

Breaking the gridlock on the GST distribution

Submission to the Productivity Commission inquiry into the GST distribution

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September 2026

Summary

We welcome the opportunity to make a submission to the Productivity Commission's inquiry into the GST distribution.

The GST plays a central role in Australia's federation, and the equalisation of fiscal capacities across states through the distribution is an important part of this.

But the way it operates today is broken. Fixing it is a necessary plank of national budget repair.

Under the 2018 GST deal, the federal government is spending billions of dollars each year to ensure that WA – the one state running strong surpluses – can offer services superior to those in the rest of the country.

This submission makes three recommendations:

1. The WA deal should be scrapped. It sacrifices equalisation without improving other features, it is fiscally irresponsible, and it is not politically durable.
2. The federal government should largely restore the pre-2018 system of GST distribution, placing equalisation back at its core, with changes to buttress its political durability and manage trade-offs.
3. The federal government should consider implementing more transparent federal grants to support efficiency and reform. The current system is being used to achieve a specific policy and political objective that is not transparent to the public. 'Out of system' grants could enable greater public scrutiny and government accountability.

Beyond the scope of the inquiry, the federal government should consider the role that broader GST reform, such as raising the rate

and/or broadening the base could play in providing a potential off-ramp for the 2018 GST deal.

We would welcome the opportunity to engage further with the Productivity Commission on matters raised in this submission.

For further information please contact Deputy Program Director, Economic Prosperity, Grattan Institute:

1 The current arrangements are not in the national interest

The 2018 changes to the GST distribution were intended to make the system more stable and more resilient to shocks, and to leave all states better off.¹

But instead, they have decoupled the GST distribution and the goal of equalisation across the states, without any principled or practical benefits. They deliver a windfall to the one state budget that needs it least (WA's), at a direct, ongoing cost to the federal budget.

Meanwhile, fiscal pressure is rising across the rest of the federation. States governments have led the rise in national (combined federal and state) debt following the pandemic, and debt is set to grow further from current record highs.²

The current arrangements sacrifice equalisation without improving other features

The Productivity Commission's interim report shows just how far the system has strayed from equalisation. It estimates that \$47 billion per year would have been needed to provide all states with the same fiscal capacity as WA in 2024-25 alone.³

With the No Worse Off guarantee in place, Australia currently has two systems operating in parallel: one for WA and one for everyone else. WA does not have to share its prosperity, but whenever the fiscal strength of any other state increases, their prosperity is shared.

Because of the new 'standard state' benchmark, if NSW or Victoria suffer a shock (such as a natural disaster) requiring a higher GST share, then, for no logical reason, WA will also get more GST.⁴

As the PC interim report concludes, the new arrangements do not reduce volatility for states other than WA, do little to improve incentives for reform, and have made the system more complex and less transparent.⁵

Australia now has a system that is not coherent, and hard to defend against any of the principles that are supposed to underpin it.

The current arrangements are not fiscally responsible

As the PC interim report shows, the 2018 changes have cumulatively cost the federal government almost \$23 billion to 2024-25,⁶ and are expected to cost almost \$50 billion by 2029-30.⁷

The link between WA's fiscal strength and the No Worse Off guarantee means that the cost of the transfers is an open-ended budget risk to the federal government.⁸

But the states cannot go without the No Worse Off guarantee. From here, pressure will only grow on the federal government to continue to

1. References to 'state governments' or 'states' throughout this submission should be taken to include both state and territory governments.
2. PBO (2026).
3. This is in addition to the \$5.4 billion in No Worse Off guarantee payments that were made in 2024-25: PC (2026), p. 26.

4. PC (ibid), pp. 27–28.
5. PC (ibid), pp. 2–4.
6. PC (ibid), p. 31
7. Between 2018–19 and 2024–25, \$22.7 billion was paid, and between 2025–26 and 2028–29, a further \$26.3 billion is expected to be paid: PC (ibid).
8. The No Worse Off guarantee is positively related to iron ore prices and has no ceiling: PC (ibid), p. 57.

tip more money into the pool as other states face greater pressure on their budgets in the future.

The current arrangements are not durable

The No Worse Off guarantee will inevitably come under pressure as the federal budget faces its own challenges.

Moreover, the 2018 changes have ruptured a system that – while states had their respective complaints about the GST distribution – was governed through a single set of common rules and administered independently of the federal budget. That is no longer true of the current system.

The current system is being used to achieve a specific policy and political objective that is not transparent to the public. The transfer to WA cannot be scrutinised as a spending decision in the same way as other federal budget items, inhibiting the public's ability to scrutinise the rationale and hold the government to account.

2 We should take seriously the trade-offs in achieving full equalisation

When identifying a preferred alternative model, it is important to take seriously the trade-offs associated with achieving the principle of full equalisation in practice.

Equalisation is not an objective to be achieved at any and all costs. There are other objectives in the balance, including ensuring that how revenue is distributed does not distort state policy decisions, avoids undue complexity, and is relatively predictable based on the broader economic circumstances.

In theory, a distribution system that seeks to achieve full equalisation can reduce the benefit state governments get from their policy effort, or dull the budget cost of spending.⁹ For instance, under equalisation a state does not necessarily keep the full fiscal benefit of raising additional revenue. But views differ on how much the potential loss or boost in GST influences states' policy decisions in practice, and the PC, along with many others, argue that there is little evidence that state decision-making has been affected.¹⁰

Ultimately, the more completely the system equalises, the more carefully it must guard against weakening the incentive for states to pursue policies that improve revenue or service delivery.

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9. The Garnaut/FitzGerald inquiry (2002) argued that 'state governments have reduced incentives to pursue growth-enhancing policies because of systematic equalisation of the revenue costs and benefits of growth-enhancing or growth-inhibiting economic policies': Garnaut and FitzGerald (2002), p. 13.
10. The PC concludes that 'even though impacts on GST payments may exist, they may be inframarginal with respect to policy decisions': PC (2026), p. 21. See also, for example, Eslake (2026), p. 17-18 ; and Victorian Government (2026), Section 6.1, p. 35.

Comprehensive equalisation is inherently complex and technically demanding

More complete forms of equalisation are necessarily more technically demanding, involving the granular assessment of many areas of spending and revenue, using specialised methodologies.

The result is that, while they produce sophisticated assessments, they also produce gains and losses for states that are difficult for governments and the public to understand. This matters for accountability.

Complexity should not be a deal breaker – indeed, there are many areas in government forecasting that rely of specialist knowledge not easily understood by the layperson – but it does mean that the Commonwealth Grants Commission's current efforts to make the system more transparent should continue and include trialing different approaches.

This could involve further developing tools and standard processes to support governments to understand the impact that policy decisions and other changes will have on their GST shares.

The outcomes of horizontal fiscal equalisation aren't always easy to predict

Complexity can also creates problems for the predictability of GST revenue. To forecast GST revenue, state treasuries must understand not only their own revenue and expenditure prospects, but the fiscal circumstances, policy settings, and shocks affecting every other state. The effect is that state GST receipts can be volatile and hard to predict.

One way that the Commonwealth Grants Commission tries to address this is by using a lagged moving average to smooth year-to-year fluctuations.¹¹ But the trade-off is that changes in a state's circumstances take time to be reflected in their GST share, and the Commonwealth Grants Commission provides GST relativities only for the upcoming financial year.¹²

Striking a compromise between contemporaneity and stability of GST revenue is a challenge, and will involve implementation trade-offs, but even incremental system adjustments towards giving states greater certainty to plan ahead would support better state budget management.

Options include shortening the lag time for changed circumstances to flow through to current-year relativities, as well as the provision of forward forecasts of GST relativities to help states plan their budgets, accompanied by appropriate caveats regarding their potential to change.¹³

11. CGC (2026), p. 10.

12. CGC (ibid), p. 10.

13. NSW Government (2026) for example suggests moving to an average of two years: NSW Government (ibid) p. 28.

3 A better way of distributing the GST

Fixing the GST distribution is a necessary plank of national budget repair.

The federal government should move back to a single, principled system for sharing GST revenue between the states. This will save federal taxpayers billions, money that can be more transparently targeted than under the current arrangements.

Almost all alternative models are better than the current one

All the methods to work out GST shares in pursuit of equalisation involve trade-offs between equity, efficiency, and predictability, and differ in their fiscal impact on the federal and state governments.

Methods that aim to achieve full equalisation, allow fiscally strong states' shares to drop low (i.e. have low or no relative floors), and do not account for dominant-state effects, tend to provide larger shares of the GST to smaller states.

In contrast, models that aim to achieve lower or 'reasonable' levels of equalisation, place limits on how low a states' share can fall, and include revenue assessment adjustments such as mining revenue discounts, tend to provide bigger shares of the GST to the larger states.

Because the GST distribution is a zero-sum exercise, disagreement among states about which model to pick is inevitable. But in the long run, all states will be better served by a more stable, politically-neutral system, that tries to balance the principle of full equalisation with system durability in practice.

The best fix is to largely restore the pre-2018 system

Restoring the pre-2018 system would return equalisation to the core of the GST distribution.

The pre-2018 system had flaws, but these can be addressed. They arise in relation to how the system manages extremes, how the revenue assessment treats states that are most dominant in one type of revenue, as well as opportunities to support states to reliably estimate their forward GST revenue.

A substantial reform would be to adopt a fixed floor, placing an upper limit on how much a stronger state supports weaker states. The current floor at 0.75 is too high and only benefits WA. If adopted, it should be much lower.

Other targeted fixes could include reviewing and updating the revenue assessment methodology to include the adoption of a different assessment method for mining revenues, which have some of the clearest dominant-state effects,¹⁴ and would improve the durability and efficiency of the system.

These types of reforms are all valid political choices about how to deliver the principle of equalisation in practice. The key is that reform

14. Analysis by the WA Government illustrates how, without the 2018 changes, WA would lose about 88 per cent of proceeds from an iron-ore royalty rate change in foregone GST grants. Applying a 25 per cent discount, for example, would mean WA loses only 63 per cent in foregone GST grants: WA Government (2026), Table 5.1, p. 95. Beyond mining discounts, reforms could include the introduction of elasticity adjustments to reflect the relationship between a tax rate and its base, the absence of which results in the overestimation of a state's tax base: NSW Government (2026).

to the GST distribution should restore the system's overall stability, transparency, and neutrality (not favour any one state), and be a responsible use of taxpayer money.

Federal grants for efficiency and reform could cost far less than the No Worse Off guarantee.

The federal government should consider making untied grants to the states to support the efficiency of the GST distribution system and improve incentives for reform.¹⁵

These would go to states whose reforms would otherwise significantly reduce their GST distribution, offsetting the disincentive without changing the rules or undermining the main job of the GST. Grants could be limited and phased out over time, but still provide an incentivising windfall.

Such grants would probably cost far less than making the No Worse Off guarantee permanent. They would also reduce the risk of unforeseen cost escalation and be far more transparent, because each grant's purpose and size would be explicit and open to scrutiny.

The federal government gets a direct pay-off if state reforms succeed. Reforms that improve the efficiency of state tax bases can support economic growth more broadly – which the federal government captures through its tax bases. Reforms that improve spending efficiency or increase revenue adequacy will reduce state pressure on the federal government to add more money to the system.

15. Others have argued in favour of similar arrangements, including, for example, that if the federal government was committed to providing WA additional funding, it should do so through targeted transfers outside of the GST system: Tasmanian Government (2026) p. 6; Victorian Government (2026) p. 2.

4 Broader GST reform could be the circuit breaker the federation needs

The GST distribution has become a political quagmire, trapped in a cycle of ad-hoc arrangements, renegotiation, and escalating compensation. All the while, the GST pool is not keeping pace with the demands placed on it.

While beyond the scope of this inquiry, broader GST reform – such as broadening the base and/or raising the rate – would mean greater revenue certainty and enable a more sustainable sharing of fiscal risks between the federal government and the states.¹⁶

This would shift the debate from who gets what share of the GST to how to make the GST do more for our federation.

16. Grattan Institute's past recommendations for raising and/or broadening the GST can be found in Sathanapally et al (2025); Wood et al (2022); and Daley and Wood (2015).

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