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No.12 GST Distribution: Addressing Some Misconceptions

**Occasional Paper**

September 2025

## Summary

* GST distribution is underpinned by the objective of horizontal fiscal equalisation and is not based on population shares or the amount of GST collected in individual states. When the GST was introduced in 2000, the Commonwealth and all states signed an intergovernmental agreement, which stated that the GST revenue would be distributed according to horizontal fiscal equalisation principles.
* GST relativities reflect how much of the GST pool states need to equalise their fiscal capacities to provide broadly comparable standards of services to their residents. The relativities only apply for one year. GST relativities change from year-to-year because states’ relative economic and socio-demographic circumstances change from year-to-year.
* The GST distribution arrangements do not compensate a state for poor fiscal management. A state is not rewarded with an increased share of GST revenue if it runs larger budget deficits than other states because of its policy choices. GST is based on states’ relative, policy neutral fiscal capacities, not their fiscal policies.
* The GST revenue collected in any year is a fixed amount. Any increase in the share of GST revenue for some states means a decrease in the share for other states.
* As in some other areas of complex and contentious public policy, the Australian Parliament has seen a role for an independent agency to assess and recommend to Government how the GST revenue should be shared. This is the role of the Commonwealth Grants Commission.

## Introduction

The Commonwealth Grants Commission (the Commission) provides independent advice to the Australian Government on how to share GST revenue among the states and territories (states). The broad aim of the GST distribution arrangements is to provide all states with the fiscal capacity to provide a broadly comparable standard of services to their residents.

This paper provides information to address some common misconceptions about GST distribution.

## Facts on GST distribution

#### GST distribution is underpinned by the objective of fiscal equalisation, not based on state population shares

Commentary on Australia’s GST distribution arrangements sometimes suggests that a state that receives less than its population share of the GST pool is being short-changed and is not receiving its ‘fair’ share. This argument is reinforced by the misconception that a state is entitled to the GST collected in their state. Data on GST paid by residents of each state are not collected and it would be difficult to do so.

These misconceptions fail to reflect the nature of the GST distribution system agreed to by the Commonwealth and the states, and included in legislation.

With the introduction of the GST in 2000, the Commonwealth and all states signed up to the 1999 *Intergovernmental Agreement on the Reform of Commonwealth‑State Financial Relations*, which stated that the GST revenue would be distributed according to horizontal fiscal equalisation principles.[[1]](#footnote-2) These principles, which were outlined in legislation in 1978, remain a central feature of the current *Intergovernmental Agreement on Federal Financial Relations*, which came into effect in 2009.[[2]](#footnote-3)

While legislated changes to the GST distribution arrangements in 2018 created a new equalisation benchmark linked to the fiscal capacity of New South Wales or Victoria (depending on which is stronger), horizontal fiscal equalisation remains the building block for determining states' GST distributions.

The fiscal equalisation objective requires the Commission to assess states’ relative fiscal capacities to determine how much of the GST pool each state ‘needs’, to have the capacity to provide a broadly comparable standard of services to its residents. The Commission assesses a state’s relative revenue raising capacity in comparison to the average revenue collected by all states. The Commission also assesses whether there are circumstances outside the control of a state that affect its cost of providing services. In assessing the relative, non-policy factors influencing each state’s cost of providing services, the Commission has regard to a range of demographic and geographic characteristics (for example, age, socio-economic status and levels of remoteness).

Fiscal equalisation is not an exact science. It depends on the availability of appropriate detailed data, including from the states, and requires the Commission to undertake estimates, make trade-offs and apply judgements in its assessments. The Commission seeks to make its judgements as consistent, transparent and understandable as possible.

The Commission recognises that in many, but not all, instances, its assessment methods are complex. In pursuing the primary objective of fiscal equalisation, complexity can arise from adopting methods that seek to best reflect states’ particular circumstances, including removing the impact of policy choices. The Commission consults the states extensively and supports states through regular engagement and training. The Commission adopts a materiality threshold as a guardrail against undue complexity.

#### GST relativities reflect how much GST a state ‘needs’ for one fiscal year only

Each state’s share of GST revenue is expressed as a ‘relativity’. If all states had the same fiscal capacity, each would have a relativity of 1 and receive the same GST revenue per person. Because their needs are different, states with a stronger than average fiscal capacity have a relativity below 1 (and receive less than the average GST revenue per person), and states with a weaker than average fiscal capacity have a relativity above 1 (and receive more than the average GST revenue per person).

For example, Western Australia currently has the strongest fiscal capacity, mainly because it has the highest revenue raising capacity due to its access to valuable mineral endowments. It has a GST relativity below 1. The Northern Territory has the weakest fiscal capacity, mainly because it has a larger share of its population living in remote and very remote areas and a larger share of its population consisting of First Nations people compared with other states. It has a relativity well above 1.

The Australian Government asks the Commission to update the GST relativities every year, using the latest available data. It is usual for relativities to change every year because states’ circumstances change. For example, the states’ main tax bases, in particular mining royalties, stamp duty on conveyances and land tax, are affected by market conditions (prices and volumes of production or sales). States vary in their share of each of these tax bases and so each state’s revenue raising capacity relative to other states can either increase or decrease depending on the market conditions in each sector of the economy.[[3]](#footnote-4)

Relativities are updated every year and often change significantly in response to changing economic and socio‑demographic circumstances. Therefore, any change in the latest GST relativities cannot be assumed to continue into future years. There is a high degree of uncertainty with any economic forecast. This uncertainty is significantly magnified with any attempt to forecast a state’s future GST relativity because it would require forecasting changes in the relative future fiscal capacities of all states.

#### The GST distribution arrangements do not compensate for poor fiscal management

An important aspect of the Commission’s approach is that the GST revenue is distributed based on each state’s relative fiscal capacity not its relative fiscal policy settings. This means states are not rewarded with an increased share of GST revenue if they run larger budget deficits than other states because of their policy choices.

To assess relative fiscal capacity, the Commission determines the policy neutral rate of taxing or spending for each major state revenue base and spending responsibility. It does this by calculating national average tax rates for the revenue assessments and national average spending levels for the expense assessments.

GST revenue is effectively distributed so that each state has the capacity to deliver the average level of services if it makes the average level of effort to raise revenue. If a state chooses to spend more in delivering services (than that assessed by the Commission to deliver the average level of services), it does not receive a corresponding increase in its GST distribution. Similarly, it does not receive a reduction in its GST distribution if it spends less than its assessed spending requirements. This is a longstanding principle underlying the Commission’s assessments.

## Conclusion

The GST revenue collected in any year is a fixed amount. Any increase in the share of GST revenue for some states means a decrease in the share for other states. Given fiscal equalisation is not an exact science, the Commission recognises that not everyone will agree with its decisions regarding GST distribution.

To maintain confidence in the process, the Commission seeks to be as transparent and as consultative as possible. It seeks to ensure that states can present their views, and clearly explains the reasons for its decisions, particularly how the decisions relate to the objective of horizontal fiscal equalisation.

1. The horizontal fiscal equalisation objective that the Commission applies is essentially the same as that contained in the *States (Personal Income Tax Sharing) Amendment Act 1978*: “……on the basis of the principle that the respective payments to which the States are entitled under this Act should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards not appreciably different from the standards of the government services provided by the other States; taking account of differences in the capacities of the States to raise revenues; and differences in the amounts required to be expended by the States in providing comparable government services.”; [1999 Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations](https://federation.gov.au/sites/default/files/about/agreements/reform_of_comm-state_financial_relations_PDF.pdf) [↑](#footnote-ref-2)
2. [The Intergovernmental Agreement on Federal Financial Relations](https://federalfinancialrelations.gov.au/intergovernmental-agreement-federal-financial-relations) [↑](#footnote-ref-3)
3. To reduce volatility, the Commission uses a rolling average of the prior 3 years of data. This means that a state’s change in circumstances will be phased in. [↑](#footnote-ref-4)