime Minister's comment also ignores the Commonwealth funding is placing Western Australia in a stronger fiscal position than the other states. As the Commission has noted, Western Australia has reduced its debt and the associated interest expense. This will provide Western Australia with the ability to provide services at a higher standard than the rest of the nation or to charge lower taxes. If this outcome continues for an extended period it will result in a nation divided in opportunity.

It is extremely disappointing that the Prime Minister has responded before the Commission has the opportunity to deliver its final report. Good public policy is the ultimate victim.

12 Prime Minister of Australia (2026a) and Prime Minister of Australia (2026b).

APPENDIX: CGC ASSESSMENT METHODS

The CGC has three methods for assessing revenue (and expenses). These are:

Differential assessment—for the revenue assessment this is done by applying the national average tax rate for a particular state revenue to each state’s revenue base, adjusted by the CGC to make them compatible. This method is used when there are differences in state policy in regard to the tax rate and/or the extent of the tax base to be subject to taxation.

Equal per capita (EPC) assessment—the assessed revenue for a particular state revenue is set equal to the Australian average per capita amount for each state. The method is used when states are assessed to have equal revenue raising capacities, reliable data could not be found to make an assessment, an assessment method could not be developed or a differential assessment would not be material. An EPC assessment means that this particular state revenue has no impact on states’ relative fiscal capacities.

Actual per capita (APC) assessment method— the assessed revenue for a particular state revenue is set equal to its actual revenue for each state. It is used when, in the CGC’s judgment, the policies of all States are the same and any differences in revenue per capita are due to differences in state circumstances.

Mining revenue is subject to a differential assessment. However, the distribution of mineral resources is quite uneven across the nation. For example, iron ore and gold are concentrated in Western Australia, coking coal, silver and zinc in Queensland, thermal coal in New South Wales and copper in South Australia. Other states have low concentration of minerals, with the Australian Capital Territory having no minerals.

It could be argued that these differences in the distribution of minerals would make an APC assessment appropriate as the ability to raise revenue from mining is due to differences in state circumstances. Table A1 indicates that the assessment of mining revenue for the assessment years of the CGC’s 2026 Update did not differ greatly from an APC assessment for the main mining states.

Table A1: Ratio of actual to assessed mining revenue, 2022–23 to 2024–25 (per cent)

<i>Year</i>	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>	<i>Average</i>
2022–23	53.2	67.5	130.8	98.5	76.5	65.2	na	195.4	100.0
2023–24	65.2	73.5	117.1	99.1	87.5	43.2	na	128.1	100.0
2024–25	98.3	87.7	104.6	97.8	85.4	61.6	na	134.5	100.0

Source: Commonwealth Grants Commission, *2026 Update GST Relativities 2026–27*, Supporting Information, Table S6-2.

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