



2026

Economic Impacts of Australia's GST Distribution on Queensland

Interim Report

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Executive Summary

Context

In 1999, the Australian, state and territory governments (hereafter 'states') agreed to reform Commonwealth–State Financial Relations with the signing of a new intergovernmental agreement (IGA) to remove a range of inefficient taxes and provide states with access to 'a more robust tax base that can be expected to grow over time' (Australian Government 1999b, pp. 2–3).

The agreement was made possible through the introduction of the Goods and Services Tax (GST) and the Australian Government's undertaking that the GST revenue would be distributed to the states as untied grants and in accordance with the principle of horizontal fiscal equalisation (HFE); a longstanding feature of Australian Government revenue assistance to the states.

The GST distribution system is intended to equalise the fiscal capacity of states by offsetting differences in revenue-raising capacity and service delivery needs and costs, so that each state has the potential to provide a similar level of services and infrastructure to its residents.

Since the introduction of the GST in 2000, the distribution of GST revenue has been based on the recommendations and methodology of the Commonwealth Grants Commission (CGC).

With GST grant revenue representing an important source of state funding, states are heavily invested in the process of GST distribution due to its influence on state budget outcomes. As a result, debate over the appropriate distribution of GST revenue has been an ongoing feature of intergovernmental financial relations in Australia. Numerous reviews have been initiated by the Australian Government and/or the states into the GST distribution system, with the first review commencing in 2002.

While the focus of these reviews has been wide-ranging, a prominent theme has been the extent to which the GST distribution system can reduce economic efficiency or disincentivise growth-promoting policy.

Interim advice: approach and scope

The Queensland Productivity Commission (Commission) has been asked to provide advice on the economic impacts of Australia's GST distribution system on Queensland.

The distribution of GST revenue primarily relates to equity (the division of economic returns) rather than the growth of economic returns (efficiency). The current distribution system aims to deliver equity by equalising the fiscal capacity of state governments, as opposed to interpersonal equity outcomes more directly. Seeking to achieve fiscal equalisation through the GST distribution system can have consequences for both equity outcomes and economic efficiency, through impacts on the allocation of resources and influence on policy decisions.

Despite long-held concerns and frequent reviews suggesting the GST distribution system has a range of consequences for economic efficiency, quantitative evidence remains limited and there is no consensus on overall economic impacts. Accurately assessing economic impacts is difficult. While fiscal impacts are more direct and measurable, economic impacts are more complicated to measure as the primary impacts are transfers (that is, the redistribution of resources without changing total resources). In addition, the most significant effects are likely to be from indirect impacts. For example, less efficient allocation of labour and capital across the economy or poor incentives for sound government spending, taxation and reform.

Consequently, this Interim Report aims to set out some initial evidence on the extent to which the GST distribution system delivers against its objectives in an economically efficient manner. Central to HFE is a set of direct and indirect trade-offs. This Interim Report identifies some areas where these trade-offs may be resulting in suboptimal economic outcomes. The Interim Report does not attempt to assess what the 'optimal' system may be, rather it seeks to provide initial evidence on the impact of the current GST distribution system on economic efficiency.

Interim findings

Over the long-term, Queensland has been a beneficiary of the GST distribution system. The GST distribution system has provided Queensland with a more favourable revenue outcome compared to alternatives suggested by the Australian Productivity Commission or other jurisdictions, such as an equal per capita basis.

While Queensland's GST grant, total revenue and expenses grew largely in line with each other until 2019, there was then a significant divergence, with a large increase in own-source revenue and expenses.

In 2025–26, Queensland is projected to receive \$16.8 billion in GST grant revenue, \$2.2 billion lower than in 2024–25. This decline represents the largest fall in GST grant revenue in a single year any state has faced since the GST was introduced. Queensland's GST grant revenue in 2025–26 equates to \$2,935 per person, effectively the same amount of revenue received as in 2002–03 in real per capita terms (\$2,943).

This interim advice finds the design and administration of the GST distribution system:

- **may increase states' reliance on inefficient taxes.** States with lower GST grant revenue per capita are more reliant on inefficient taxes and Queensland has become more reliant on inefficient taxes as the contribution of the GST grant revenue to state revenue has fallen. GST revenue has not grown in line with overall growth in economic activity. If GST, as a share of gross domestic product, had remained at its 2003–04 level, the GST pool would be \$17.1 billion larger than currently expected in 2025–26, potentially providing Queensland with up to \$3.5 billion in additional GST grant revenue
- **may impede efficient labour and capital flows.** The reallocation of fiscal resources between states leads to a shift in economic resources, including the redistribution of population across states over the long term. While empirical evidence on the precise efficiency impacts is limited, if labour and capital relocate to where they are less productive it will result in economic costs
- **can create poor incentives for growth-enhancing policy.** States do not bear the full cost or gain the full benefit of policy decisions. Inefficiencies can arise from the design and administration of the GST distribution system when:
 - recipient states become dependent on fiscal equalisation transfers to fund state services, rather than through pursuing growth policies. The GST distribution system has cumulatively redistributed \$124 billion in GST revenue from donor to recipient states since its introduction in 2000, relative to an equal per capita share. While the literature and past reviews are inconclusive, recipient states have relatively larger public sectors than donor states and states have typically been entrenched in their status as recipients or donors since the introduction of the GST
 - states do not bear the full cost of policy initiatives that restrict economic activity. For example, in the case of gas policy, New South Wales and Victoria have restricted onshore gas development. The GST distribution system has redistributed revenue toward these states as compensation for not receiving gas royalties
 - states may not gain the full benefit of their policy decisions. States can face costs through the GST distribution system for pursuing economically efficient policy initiatives and as a result the distribution of GST can dampen incentives for policy reform. Apart from the Australian Capital Territory Government's move to replace stamp duty with land tax, which is ongoing, there has been no significant, sustained state tax reform since the GST was introduced
 - the assessment of expenditure needs effectively overrides some specific purpose funding agreements between the Australian Government and states.
- **may make it more difficult for states to respond to economic conditions.** Costs can arise where the GST distribution system slows adaptation to structural change, which has economic impacts. For Queensland, the GST grant has also become pro-cyclical, such that it is amplifying fluctuations in state revenue. This can contribute to economic inefficiency through misallocation of windfall revenue gains and constrain budget management when responding to economic conditions

- **continues to compromise economic efficiency despite adjustments.** The 2018 changes have not addressed the ways in which fiscal equalisation can compromise efficiency. The main effect of the 2018 changes is to provide additional fiscal support to Western Australia over and above CGC assessed expenditure needs. Had transitional arrangements not been in place, the 2018 changes would have resulted in Western Australia retaining an estimated additional \$30 billion in GST revenue by 2025–26.

Next steps

This Interim Report sets out the Commission's initial advice.

The Commission will continue to assess the key impacts identified in this advice and expand further on matters covered by the direction in its Final Report. This will include providing further analysis on the impact of the GST distribution system on policy incentives and the interaction of the GST with other Australian Government payments.

In accordance with the direction, the Commission will provide its final report to the Treasurer by 17 April 2026.

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1.0 Background

1.1 Introduction

Direction

On 17 November 2025 the Queensland Treasurer directed the Queensland Productivity Commission (Commission) to provide advice on the economic impacts of Australia's Goods and Services Tax (GST) distribution system on Queensland ('the direction'). The full direction is provided in Appendix A.

The Commission has been asked to assess the economic impact of GST distribution including on:

- Queensland's economy and the State's capacity to deliver services to support growth and social outcomes, considering that from 2015–16 to 2025–26 Queensland's GST revenue grew by 28 per cent instead of 75 per cent in line with the growth in national GST payments
- other key economic outcomes for Queensland relative to other states and territories, including capital and labour mobility
- Queensland, relative to other states and territories, as a result of the 2018 GST distribution system changes.

The Commission has also been asked to assess:

- whether GST distribution outcomes have appropriately incentivised sound policy decisions and reform
- the unintended consequences of the interaction between GST distribution and the broader Commonwealth–State funding and policy framework
- any other relevant matter relating to the economic and equity impacts of GST distribution.

Approach

Consistent with the direction, the Commission has focused on providing targeted economic advice on the economic impacts of the GST distribution system on Queensland.

In preparing this Interim Report, the Commission has drawn on the existing body of literature concerning the economics of horizontal fiscal equalisation (HFE) and fiscal federalism, supplemented with its own analysis.

As this report was commissioned as advice under section 9(1)(d) of the *Queensland Productivity Commission Act 2025* (Qld), the Commission has not initiated formal consultation nor requested submissions. To support delivery of this Interim Report and consistent with the requirements of the direction, the Commission has undertaken targeted consultation with Queensland Treasury, the Australian Productivity Commission (PC) (concerning its 2018 Horizontal Fiscal Equalisation Inquiry), the Commonwealth Grants Commission (CGC) and academics with relevant technical expertise in fiscal federalism.

The Commission is grateful for the contributions of these organisations and individuals to the preparation of this interim advice.

To address the direction, the Interim Report:

- provides background information on the GST distribution system in Australia, with a particular focus on its objectives, recent developments and discussion of past reviews (Section 1)
- sets out a framework for considering how the GST distribution system affects economic efficiency (Section 2)
- sets out preliminary advice on the outcomes of GST distribution for Queensland (Section 3) and impacts on economic efficiency that may arise from the design and administration of the GST distribution system (Section 4).

Consistent with the direction, the advice does not examine the broader fiscal, equity, governance and methodological issues of GST distribution, except where these are relevant to discussing economic impacts on Queensland. The advice also does not consider or recommend alternative policy options nor reforms to the system of GST distribution.

The advice relies heavily on publicly available data and materials from the Australian Bureau of Statistics (ABS), federal and state budget papers, past reviews, the economic literature, the CGC and public submissions to the current PC Inquiry into the GST distribution reforms. The Commission has not relied on any proprietary models, such as the CGC's model, as they are confidential and would require agreement from states and territories (hereafter 'states') for access.

1.2 The GST distribution system

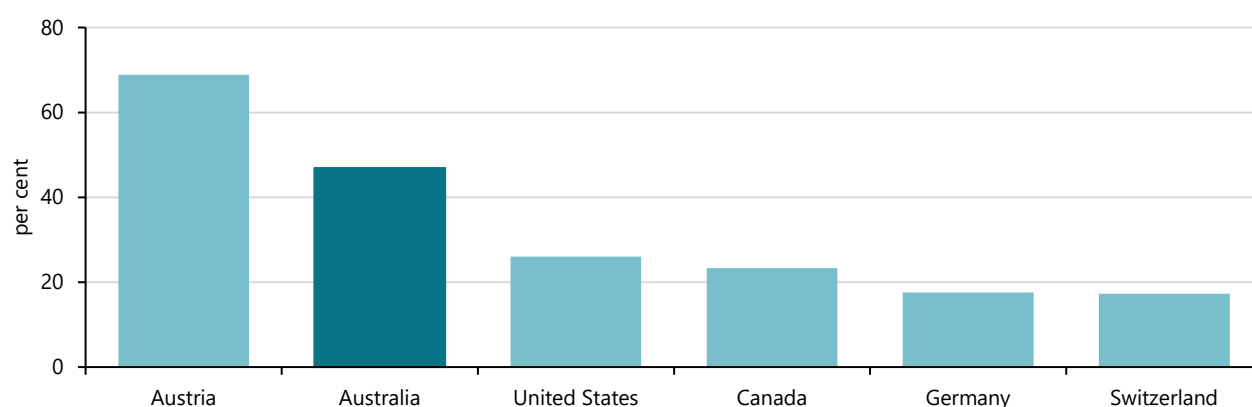
The key elements of the GST distribution system relate to the methodological approach to achieve HFE (that is fiscal equalisation) and the application of the HFE methodology to apportion GST revenue between the states.

Introduction of the Goods and Services Tax

Under Australia's system of fiscal federalism, the Australian Government's revenue-raising effort significantly exceeds its spending responsibilities, while the converse is the case for the states. This results in a vertical fiscal imbalance (VFI), the imbalance between spending responsibilities and revenue raising powers. Among comparable federations, Australia has a high level of VFI, such that states rely heavily on Australian Government transfers (Figure 1.1).

Figure 1.1 Australia has a relatively high level of vertical fiscal imbalance

Vertical fiscal imbalance across selected, comparable federations, 2020



Note: The VFI measure in Figure 1.1 is calculated one minus the ratio of the subnational government's own revenue compared to its own spending. As shown, a high level of VFI (such as in Austria and Australia) indicates the subnational government's spending is far greater than its revenue (Browne 2021, p. 5).

Source: *International Monetary Fund 2026*.

The introduction of the GST and the supporting distribution system aimed to deliver two broad objectives:

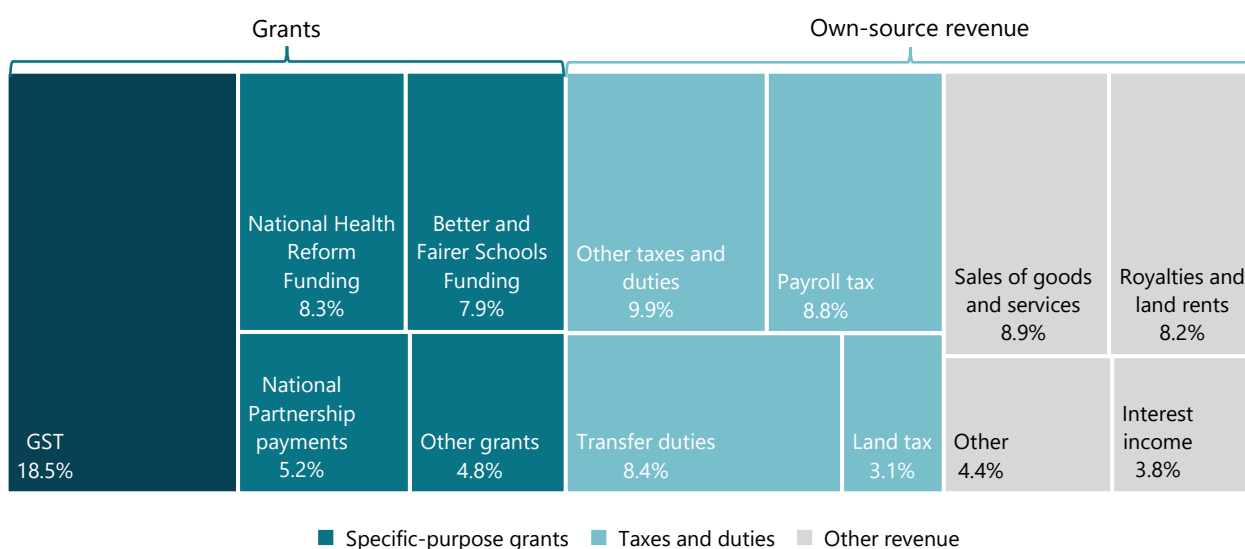
- First, the quarantining of GST revenue for distribution to the states to assist with addressing VFI.
- Second, the associated distribution system sought to address differences in fiscal capacities across the states in accordance with HFE. HFE aims to deliver fiscal equality by addressing differences in states' fiscal capacities that arise from variations in revenue-raising abilities and the cost of delivering services (CGC 2025c; PC 2025b, pp. 6–7).
 - The 1999 Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations (IGA) (see Box 1.1) provides for the total 'pool' of GST revenue to be distributed to the states in accordance with the principle of HFE.

GST payments are a large and important component of Australian Government transfers to the states. Of the \$194.7 billion paid from the Australian Government to the states in 2024–25, \$91.2 billion, or 47 per cent, represented GST payments (Australian Government 2025b, pp. 59, 64). GST grant revenue represents, on average, just under one-quarter of total state government revenue (Parliamentary Budget Office 2020, p. 2), affording the GST distribution significant influence over state budget outcomes.

Since its introduction in 2000, the GST has represented the Queensland Government's single largest source of revenue (as in most other states), averaging around 24 per cent of total State revenue. In 2025–26, the GST grant is expected to provide 18.5 per cent of total Queensland Government revenue (Figure 1.2).

Figure 1.2 GST is expected to remain Queensland's largest single source of revenue in 2025-26

Budgeted contributions towards Queensland's total revenue, 2025-26



Note: Data on grant revenue (including GST grant revenue and payments for specific purposes) is from the Australian Government's Mid-Year Economic and Fiscal Outlook (MYEFO). There is a minor discrepancy in the MYEFO's estimate of Queensland's GST grant revenue (\$16.816 billion) compared to the Queensland Government's Mid-Year Fiscal and Economic Review's (MYFER) estimate (\$16.802 billion). 'Other grants' includes other Australian Government grants and other grants and contributions. Data on own-source revenue is from the MYFER. 'Other' includes dividends and tax equivalents, fines and forfeitures, and revenue not elsewhere classified; and was calculated by subtracting the value of 'Royalties and land rents' and adding the value of 'Dividends and tax equivalents' to the 'Other revenue' category reported in the MYFER. Numbers may not add to 100 per cent due to rounding.

Source: Australian Government 2025c; Queensland Government 2025a.

Box 1.1 The 1999 Intergovernmental Agreement

The GST was introduced under the 1999 IGA, which sought to:

1. implement a new national tax system including through reform of state taxes and removal of wholesale sales tax
2. provide state governments with revenue from a more robust tax base that can be expected to grow over time
3. improve the financial position of all state governments (Australian Government 1999b, pp. 2–3).

While the GST is a tax levied by the Australian Government and shared with the states, the 1999 IGA requires all jurisdictions to agree to any changes in the tax rate and base (Australian Government 1999b, p. 6).

Central to the agreement was the sharing of the total pool of GST revenue with the states in exchange for the removal of a number of inefficient state taxes (Australian Government 1999b, pp. 2–3). These tax reforms aimed to deliver a more efficient and equitable tax system as a means of supporting higher productivity, living standards and Australia's international competitiveness (Australian Government 1998, pp. 9–10).

Some of the key inefficient state taxes abolished with the introduction of GST included:

- bed taxes
- financial institutions duty
- debits tax (bank account debits tax)
- stamp duties on various business-related transactions, such as marketable securities, business inputs/assets, credit arrangements and hire of goods (Australian Government 1999b, pp. 12–13; Australian Treasury 2006).

In Queensland, the key taxes abolished through the GST reform process included debits tax, stamp duty on quoted marketable securities, and other inefficient duties. Some taxes slated for abolition noted above were not levied in Queensland, such as financial institutions duties and bed taxes (Queensland Government 2000, p. 59).

The 1999 IGA increased VFI through the replacement of state revenue bases with Commonwealth grants. With this dependence on centrally determined payments, states are heavily invested in the GST distribution system due to its influence on state budget outcomes.

Horizontal Fiscal Equalisation

HFE has been a core feature of the Australian federation. While different approaches have been adopted over time, a core principle has been that irrespective of the state in which a citizen resides, that state should have the capacity to deliver public services to an agreed standard.

Untied funding or general revenue assistance (where the states retain expenditure discretion) has been distributed to the states in accordance with HFE since the introduction of the CGC in 1933.¹

The objective of HFE has changed over time, as noted in Box 1.2. The changes have been driven by a range of factors including the challenges of targeting equity through fiscal equalisation and the trade-offs that arise from that approach for equity and economic efficiency.

¹ The history of HFE has been detailed extensively elsewhere, such as in the PC's 2018 Inquiry into Horizontal Fiscal Equalisation.

Box 1.2 The evolution of the HFE objective since the introduction of the GST

The 1999 IGA did not include an agreed or explicit definition of HFE.

However, at the time of signing the IGA, revenue from the GST was treated like other forms of general revenue assistance. This was to provide each state with the capacity to deliver the average standard of public services, if it made the same effort to raise revenue as the states on average and operated at an average level of efficiency (Australian Government 1999a, pp. 15–18).

This approach has been referred to as achieving ‘full’ equalisation (PC 2018, pp. 75–76). This refers to a ‘zero-sum’ distribution, where the CGC estimates the fiscal capacities of all states, and then aims to comprehensively and fully equalise each state’s fiscal capacity to that of the strongest state (PC 2018, pp. 74, 224).

From 2021–22, following the implementation of the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) (discussed below), the objective of HFE transitioned towards a system of achieving ‘reasonable’ equalisation. ‘Reasonable’ is described as the effect of equalising to the fiscally stronger of New South Wales or Victoria, rather than to the strongest state (Commonwealth Parliament 2018, p. 3).

The Terms of Reference for the PC’s current inquiry into the 2018 GST distribution reforms requires it to consider whether the 2018 legislative changes deliver a ‘reasonable’ level of HFE, and how ‘reasonable’ equalisation should be defined (PC 2025b, p. 14).

The CGC’s methodology for assessing each state’s relative fiscal capacity

The Australian Government determines the GST distribution based on the advice of the CGC (CGC 2025d, p. 230). In general terms,² the CGC seeks to assess each state’s relative fiscal capacity by estimating the amount a state would need to spend to provide all-state average services and infrastructure, and the revenue it could raise from its own sources if it made the average effort (CGC 2025d, p. 230).

This complex assessment includes consideration of each state’s service delivery needs and costs, and revenue raising capacities across a set of established categories (see Figure 1.3). It also accounts for factors outside the control of each state (or ‘non-policy’ factors) that increase its costs of delivering services or that hinder its ability to raise revenue (CGC 2025d, p. 230; PC 2018, p. 47). These factors include demographic factors, population size and dispersion, and natural endowments (Commonwealth Parliament 2018, pp. 6–7).

The methodology used by the CGC to assess each category can change over time as part of the CGC’s methodology reviews, which are typically undertaken every five years. When applying the methodology, the CGC uses the average of three financial years to balance contemporaneity, predictability and stability.³ There is also a two-year lag from the year being calculated to account for data availability (CGC 2025b, p. 58).

² The methodology is not discussed in detail in our advice but has been extensively discussed in past reviews and is outlined in the CGC’s GST Relativities 2025–26, Attachment A (2025f, p. 59).

³ ‘Contemporaneity’ is defined by the CGC as ‘to the extent reliable data will allow, the distribution of GST in a year should reflect state circumstances in that year’ (CGC 2023, p. 17). ‘Predictability’ and ‘stability’ are considered by the CGC within the context of ‘contemporaneity’. In its 2010 methodology review, where the current four supporting principles were first settled (Box 1.3), the CGC indicates the ‘averaging process smooths the effect of data irregularities and short-term events thereby making state shares of GST less volatile. Many states value this over a more up-to-date assessment because it provides some more stability in a major source of revenue, despite volatility in state own-source revenue’ (CGC 2010, p. 38).

Figure 1.3 Categories considered as part of the CGC's assessment of a state's fiscal capacity

Revenue	Expenditure	Capital
Payroll tax	Schools education	Investment
Land tax	Post-secondary education	Net borrowing
Stamp duty on conveyances	Health	
Insurance taxes	Housing	
Motor taxes	Welfare	
Mining revenue	Services to communities	
Other revenue	Justice	
Revenue from commonwealth payments	Roads	
	Transport	
	Services to industry	
	Wage costs	
	Geography	
	Socio-economic status	
	Other expenses	
	Depreciation	

Note: 'Other revenue' includes revenue such as gambling taxes, fees and fines, interest and dividend income (CGC 2025d, pp. 37, 224). 'Other expenses' includes expenses such as the expenses of general public services and natural disaster relief (CGC 2025d, p. 183). 'Investment' only refers to investment in new infrastructure and equipment, with the replacement of existing assets assumed to be funded through depreciation expense (PC 2018, p. 88).

Source: CGC 2020b, 2025d; PC 2018, p. 88.

The CGC also adopts four supporting principles to guide the application of HFE (Box 1.3).

Box 1.3 The CGC's supporting principles

The CGC uses four supporting principles to guide considerations in designing and evaluating alternative assessment methods:

- 'what states do': the CGC's methods should, as far as possible, reflect what states collectively do, not what they could do or should do
- policy neutrality: a state's policy choices (in relation to the revenue it raises or the services it provides) should not directly influence its GST share; and the CGC's assessments should not create incentives to choose one policy over another
- practicality: assessments should be based on sound and reliable data and methods and should be as simple as possible, while capturing the major influences on state expenses and revenue
- contemporaneity: to the extent reliable data will allow the distribution of GST in a year should reflect state circumstances in that year.

However, these principles are subsidiary to the objective of achieving HFE and their application can also be affected by guidance from the Australian Government, in the form of the Terms of Reference from the Australian Treasurer. Such guidance can have a material impact on the recommendations of the CGC.

For example, the Terms of Reference for the 2025 Methodology Review, asked the CGC to consider whether it should be given the flexibility to consider alternative assessment methods 'in cases where there is a significant unanticipated shock (such as a pandemic) or where major policy reforms have occurred between reviews.'

Source: Australian Government 2023b, p. 6; 2026; CGC 2025b, p. 312.

A state's share of the GST pool is primarily determined by its relative fiscal capacity. When a state is assessed as having a below-average fiscal capacity, the state receives more than its population share of GST revenue. Conversely, when a state is assessed as having an above-average fiscal capacity, the state receives less than its population share (CGC 2025a). The CGC express this outcome as a GST relativity (Box 1.4).

Box 1.4 GST relativities

The CGC expresses a state's GST distribution outcome in terms of a GST relativity.

A GST relativity is a measure of a state's fiscal capacity relative to the all-state average.

States with a stronger-than-average fiscal capacity will record a relativity below 1.0 and receive less GST than their population share. States with a weaker-than-average fiscal capacity will record a relativity above 1.0 and receive more than their population share. Because the GST pool is fixed, if some states' GST share increases, the GST shares of other states will decrease. Put simply, the GST is allocated on a 'zero-sum' basis, such that a change in the GST share of one state will affect the shares of all other states.

Source: CGC 2025e, p. 2.

The 2018 changes to GST distribution

In 2018, the Australian Government announced significant changes to the GST distribution system, identifying four broad aims:

- affirming a commitment to the 'fair go' principle of HFE
- maintaining and improving HFE with minimal disruption
- improving the stability of the system, reducing volatility for states' revenue
- ensuring all states are better off (Australian Government 2018, p. 11).

The Australian Government aimed for the transition to be one that is 'fair, reasonable and sustainable' for all states (Commonwealth Parliament 2018, p. 9). Following the transition, according to the Australian Government, the new arrangements should leave 'Australia with a more stable and predictable source of revenue for all States and Territories', while ensuring that key features of HFE relating to equity are retained to ensure all states are better off (Commonwealth Parliament 2018, p. 7).

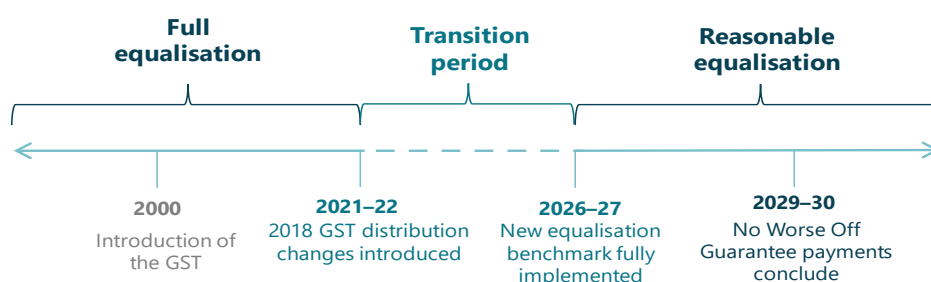
The main changes announced by the Australian Government were:

- a **new equalisation benchmark** linked to the fiscally stronger of New South Wales or Victoria (known as the 'standard state') (Australian Government 2018b, p. 16) — replacing the use of the 'fiscally strongest state' as a benchmark for equalising fiscal capacities. When a state is assessed as having a stronger fiscal capacity than the 'standard state', that state will have its assessed relativity increased to the assessed relativity of the 'standard state', while all states will have their relativities adjusted down on a population share basis (CGC 2021, p. 2). As discussed in Box 1.2, the change in the benchmark transitioned the objective of HFE from 'full' to 'reasonable' equalisation
- a **GST relativity floor** was introduced for all states. From 2022–23 every state must receive at least 70 cents for every dollar of GST distributed on an equal per capita (EPC) share basis. The floor increased to 75 cents from 2024–25 (CGC 2021, p. 2). As GST comes from a fixed funding pool, where this occurs, states will again have their relativities adjusted down on a population share basis to accommodate the floor.
- **Australian Government funded top-ups** to the GST pool in perpetuity, and for the top-up to grow at an indexed rate. This permanent boost to the GST pool, in addition to the temporary 'no worse off' payments (discussed below), were designed to ensure all states are better off during and following the transition (CGC 2024, p. 1)

- the introduction of **temporary 'no worse off' (NoWO) guarantee payments** to states — to be paid in instances when a state would have received more GST revenue under the previous GST distribution system (CGC 2021, p. 3). A state's GST grant may still fluctuate on a year-to-year basis, but the NoWO guarantee is intended to prevent any state from receiving less GST than they would have under the previous arrangement, until the NoWO guarantee expires.

These changes were enacted by the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) and were to be introduced over a six-year transition period from 2021–22 to 2026–27 (inclusive). In November 2024, the NoWO guarantee was extended to 2029–30 for all states except Western Australia (Australian Government 2024). The transition is illustrated in Figure 1.4.

Figure 1.4 The transition from 'full equalisation' to 'reasonable equalisation'

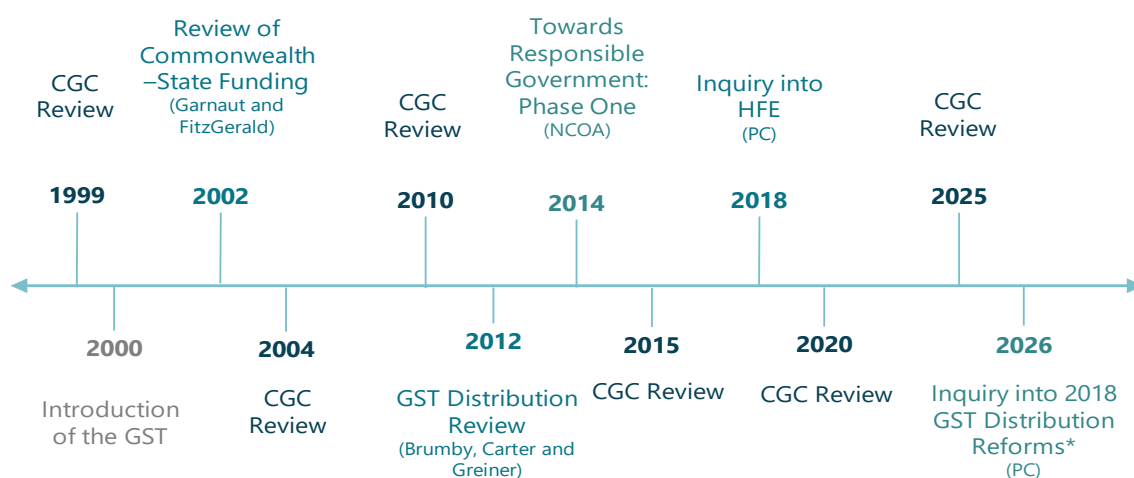


Note: Under the transition period the equalisation moves from 'full' equalisation to 'reasonable' equalisation through the progressive implementation of the new equalisation benchmark.

Source: QPC.

1.3 Past and current reviews of GST distribution and HFE

The distribution of GST revenue, and HFE more broadly, have been the focus of several reviews since the introduction of the GST in 2000 (see Figure 1.5). The key findings of these reviews are detailed in Box 1.5.

Figure 1.5 Timeline of reviews into GST distribution and HFE

Note: 'CGC' refers to the Commonwealth Grants Commission, 'NCOA' refers to the National Commission of Audit, 'PC' refers to the Australian Productivity Commission'. Not included are individual states' reviews into GST distribution.

* In September 2025 the PC was asked to undertake an inquiry into the 2018 GST distribution changes. As part of this inquiry the PC will consider whether the changes are operating efficiently, effectively and as intended, as well as the fiscal implications for the Australian Government and each state. The inquiry will also examine whether alternative arrangements would better achieve the objectives of the changes introduced in 2018.

Source: QPC, PC 2018, p. 54, 2025b, p. 5.

A key theme of past reviews has been the complexity and opacity of the CGC methodology. The CGC notes that by its very nature, HFE is a complex process, and there is a trade-off between assessing states' relative fiscal capacities comprehensively and adopting more simple assessment methods. That is, should the CGC assess how GST should be distributed using a simpler method, there is a risk of failing to align with the HFE objective (CGC 2025g).

In addition to providing submissions to previous inquiries, several individual states have also undertaken their own reviews into GST distribution. For example, the 2022 Inquiry into Commonwealth Support for Victoria, undertaken by the Economic and Infrastructure Standing Committee of the Victorian Parliament (Parliament of Victoria 2022).

Box 1.5 Key findings of previous reviews that considered GST distribution and HFE

Review of Commonwealth–State Funding (Garnaut & Fitzgerald 2002)

Commissioned by New South Wales, Victoria, and Western Australia, the review found the system reduces economic efficiency and does not incentivise productivity and growth-promoting policy.

It recommended allocating GST revenue primarily on an EPC basis, with a reformed and less prescriptive specific purpose payments system used to address state disadvantages and more clearly target equity.

The review was presented to the Australian Government, which advised states to advocate through the CGC's 2004 methodology review (New South Wales Government 2004, pp. 7–14). The substantive proposals were not adopted, although some of the issues raised informed the CGC's 2010 methodology review (CGC 2004, pp. 83–84).

GST Distribution Review (Brumby et al. 2012)

This review was commissioned by the Australian Government to understand whether the GST distribution system would ensure Australia is best placed to respond to expected significant structural change in the economy and would maintain public confidence in financial relationships within the federation.

The panel found there was little evidence that Australia's system of HFE system discouraged states from pursuing their own tax reform. The review identified that while dramatic simplifications were unfeasible without compromising equity, small adjustments, such as increasing materiality thresholds and rounding relativities, could improve transparency. The review highlighted the need for a robust GST base and greater state flexibility in revenue-raising to address fiscal pressures.

Key recommendations included improving communication and addressing mining revenue assessments to avoid excessively large GST share effects. The review suggested EPC distribution is not viable in Australia in the short or medium term without 'realignment of national tax bases and service responsibilities' due to the high level of VFI that makes HFE in its current form necessary.

Following the review, the GST continued to be distributed consistent with the CGC's assessment. In 2014, the Australian Government requested the CGC consider the treatment of GST relativities where a particular revenue source is a large and volatile proportion of a state's revenue. In response, the CGC declined to modify the system.

Towards Responsible Government: Phase One (National Commission of Audit 2014)

The National Commission of Audit (NCOA) was initiated by the Australian Government to examine the scope and efficiency of government and identify areas for reform in response to growing concerns about Australia's fiscal sustainability. It sought to improve efficiency and support long-term economic growth.

The NCOA recommended the Australian Government withdraw from certain policy areas, providing states with greater autonomy and the ability to raise greater revenue to reduce VFI. The audit recommended EPC distribution, supported by no worse off payments.

While several recommendations from the NCOA were implemented in the 2014–15 Budget, the recommended changes to the GST distribution system were not pursued.

Inquiry into Horizontal Fiscal Equalisation (PC 2018)

The inquiry was commissioned by the Australian Government as some states had suggested Australia's approach to HFE does not sufficiently consider each state's individual circumstances or their efforts to manage those circumstances, creating disincentives for reform.

The inquiry noted the need for the HFE system to achieve a better balance between equity and efficiency, finding HFE may distort state policy and discourage large scale state tax reform.

The PC recommended the adoption of 'reasonable' equalisation, by equalising to the average fiscal capacity of all states and suggested a relativity floor would only be a 'band-aid solution'. The PC also suggested an EPC approach with top-up funding should only be considered with broader reform of federal–state financial relations.

The Australian Government responded to the inquiry by implementing the 2018 changes to the GST distribution system (discussed above). This included adopting an alternative equalisation benchmark to that proposed by the PC and incorporating a relativity floor (Australian Government 2018).

CGC Methodology Reviews (1999, 2004, 2010, 2015, 2020, 2025)

Every five years the CGC is instructed to review their assessment methodology. The CGC reconsiders methods and supporting principles it uses to determine advice it provides on GST distribution. The review process generally takes two to three years, requiring extensive consultation with states.

On the release of the 2025 Methodology Review report, Queensland Treasury estimated methodology changes introduced by the review would result in Queensland receiving \$5.3 billion less in GST revenue over the next three years (Queensland Government 2025b).

2.0 Assessing the economic impacts of the GST distribution system

A primary objective of Australia's system of intergovernmental financial relations is the improvement of the wellbeing of all Australians through 'the equalisation of fiscal capacities between States and Territories' (Australian Government 2009b, p. 3).

As such, the Australian Goods and Services Tax (GST) distribution system concerns the division of economic returns (equity), rather than the growth of economic returns (efficiency).

However, the GST distribution system seeks to achieve fiscal equality through equalising state fiscal capacities to cover their expenditure needs. This is an indirect way to attempt to achieve equity.

2.1 Equity vs Efficiency

Equity

The specific goal of GST distribution is achieved through horizontal fiscal equalisation (HFE) (Australian Government 2009b, p. 5). This refers to the equalising of states' fiscal capacities, that is, their ability to raise revenue to cover their expenditure needs.

Under HFE, transfers are made from fiscally 'strong' states to fiscally 'weak' states. In doing so, the GST distribution system is designed to allow the federation to deliver outcomes that are comparable to a unitary model of government.

Underlying HFE is a broader objective, for states to be able to provide their residents with a similar level of services, thereby removing inequality across states. However, HFE is not a true equity goal. States are not individuals and equalising fiscal capacity between states does not directly deliver an equity outcome for individuals (Buchanan 1950, pp. 586–588; PC 2018, pp. 55–56, 165–166).

Moreover, Australia's GST distribution does not directly deliver these objectives. Under HFE, states retain policy autonomy in expenditure and revenue decisions as GST is delivered as an untied grant. As a result, HFE does not guarantee equalisation of outcomes (Brumby et al. 2012, pp. 40–41; Garnaut & Fitzgerald 2002, p. 130). This was also recognised by the Australian Productivity Commission (PC) (2018, p. 6), which regarded HFE as seeking 'equal fiscal treatment of jurisdictions, not interpersonal equity' in its 2018 Inquiry into Horizontal Fiscal Equalisation.

Efficiency

While the GST distribution system seeks to deliver an equity objective through HFE, our Terms of Reference seek advice on the economic impacts of GST distribution.

As described by the PC (2013, p. 2):

overall economic efficiency is attained when individuals in society maximise their utility, given the resources available in the economy.

In the context of HFE, Buchanan (2002, p. 7) noted:

efficiency requires that [resources] be used to [their] value maximizing level.

Where economic resources (such as labour and capital) are allocated and utilised efficiently, the productive capacity of the economy is larger, without additional effort.

The advice considers whether GST distribution contributes to or detracts from economic efficiency.

Why efficiency matters

Ultimately, both equity and economic efficiency affect household wellbeing.

A more efficient economy supports wellbeing by allowing households to receive a greater return for their work and investments and by providing a larger revenue base from which governments can support service delivery.

The GST distribution system can affect efficiency through its impact on the allocation of labour and capital across the economy and incentives for sound government spending, taxation and reform.

While the fiscal outcomes of the GST distribution are clear and quantifiable, there is limited empirical evidence to support a definitive assessment of the overall net economic impacts of the GST distribution system.

This Interim Report examines the extent to which the GST distribution system delivers its objectives in an economically efficient manner.

3.0 Queensland's GST experience

Since the introduction of the Goods and Services Tax (GST), Queensland has typically been a recipient state. Key factors contributing to this status have included lower revenue raising capacity in property and payroll taxes and greater expenditure needs from population dispersion, Indigeneity, population growth and natural disaster relief. However, Queensland's GST relativity — the measure of a state's fiscal capacity relative to the average — has changed over time, particularly due to increased revenue raising capacity from mineral resources and changes to the Commonwealth Grant Commission (CGC) methodology, which have reduced Queensland's GST share.

3.1 Queensland has generally benefitted from the GST distribution system

Since the introduction of the GST, the current GST distribution arrangement has delivered Queensland higher real GST grant revenue per capita than if GST had been distributed under alternative arrangements, such as an equal per capita basis (EPC) or indicative consumption share (Figure 3.1).

As a result, Queensland has cumulatively received more in GST revenue than its EPC and indicative consumption share of GST (Figure 3.2). Over the 10 years to 2025–26, the cumulative fiscal gain to Queensland was around \$6.9 billion above the EPC share and an estimated \$14.5 billion above its indicative consumption share. This reflects Queensland having historically been assessed by the CGC as having a slightly lower fiscal capacity than other states, on average.

Figure 3.1 Queensland's real GST grant per capita under three distribution arrangements

Queensland's real GST per capita, 2000-01 to 2025-26

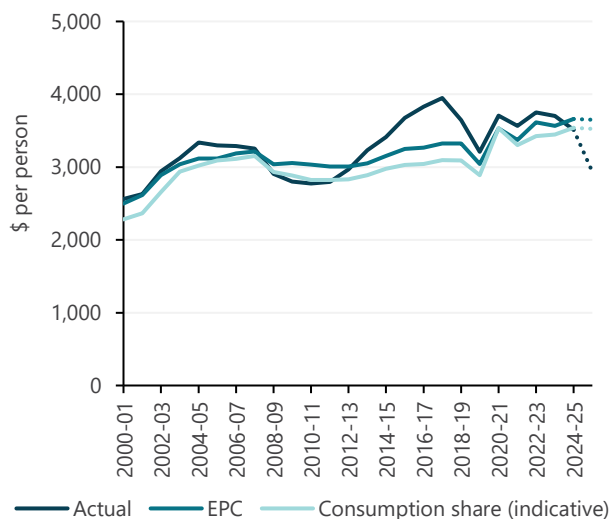
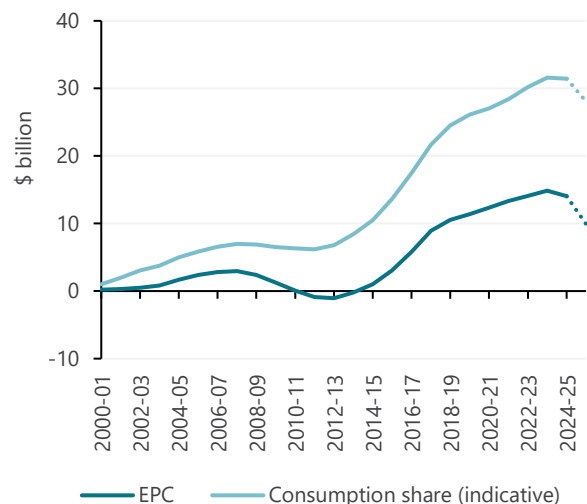


Figure 3.2 Comparative cumulative benefit of the GST distribution

Queensland's cumulative real GST grant revenue above EPC and indicative consumption share, 2000-01 to 2025-26



Note: GST from 2000–01 to 2024–25 is from each year's Final Budget Outcome. Estimated GST is from the Australian Government 2025–26 Mid-Year Economic and Fiscal Outlook (MYEFO). Population estimates are from the CGC's 2025 GST relativity report, which enables comparisons with other states. Consumption share of GST includes only GST-applicable consumption, following the methodology used by Begg (2018) and the Parliamentary Budget Office's (2020). It assumes GST is collected in proportion to state final consumption relative to national final consumption. The state in which GST is raised is not tracked, so this is only indicative.

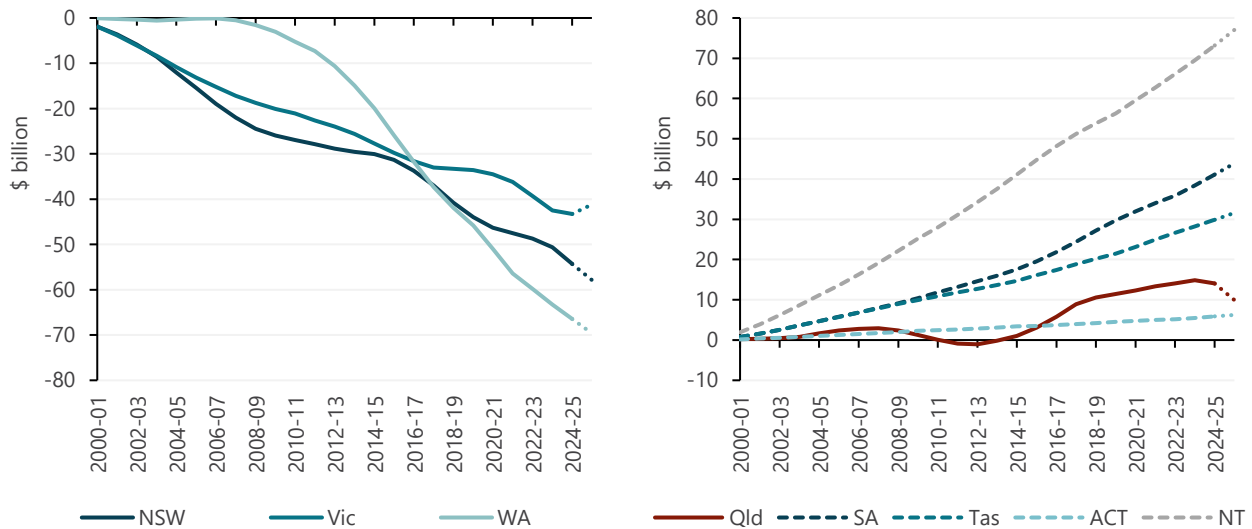
Source: QPC based on ABS 2026; Australian Government 2001 to 2025b, 2025c; CGC 2025f.

While substantial in dollar terms, the cumulative benefit of the GST distribution to Queensland under HFE should be assessed against Queensland's total revenue. For example, the 'additional' \$6.9 billion accumulated by Queensland over the last 10 years under horizontal fiscal equalisation (HFE) has boosted its real GST grant revenue and real total state revenue by 3.8 per cent and 0.9 per cent, respectively, compared with a GST distribution on an EPC basis.

Queensland is not alone in being a net beneficiary of the GST distribution system (Figure 3.3). However, compared with some other net beneficiaries, the benefit Queensland derives is relatively small.

Figure 3.3 Queensland is not alone in being a net beneficiary of the GST distribution system

Cumulative real GST grant revenue above EPC share, 2000-01 to 2025-26



Note: GST from 2000–01 to 2024–25 is from each year's Final Budget Outcome. Estimated GST is from the Australian Government 2025–26 MYEFO.

Source: QPC based on Australian Government 2001 to 2025b, 2025a; CGC 2025f.

3.2 Recently there has been a significant decline in Queensland's GST grant revenue

Since its introduction in 2000, Queensland's GST grant revenue has grown in real and nominal terms (see Figure 3.4). Over that time, Queensland's nominal GST grant revenue has increased at an average annual pace of 5.3 per cent, slightly below the growth of the nominal GST pool of 5.9 per cent, and the state's share of the GST pool has averaged around 20.5 per cent (see Figure 3.5), slightly above its average population share of 19.5 per cent.

Figure 3.4 Queensland's GST grant revenue has grown since 2000-01

Queensland's GST grant revenue, 2000-01 to 2025-26

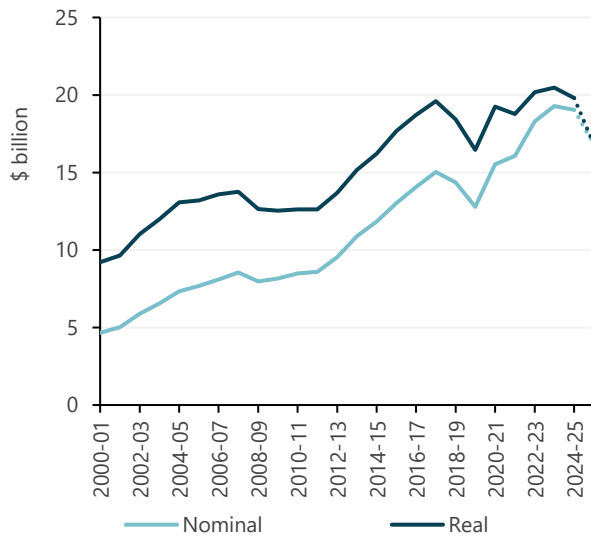
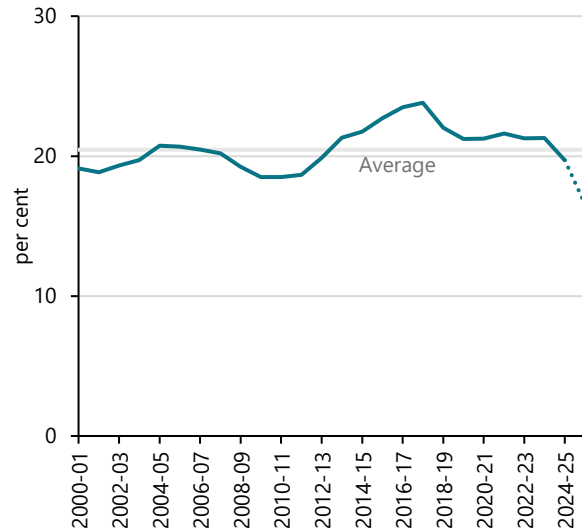


Figure 3.5 Recently, Queensland's GST share fell below its average

Queensland's share of the GST pool, 2000-01 to 2025-26



Note: GST from 2000–01 to 2024–25 is from each year's Final Budget Outcome. Estimated GST is from the Australian Government 2025–26 MYEFO.

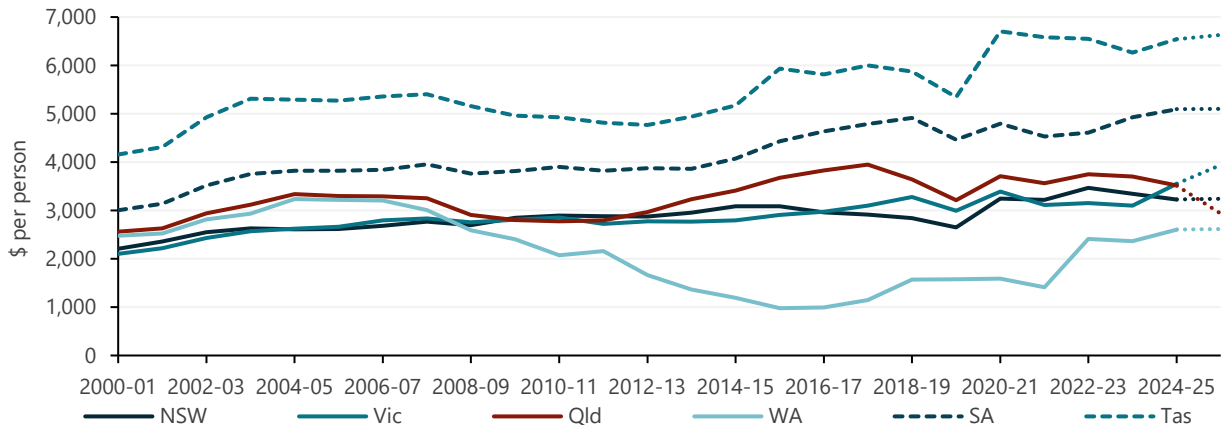
Source: QPC based on ABS 2026; Australian Government 2001 to 2025b, 2025c.

Queensland's grant revenue peaked in 2023–24 and is expected to fall a further 11.7 per cent to \$16.8 billion in 2025–26 (in nominal terms), representing a \$2.2 billion⁴ decline. This decline represents the largest fall in GST grant revenue in a single year any state has faced since the GST was introduced.

As a result of this decline, Queensland's GST receipts have fallen sharply in per capita terms (see Figure 3.6). Queensland is expected to receive \$2,935 per person in GST grant revenue in 2025–26, effectively the same revenue received per person as in 2002–03 in real terms. Western Australia is the only state receiving less GST per capita in 2025–26 than Queensland.

⁴ The Terms of Reference note a \$2.3 billion contraction, but they were issued before the release of the Australian Government's MYEFO, which upgraded the estimates for the size of the GST pool. As noted in the Queensland Government's MYFER (2025a, p. 9), the estimated increase in the GST pool resulted in a slightly higher estimate of Queensland's GST grant revenue.

Figure 3.6 States' real GST receipts per capita
Real GST grant revenue per capita, 2000-01 to 2025-26



Note: GST from 2000-01 to 2024-25 is from each year's Final Budget Outcome. Estimated GST is from the Australian Government 2025-26 MYEFO. To aid presentation territories have been excluded.

Source: QPC based on ABS 2026; Australian Government 2001 to 2025b, 2025c; CGC 2025f.

The decline in Queensland's GST grant revenue in 2025-26 reflects a fall in the State's relative to an historic low (Figure 3.7).

The Queensland State Budget (2025c) and Mid-Year Fiscal and Economic Review (MYFER) (2025a) forecast growth in Queensland's GST grant revenue to improve over the forward estimates, as the effects of temporarily higher coal royalties and the CGC's decision to redistribute GST for previous COVID-19 government expenses unwinds from GST calculations (Queensland Government 2025a, p. 9). As a result, the contribution of GST grant revenue to Queensland's total revenue is forecast to revert towards its long-term average of 24.1 per cent from 2026-27 (Figure 3.8).

Figure 3.7 Queensland's 2025-26 GST relativity is its lowest level on record

Queensland's GST relativity, 2000-01 to 2025-26

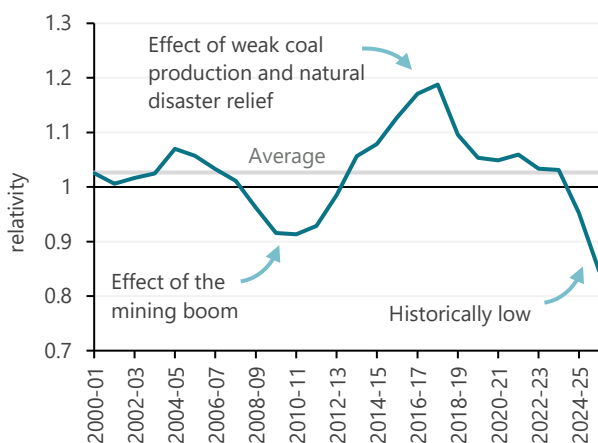
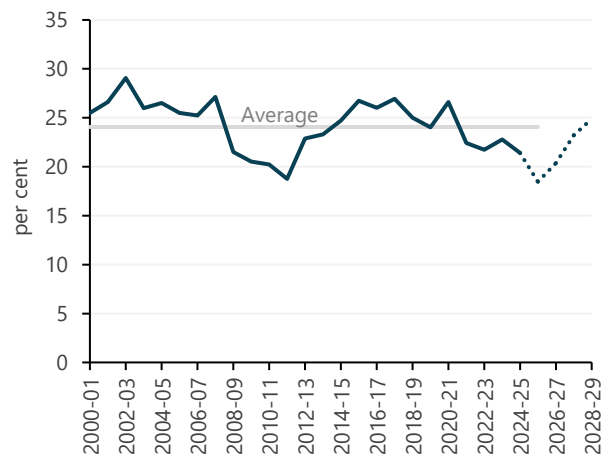


Figure 3.8 Queensland's GST grant revenue has fallen as a share of total State revenue

GST grant revenue as a share of total revenue, Queensland, 2000-01 to 2028-29



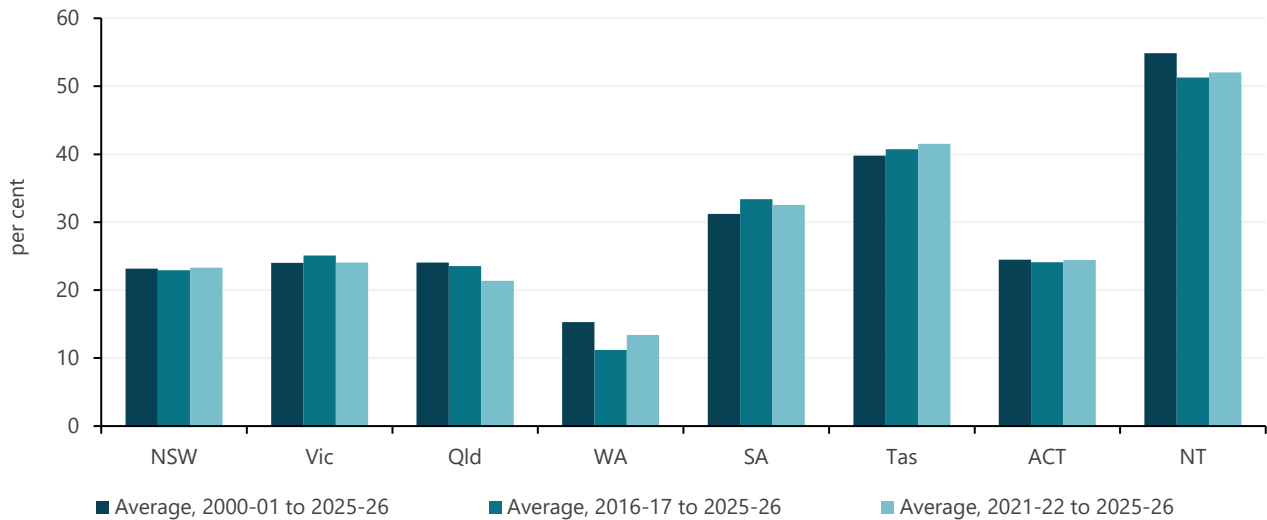
Note: GST from 2000-01 to 2024-25 is from each year's Final Budget Outcome. Estimated GST is from the Australian Government 2025-26 MYEFO. Total revenue until 2023-24 is from the Australian Bureau of Statistics (ABS) Government Finance Statistics (annual). Actual and estimated revenue (2024-25 and 2025-26 onwards) and all projections (2026-27 onwards) are from the Queensland Government 2025-26 MYFER.

Source: QPC based on ABS 2011a, 2015a, 2019, 2025b; Australian Government 2001 to 2025b, 2025c; Queensland Government 2025a; CGC 2025f.

While the recent decline in GST grant revenue as a share of total state revenue is not unique to Queensland, no other jurisdiction has experienced the same rate of decline. In contrast, in some states such as Tasmania and Western Australia, GST grant revenues over the last decade have represented a growing source of state revenue (Figure 3.9).

Figure 3.9 Contribution of GST grant revenue to state revenue across states and over time

GST grant revenue as a share of total revenue, averaged, 2000-01 to 2025-26



Note: GST from 2000–01 to 2024–25 is from each year's Final Budget Outcome. GST for 2025–26 is from the 2025–26 Australian Government MYEFO. States' total revenue for 2000–01 to 2023–24 is from the ABS Government Finance Statistics (annual). States' total revenue for 2024–25 and 2025–26 is from state budgets or budget updates.

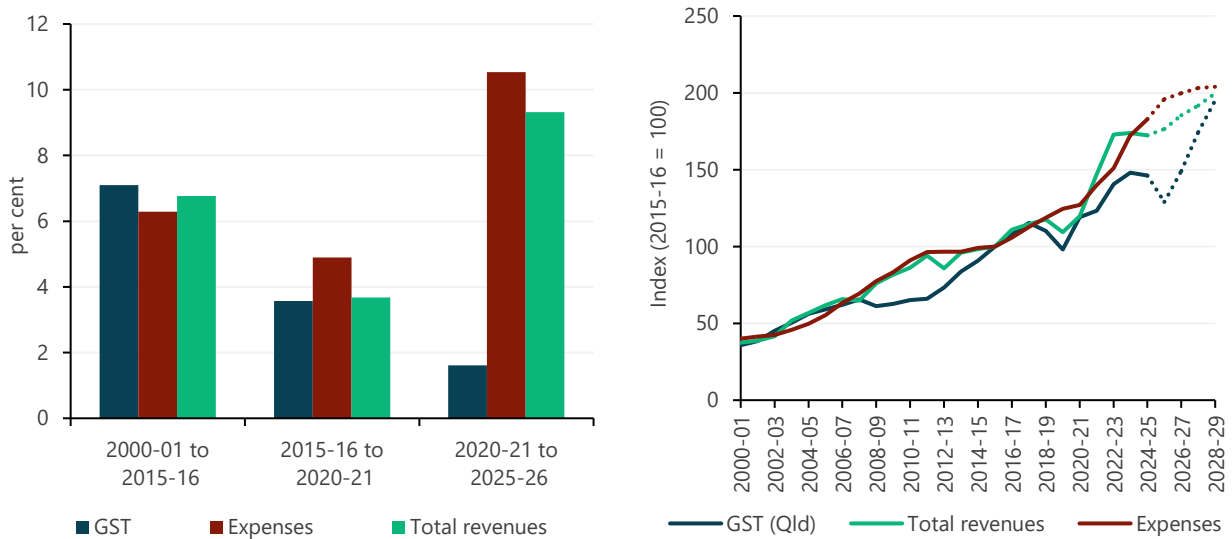
Source: QPC based on ABS 2011a, 2015a, 2019, 2025b; ACT Government 2025; Australian Government 2001 to 2025b, 2025c; Government of South Australia 2025; Government of Western Australia 2025; New South Wales Government 2025; NT Government 2025; Queensland Government 2025a; Tasmanian Government 2025; Victorian Government 2025.

The recent decline in Queensland's GST grant revenue was preceded by a significant increase in both state revenue and expenses. While over the longer-term Queensland's GST grant, total revenue and expenses growth broadly tracked in line with each other, over the last five years in particular there has been a material divergence as shown in Figure 3.10 below.

Over the forward estimates, Queensland Treasury expects slower growth in expenses and total state revenue to coincide with a pickup in GST grant revenue.

Figure 3.10 Growth in Queensland's GST grant revenue has diverged from growth in total revenue and expenses

Growth in nominal GST, total revenue and expenses, CAGR (LHS) and index (RHS), 2000-01 to 2028-29



Note: GST from 2000–01 to 2024–25 is from each year’s Final Budget Outcome. GST for 2025–26 is from the 2025–26 Australian Government MYEFO. Total revenue and expenses until 2023–24 are from the ABS Government Finance Statistics (annual). Actual and estimated revenue and expenses (2024–25 and 2025–26) and all projections (2026–27 on) are from the Queensland Government 2025–26 MYFER. The growth rate is calculated as the compound average growth rate (CAGR). The indexes for revenue and expenses have been adjusted to account for the use of different data series after 2024–25.

Source: QPC based on ABS 2011a, 2015a, 2019, 2025b; Australian Government 2001 to 2025b, 2025c; Queensland Government 2025a.

4.0 Economic impacts of the GST distribution system

The Goods and Services Tax (GST) distribution system can affect economic efficiency through its impact on the allocation of resources and influence on policy decisions. While economic impacts are difficult to quantify, they have the potential to be substantial. Preliminary analysis of available evidence and economic literature suggests the GST distribution system:

- may increase states' reliance on inefficient taxes (Section 4.1)
- may impede efficient labour and capital flows (Section 4.2)
- can create poor incentives for growth-enhancing policy (Section 4.3)
- may make it more difficult for states to respond to economic conditions (Section 4.4)
- continues to compromise economic efficiency despite periodic adjustments (Section 4.5).

4.1 Reliance on inefficient taxes

Economic efficiency of the tax mix

Taxes distort the behaviour of households and businesses, resulting in measurable losses in efficiency with implications for overall economic activity. Therefore the tax mix a jurisdiction adopts to fund expenses has important economic implications (Freebairn 2015, 2020; Nassios et al. 2019; PC 2025a).

States raise revenue from a variety of taxes, each with varying distortionary effects or levels of efficiency loss — see Table 4.1. To the extent a state becomes more reliant on distortionary revenue sources, economic activity will be impeded with flow-on impacts to household incomes and living standards. Compared with most state taxes, the GST has a relatively low distortionary effect on economic activity (Nassios et al. 2019).

Table 4.1 GST is estimated to be more efficient than state-based taxes

Marginal excess burden of select state taxes and the GST

Tax	Cao et al. (2015)	Murphy (2016)	Nassios et al. (2019)	Nassios & Giesecke (2025)
Stamp duty on conveyances	0.72	0.87	1.07	0.76
GST	0.19	0.18	0.15	0.24
Land tax	-0.10	0.48	0.08	
Insurance duties		0.58	0.27-0.36	0.38
Payroll tax (rate)		0.37	0.22	
Motor vehicle taxes			0.24 (used) 0.97 (new)	
Gambling taxes			0.46	

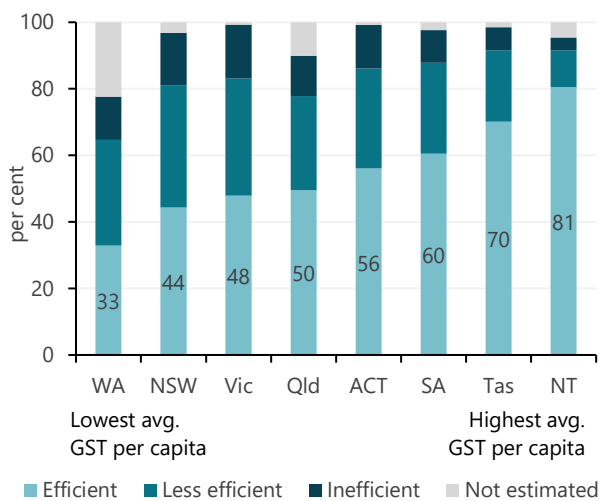
Notes: 1) Efficiency loss is measured by calculating the economic loss (in dollars) of each additional dollar raised in tax (the marginal excess burden) and the total economic loss (in dollars) divided by the total taxation revenue (the average excess burden). A marginal excess burden of 0.15 means an additional dollar of GST revenue raised would cost 15c in losses. 2) Nassios et al. (2019) estimate efficiency losses for New South Wales. While efficiency loss is likely to differ across states, the estimates are considered indicative of the relative efficiency of different taxes across states. They provide the most contemporary estimate for the largest range of state-level taxes and are consistent with other studies of Australian state level taxes (Murphy 2016; Nassios & Giesecke 2025).

Source: Cao et al. 2015; Murphy 2016; Nassios et al. 2019; Nassios & Giesecke 2025.

A state's tax mix is a function of the state's share of GST revenue to total revenue. States that receive more in GST revenue per capita have more efficient tax systems than those that receive less in GST revenue per capita (Figure 4.1). For Queensland and Western Australia, where the GST grant has come to contribute a lower share of tax revenue over time, reliance on inefficient taxes has increased (Figure 4.2).

Figure 4.1 GST distribution outcomes are correlated with the efficiency of states' tax systems

Average share of taxation revenue (own source plus GST) by efficiency, ordered by lowest to highest average GST revenue per capita, 2000-01 to 2023-24



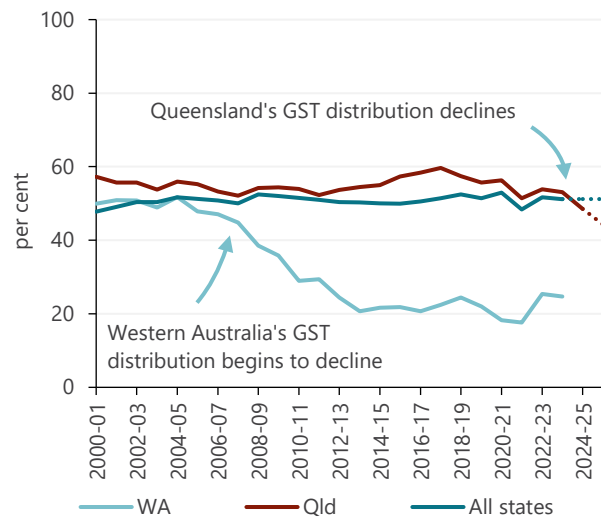
Note: Taxation revenue includes GST and all own-source revenue. Efficiency has been defined relative to GST (see Table 4.1) and follows Warren (2006, p. 67) and Nassios (2019, p. 17).

Source: QPC based on ABS 2011b, 2015b, 2025e; Australian Government 2001 to 2025b, 2025a; Cao et al. 2015; Murphy 2016; Nassios et al. 2019; Nassios & Giesecke 2025; Queensland Government 2025a.

Beyond the GST distribution system, a state's GST grant revenue is also affected by the size of the GST pool (see Box 4.1).

Figure 4.2 Declining contribution of GST revenue is associated with increased state reliance on inefficient own-source tax bases

Share of taxation revenue (own source plus GST) that are efficient, 2000-01 to 2024-25



Note: Revenue sources for which efficiency has not been estimated, such as mining royalties, have been excluded from this calculation to remove variation in the efficiency of revenue bases arising from the variation of those revenue sources.

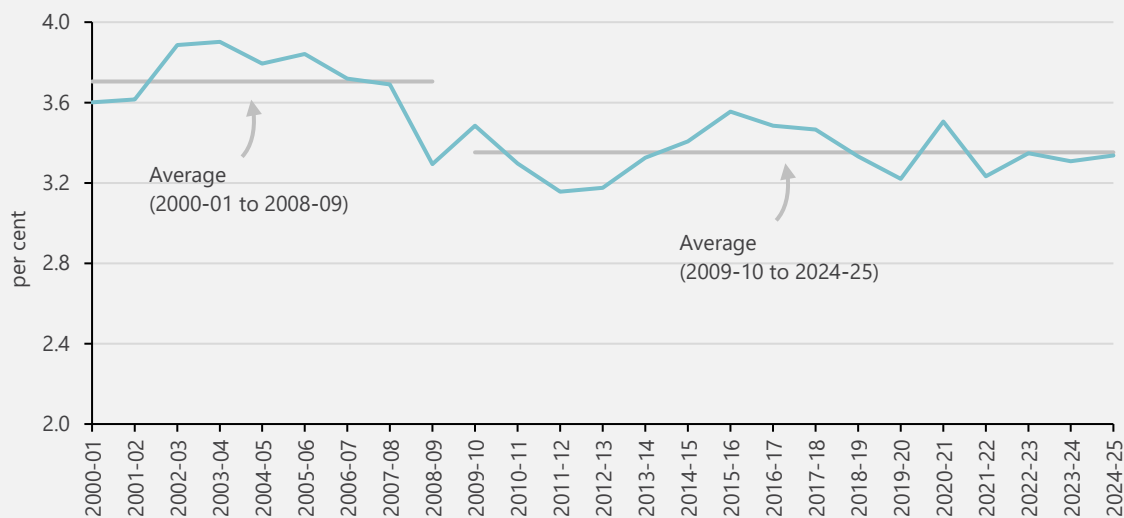
Box 4.1 The GST pool

There has been considerable conjecture about the performance of the GST as a growth tax. Some analysts suggest the GST is not adequately providing the growing and secure funding base it was intended to provide (Daley & Wood 2015, pp. 4–5; Dennis et al. 2025; Evans 2020, p. 55; PC 2018, pp. 78–79; PWC 2020, p. 3; Tran-Nam & Abdellatif 2025).

As shown in Figure 4.3, the GST revenue pool has declined from 3.9 per cent of Gross Domestic Product (GDP) at its peak in 2003–04, soon after the GST was introduced, to 3.3 per cent in 2024–25. Since 2009–10, GST has averaged around 3.4 per cent of GDP.

Figure 4.3 The GST pool has declined as a share of GDP

Nominal GST pool relative to GDP 2000-01 to 2024-25, national accounts basis



Source: QPC based on ABS 2025a.

If GST revenue had remained at its 2003–04 level as a share of GDP, the GST pool would have been \$17.5 billion larger than currently expected in 2025–26, all other things being equal, potentially providing Queensland with up to \$3.6 billion in additional GST grant revenue.⁵

The factors contributing to the decline in GST revenue as a share of GDP have been well-explored by others (see in particular Parliamentary Budget Office 2020, p. 3; Evans 2020, pp. 63–65) and concern:

- the changing share of household consumption (as the tax base for GST) compared to GDP
- unequal price growth between GST applicable and GST-free goods
- changes in spending patterns between GST applicable and GST-free goods
- compliance gaps in GST collections
- technical issues with how the Australian Bureau of Statistics (ABS) measure GDP and components of household consumption.

In addition to adjustments to expenditure and revenue choices, states may choose to accommodate changes in GST grant revenue through borrowing. In the long run, debt needs to be repaid either through a reduction in services or via future additional taxation, placing a burden on future generations and potentially reducing intergenerational equity.

⁵ Using the GST pool before the inclusion of top-ups and assuming the additional revenue is provided to states on an equal per capita (EPC) basis.

Public debt can also crowd out private investment by competing for the same limited pool of money and economic resources. In doing so, public debt may place upward pressure on interest rates. Public debt is particularly an issue when the economy is already experiencing capacity constraints and if public expenditure is put to less productive uses than it would have been in the private sector.

In summary, as a form of taxation, the GST is comparatively more efficient than other state taxes. As a state’s grant revenue adjusts over time — due to the size of the GST pool or the outcome of the Commonwealth Grants Commission (CGC) assessment — there may be an increased propensity by states to adopt less economically efficient forms of taxation or funding mechanisms.

4.2 Impacts on labour and capital flows

Efficient flow of labour

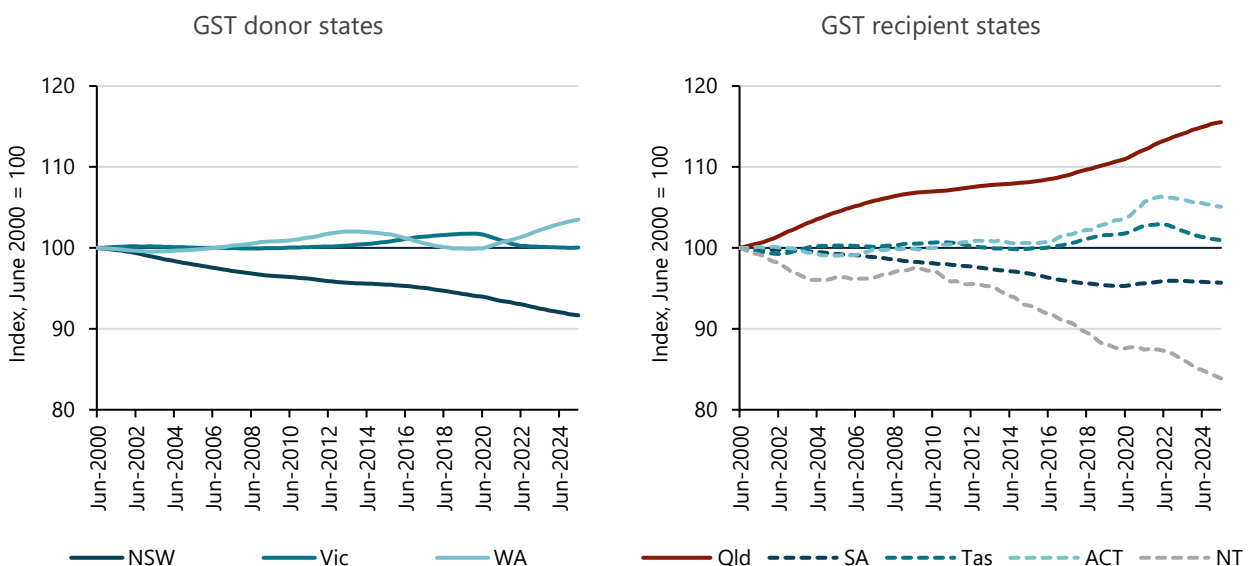
While HFE seeks to achieve an equity objective, some have suggested it can theoretically also deliver an economically efficient outcome. For example, Buchanan (1950, p. 589) proposed that HFE can result in a more efficient outcome by incentivising individuals to locate themselves where they are most productive, rather than making migration decisions based on interjurisdictional fiscal differences, or so-called ‘fiscal benefits’, arising from variations in taxation and/or government services across borders.

This perspective remains contested and more contemporary studies suggest the relationship may be more nuanced and that economic efficiency may be negatively affected through the GST distribution system.

As shown in Figure 4.4, there is no directly observable relationship between net interstate migration outcomes and whether a state is a net contributor or recipient of GST revenue through horizontal fiscal equalisation (HFE). New South Wales (a net contributor) and the Northern Territory (a net recipient) have both recorded considerable net interstate migration outflows since 2000. Queensland has consistently experienced substantial net interstate migration inflows while its GST relativity has fluctuated.

Figure 4.4 There is no observable relationship between GST outcomes and net interstate migration

Change in population due to interstate migration, compared to June 2000, 2000 to 2024



Note: Recipient/donor state status is based on cumulative GST distributions since 2000–01, relative to an equal per capita (EPC) share.

Source: ABS 2025c.

Various studies have been conducted to explore the reasons for interstate migration. Overall fiscal benefits are considered to have a small direct impact on interstate migration decisions:

- The Australian Productivity Commission (PC) (2018, p. 162) – found that employment opportunities and family reasons are the largest drivers of interstate migration. During Australia’s mining boom, substantial high-wage employment opportunities attracted few interstate migrants relative to overseas migrants, suggesting that if large differences in wages are not a sufficient incentive to move, then small differences in ‘net fiscal dividends’ are unlikely to trigger significant additional internal migration.
- The Centre for International Economics (CIE) (2023, pp. 136, 138, 145) – found that:
 - although housing affordability and the cost of living are influential factors behind migration decisions, the biggest drivers are employment and family reasons
 - improving government services (an outcome of HFE) resulted in a modest net population increase of 0.3 per cent over a five-year period in a region, when that region’s service level moves from the 25th percentile to the 75th percentile. However, this estimate was not specific to interstate migration.
- Kalembe et al. (2022, p. 292) – found that employment and family are the biggest drivers of interstate migration.
- Kaplan and Schulhofer-Wohl (2017, p. 59) – noted in the American context, the most common reasons for moving were related to employment and family.
- Walsh (PC 2006, p. 72) – indicated that empirical studies have found policy-induced mobility of households exists but it is a small driver of mobility in comparison to other factors. This is partly due to the costs of moving.
- Brumby, Carter and Greiner (2012, p. 40) – stated that citizens are unlikely to correctly identify a difference in fiscal capacity between states, particularly if differences are not extreme, meaning fiscal benefits are unlikely to be an important and direct driver of migration decisions in Australia.

Influence of HFE and the GST distribution system on labour flows

Available evidence suggests HFE and the form of GST distribution does influence patterns of interstate migration.

The greater fiscal capacity provided to recipient states has allowed those states to support a higher level of government service delivery and economic activity than would otherwise be the case, with the converse true for donor states.

Where the substantial transfer of fiscal resources between states results in changes to the location of economic activity and employment, these changes allow the GST distribution system to influence migration decisions, even where individuals’ migration decisions are driven predominantly by work or family reasons.

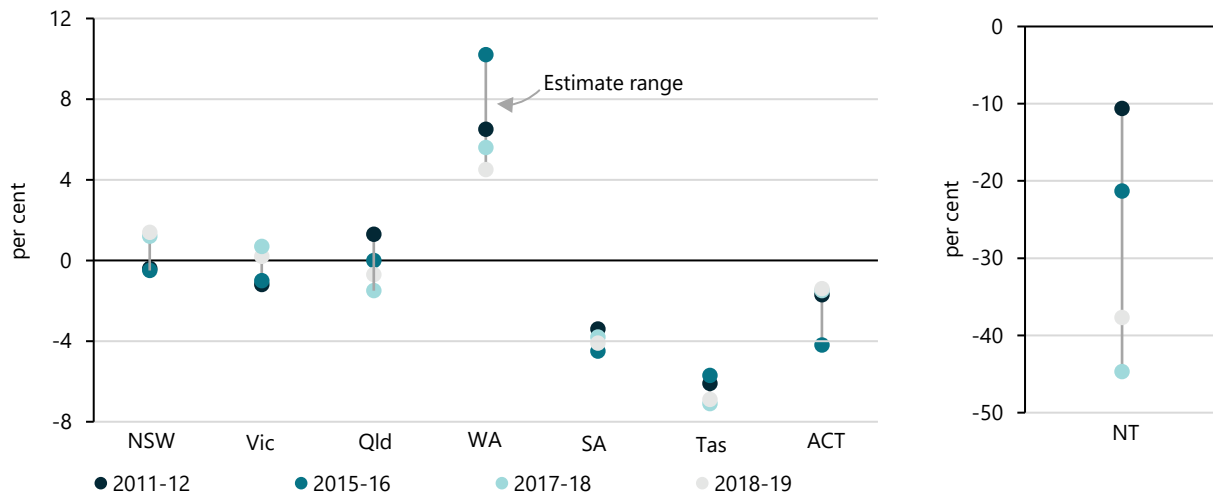
Modelling conducted by Murphy (Murphy 2018, 2021; and modelling done for Independent Economics 2012, 2015) suggest long-run population outcomes are influenced by the impact of the GST distribution.

Depending on the assumptions (that is, for which years the CGC assessment outcome was used), modelling found population changes of up to a 10.2 per cent increase for Western Australia and declines of up to 44.7 per cent for the Northern Territory over the long term from an EPC distribution relative to the CGC’s actual methodology at the time (see Figure 4.5).⁶

⁶ Murphy’s modelling was undertaken for the assessment years 2011–12, 2015–16, 2017–18, 2018–2019, with the counterfactual being a modified EPC system. Further modelling for 2021–22 provides consistent results but uses an alternative counterfactual. Murphy notes six qualifications to the modelling. He assumes labour is fully mobile between states; factors of production are fixed at the national level; states take equalisation grants as given (i.e. they do not further alter their behaviour to achieve a GST distribution outcome); state services are private in nature (i.e. there is no fiscal externality such as there is with national services such as defence); the modelling only considers locational distortions (i.e. policy influences on migration decisions) caused by central government grants, not from central government budgets; and congestion externalities are not taken into account. These assumptions are reasonable for assessing the isolated impacts of fiscal equalisation on migration outcomes. We do not report Murphy’s overall welfare impacts here as limitations mean that while estimated impacts on migration outcomes are reasonable, welfare impacts are more contestable.

Figure 4.5 Alternative forms of GST distribution deliver material changes to population outcomes

Modelled changes in long run population under an EPC distribution relative to current HFE arrangements, by assessment year



Source: *Independent Economics 2012, p. 40, 2015, p. 22; Murphy 2018, p. 33.*

Murphy's modelling indicates that while net recipient states such as South Australia, the Northern Territory and Tasmania have experienced net outflows (or little overall change) in interstate migration since 2000 (per Figure 4.4), economic activity would have been lower and outflows may have been greater if HFE had not been in place. Conversely, New South Wales may have recorded lower net outflows of interstate migration if HFE had not been in place and Western Australia and Victoria may have recorded greater net inflows of interstate migration, all else being equal.

Similar outcomes have been observed in international studies. In modelling the effects of equalisation transfers in the Canadian context, Tombe & Winter (2021, pp. 542–543) also found transfers increased recipient provinces' populations at the expense of contributor states, compared to a counterfactual where transfers were distributed to provinces according to their output shares.

In summary, while employment opportunities and family reasons are primary drivers for interstate migration, available evidence suggests that the shifts in resources as a result of the GST distribution can influence interstate migration. It remains unclear how efficient that reallocation of labour is and therefore the precise level of economic impacts.

Efficient allocation of capital

Labour and capital are similarly mobile between states but with some notable differences:

- once capital is embodied, such as plant or infrastructure, it can become highly immobile. This may vary long-term capital formation patterns in a way that does not necessarily align with migration, although labour can also become less mobile over the lifecycle
- international capital flows are highly mobile and there are less restrictions on international capital flows than on labour flows.

As for labour, there is no consensus on whether HFE can improve the allocation of capital across a federation.

Similar to Buchanan's theory of efficient migration, HFE is theorised to improve capital allocation by reducing incentives for states to shift their policy mix solely to attract investment (Bucovetsky 2005; Taylor 1992; Wilson 1986, p. 198). By reducing incentives for states to intervene and attract capital, capital is more likely to form where it is most productive.

However, there are opposing views to this efficiency argument, suggesting HFE may result in less efficient outcomes such that:

- states may become less competitive at the international level if they do not set taxes low enough. This may limit the states' ability to attract international capital under a system of HFE, where equilibrium tax rates are higher (Becker & Kriebel 2017)
- transfers may impact the attractiveness of high value destinations for capital investment (Garnaut & Fitzgerald 2002, p. 149)
- transfers may contribute to a higher degree of capital formation in recipient states than would have occurred in the absence of HFE (PC 2018, p. 152), at the expense of capital formation in donor states.

As the allocation of economic resources across state borders responds to the allocation of fiscal resources, the GST distribution system may result in an inefficient outcome, where labour and capital are incentivised to locate where they are not put to their most productive use. This could occur where the GST distribution system allocates revenue to states to compensate for inefficient revenue or expenditure policies.

In summary, while available evidence suggests HFE and the form of the GST distribution system could influence the movement of capital; it remains unclear how material the impact would be on economic efficiency.

4.3 Poor incentives for growth-enhancing policy

The GST distribution system has the potential to alter the underlying incentives associated with state policy decisions, as states do not bear the full cost or gain the full benefit of policy decisions. For example:

- where a state has restricted, banned or otherwise not progressed an activity to support economic activity (e.g. gas exploration) it can result in the state being compensated by other states via the GST distribution system
- a state does not bear the consequences of a taxation or expenditure decision via the GST distribution system until several years after the decision is made.

The 2018 PC inquiry confirmed the GST distribution system creates theoretical disincentives for interstate policy competition and policy reform, but found little evidence to suggest the GST distribution system affects policy decisions in practice (PC 2018, pp. 111–112). Similarly, the 2012 GST distribution review (2012, p. 136) found no correlation between GST incentives and a state's policy effort, or even anecdotal evidence of GST incentives playing into state decisions.

Regardless of whether states act on incentives or not, the outcomes of the GST distribution system are responsive to state policies. In turn, this results in changes to fiscal allocations and consequent impacts for the allocation of economic resources in ways that may be more or less efficient.

These effects can occur because of the design of the GST distribution system or because of the administration of the GST distribution system. The potential impact of the GST distribution system for a range of policy instances is considered below.

Transfer dependency

Transfer dependency (and the closely associated flypaper effect⁷) are often discussed in the context of Australia's high level of vertical fiscal imbalance (see Section 1) and high degree of fiscal equalisation. They refer to the idea that states may rely on fiscal transfers to finance their current expenses, rather than pursuing growth policies to support revenue or manage expenses growth.

Transfer dependency can have consequences for economic efficiency where states are not incentivised to pursue growth policies and efficient service delivery.

As suggested by Garnaut and Fitzgerald (2002, pp. 145–146), over time, recipient states may prioritise policy in a way that is less favourable to productivity and economic growth. For example, some claim Australia's recipient states have historically given higher priority to social and environmental development objectives and less priority to economic development objectives, which may reinforce dependence on transfers and increase the relative size of states' public sectors (Garnaut & Fitzgerald 2002, p. 13). Under such conditions, recipient states may become structurally reliant on transfers to sustain existing service levels.

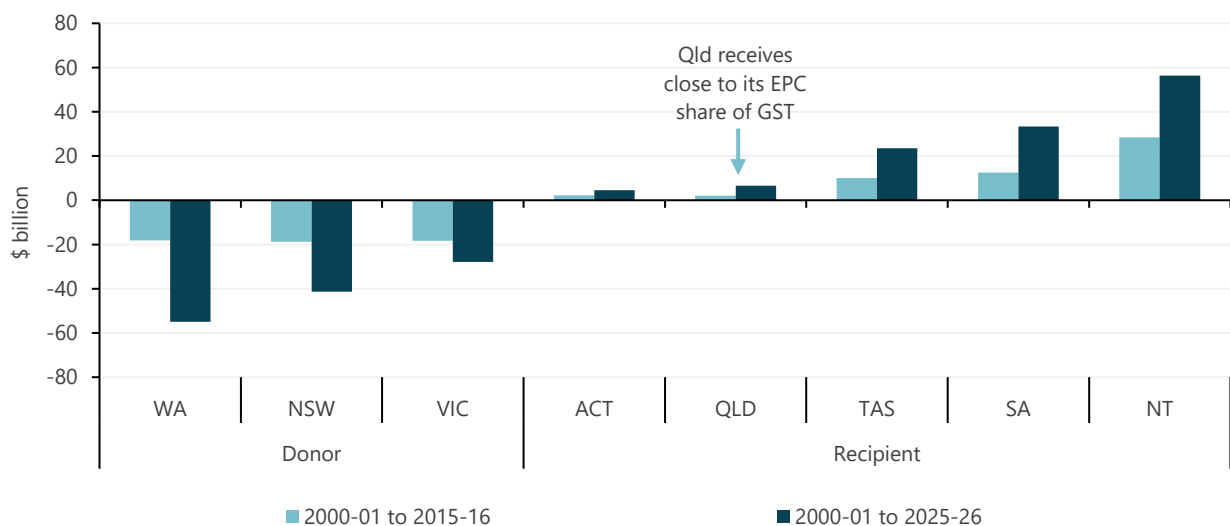
Similarly, as Australian states do not bear the cost of collecting GST revenue, they may not account for the efficiency cost of the GST system in broader decision-making. Such instances have been found to result in suboptimal levels of public expenditure (Dahlby 2010, see also Harvey & Gayer 2008, pp. 534–535; Shanmugam & Shanmugam 2022, p. 9).

This can result from states underestimating the efficiency cost of revenue raising when the revenue is received via a transfer, particularly because they do not bear the full cost of the revenue raising activity. As recipient states receive an even higher share of their revenue via intergovernmental transfers relative to donor states, they have a higher chance of having inefficiently-high spending due to the flypaper effect (Garnaut & Fitzgerald 2002, p. 145).

Since the introduction of the GST, states have typically been entrenched in their role as either a donor or recipient of GST, which gives some weight to the potential for transfer dependency (Figure 4.6).

Figure 4.6 Over the last 10 years, states have typically been entrenched in their roles as donors or recipients of GST revenue

Cumulative GST grant revenue above EPC share, 2000-01 to 2015-16 and 2000-01 to 2025-26



Source: QPC based on Australian Government 2001 to 2025b, 2025a; CGC 2025f.

⁷ The flypaper effect refers to the idea that money 'sticks where it hits', in that money received by subnational governments through intergovernmental transfers tends to remain with and be spent by government. If this effect was not occurring, only a small portion of government revenue from transfers would be used for public services (similar to what private citizens would spend on public services via income tax), with the rest being passed on to taxpayers via tax cuts (Brumby et al. 2012, pp. 31–32; Singhal 2007, p. 1).

Transfer dependency is difficult to measure as it is not clear what policies recipient states would pursue had GST distribution not been in place.

Typically, studies have focused on the size of the public service as a proxy for transfer dependency. Over time, these studies have, for example, consistently observed that recipient states typically have a larger public service (Figure 4.7).

Figure 4.7 Recipient states tend to have a larger public service than donor states

State government employees per '000 population, June 2025



Note: This chart does not account for full time equivalent employees, only persons employed. Victoria, South Australia, Tasmania and the Australian Capital Territory typically have more part-time public sector workers than other states (CGC 2025f, p. 27), so their public sector employment rate may be inflated relative to other states.

Source: ABS 2025d, 2025c.

This type of analysis should be viewed cautiously as it may not reflect transfer dependency but rather genuine need. For example, the CGC (2022b, p. 15) note the minimum costs of running government (per person) are high in Tasmania. This may be related to (among other things) Tasmania's highly decentralised population, and subsequent difficulty in achieving economies of scale in its service provision. Providing a full range of services in a small, regional or remote jurisdiction will always be more challenging due to the small absolute size of the public sector (Johnson et al. 2024, p. 489).

There is no consensus on whether transfer dependency and the flypaper effect are an outcome of the GST distribution system. However, recent international studies suggest there is transfer dependency arising from fiscal equalisation, albeit in different contexts to Australia's GST distribution system:

- Yaroshevych et al. (2024, pp. 13–14) examined the mechanism for aligning horizontal fiscal imbalances in Ukraine, and found transfers can reduce incentives for recipient communities to expand their own revenue base. The mechanism can instead encourage recipient communities to continue dependence on transfers and, in some cases, increase borrowing to fund expenses.
- Banaszewska (2023, p. 61) studied Poland's equalisation grant system and found higher equalisation transfers are associated with lower local tax effort. This indicates recipient jurisdictions partially substitute grants for own-source revenue.⁸ This suggests equalisation payments may soften budget constraints and reduce incentives for fiscal autonomy, particularly where grants are untied and not linked to development outcomes.

⁸ This study considers both horizontal and vertical fiscal equalisation, the latter of which Poland relies heavily on. This means the conclusions largely stem from vertical equalisation payments coming from central government funds.

Policy incentives and the CGC assessment methodology

Under the GST distribution system states do not bear the full cost or gain the full benefit of policy changes. These effects occur because, while policy neutrality is a supporting principle of GST distribution arrangements, in practice the CGC's methodology and assessments reflect other supporting principles and the overall equalisation objective. The main effects occur through:

- equalising for certain cost and revenue differences
- risk sharing
- tax rate and tax base effects
- expense assessments
- the dominant state problem
- differential treatment of government policies.

These issues have consequent impacts on the level and adoption of expenditure, revenue and tax reform policies. Similarly, the interactions with other Australian Government payments impact state policies. These effects are discussed below.

Equalising for certain cost and revenue differences

The CGC's assessment methodology equalises for all material differences in assessed revenue raising capacity and expenditure needs. This reflects the CGC's principle that their methods should, as far as possible, reflect what states collectively do, not what they could or should do (as discussed in Section 1), including from an economic efficiency perspective.

The CGC's approach to HFE has been criticised for encouraging inefficient outcomes, due to the breadth of factors considered in its assessment methodology and for not equalising for differences in the operating efficiency of state governments. These criticisms suggest:

- a GST distribution system that maximises consumer welfare would exclude equalisation for economic circumstances and include only partial equalisation for geographic circumstances (Independent Economics 2015, p. xi)
- equalising for factors such as wages or labour productivity of comparable workers across states is likely to dull the market signals of economic opportunity that drive interstate migration in an efficient national labour market (Independent Economics 2015, p. xi)
- equalising for both payroll tax and 'other revenue effects' is inefficient (Independent Economics 2015, p. xi)
- some elements of the CGC's methodology aimed at equalising for geographic circumstances are either not warranted due to externalities or work directly against economic efficiency (Garnaut & Fitzgerald 2002, p. 140).

The potential materiality of the CGC assessment methodology and the inherent efficiency trade-offs is illustrated through the assessment of transport expenditure needs (see Box 4.2). Furthermore, these effects represent a distinct trade-off between fiscal equalisation and efficiency.

Box 4.2 Transport Expenditure – Case study of the impact of CGC assessment methodology and efficiency trade-offs

The CGC's assessment of states' transport expenditure needs results in a greater GST distribution to states with higher population-weighted density in cities because greater density leads to higher public transport usage to avoid the higher costs associated with parking and road congestion (CGC 2020a, pp. 327–328). However, equalising for geographic circumstances may not support the efficient allocation of resources across states.

Similarly, the CGC assesses needs for states with a more dispersed population to support the provision of services in higher cost areas. This may encourage people to live in these higher cost areas, in the case where services are provided by states, as they do not bear the full cost themselves.

Both outcomes may detract from national welfare and economic efficiency.

These effects represent a distinct trade-off between fiscal equalisation and efficiency. The CGC's methodology to equalise for certain cost-differentials between states means states are not bearing the full cost of the services they provide, where those services are more costly to deliver. It can also provide an incentive for states to over-provide services where, due to the GST distribution, they are not bearing the full cost of service delivery.

Regardless of whether states act on these incentives or not, the equalisation of these cost and revenue differences will result in inefficient outcomes. States which are relatively more efficient will bear some of the cost of other states' expenses, and consequently will be less able to support activity within their state.

Risk sharing

As states do not bear the full cost of their decisions, the GST distribution system introduces an element of risk sharing between states. This includes cyclical and structural risks, such as the reliance of a state economy on mineral revenue, and risks associated with unforeseen events, such as natural disasters or pandemics. This may create adverse incentives for states to take on risk, in addition to lowering incentives for states to reduce risk.

An individual state may be inclined to underinvest in risk-reducing measures knowing that risks are shared between states and that the GST distribution system acts as a form of mutual insurance. This results in a risk of moral hazard where states collectively underinvest in risk reduction in the knowledge they will be at least partly compensated for the negative outcomes of risky decisions.

The inclusion of natural disaster recovery expenses in the GST distribution methodology for example, acts as a mutual insurance for the cost of natural disaster recovery between states but may also reduce states' incentives to invest in disaster mitigation measures. This can have adverse effects by reducing the cost borne by a state for enabling people to locate in more disaster-prone areas instead of lower-risk areas.

Again, regardless of whether states bear greater risk due to these incentives or not, the equalisation of the consequences of risky decisions means states that have better judged risks will bear some of the cost of other states' decisions.

Tax rate and tax base effects

Under the CGC's methodology, a state's GST needs are estimated based on a state's assessed revenue raising capacity — which differs from actual revenue raised. This assessed revenue raising capacity is a function of both the average tax rate across jurisdictions and an individual state's tax base (PC 2018, p. 101).

Individual states can alter their tax rates, which will have an influence over the average tax rate. However, this influence will vary based on the state's share of the tax base. For example, if a state has 30 per cent of the tax base, they will have a 30 per cent weighting on the average tax rate. For this reason, smaller states often have less impact on the average policy for tax bases that are usually larger due to population size (for example, stamp duties).

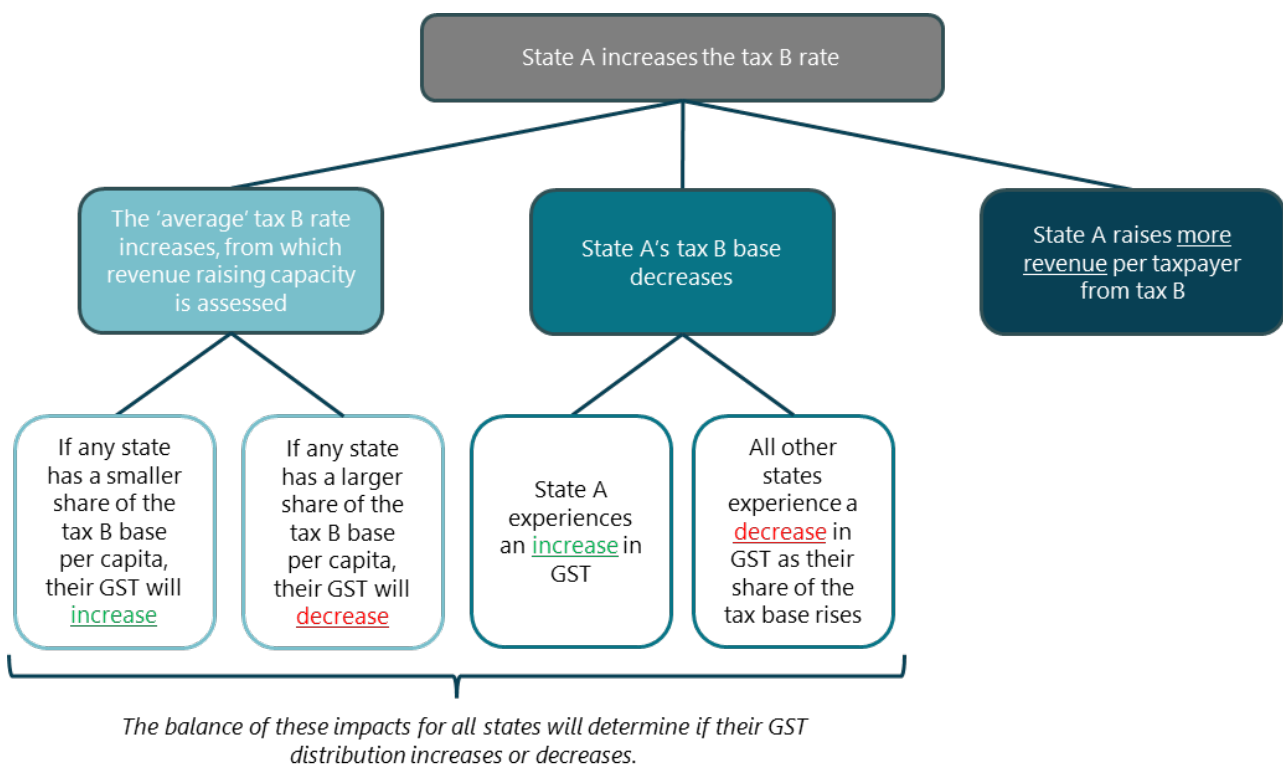
Changing the tax rate has two impacts on the GST distribution:

- An increase (decrease) in the tax rate in a state will increase (decrease) the 'average tax rate' across all states, from which revenue raising capacity is assessed. Whether this results in an increase or decrease in GST distributed to any state depends on the size of the tax base in the state, relative to population.
- An increase (decrease) in the tax rate will result in a decrease (increase) in the tax base as a result of the higher (lower) price point resulting in a reduction (increase) in demand. This is referred to as the elasticity impact on the tax base (PC 2018, p. 101).

In addition, changing any tax rate also has direct implications for state governments' own-source revenue from the affected tax. As a result, tax reform can have a two-fold impact on state revenue, through the affected tax and through the impact of the GST distribution system on GST grant revenue – see Figure 4.8.

Figure 4.8 A tax rate policy change can result in a state changing their GST share

The impact of an increase in the tax rate on GST distribution



Source: QPC.

In general, changes to the tax base have a more significant impact on the GST distribution than changes to the tax rate. The tax rate is assessed based on the average rate, while the CGC's methodology typically relies on observed, rather than underlying, tax bases to account for differences in states' revenue raising capacities (see CGC 2023, pp. 11–12). This results in a greater disincentive to pursue policies that will increase the observed tax base, such as compliance-based policies, or tax cuts that stimulate greater activity (PC 2018, p. 103). It also results in differing effects on GST distribution outcomes dependent on the elasticity of the tax base to changes in the tax rate.

Expense assessment effects

The CGC's approach to assessing states' expenditure needs involves the assessment of states' unique attributes — such as regional dispersion, the median age of the population, and indigeneity (Garnaut & Fitzgerald 2002, pp. 149–150).

There are cases where the absence of data means that a state's expenditure needs due to these attributes are assessed by the CGC based on how the state's expenditure deviates from the average. This approach may not account for existing cost inefficiencies that could be avoided (PC 2018, p. 115).

This assessment approach reduces the incentive for states to undertake reform that reduces the cost of service delivery, as such cost savings could be lost through the redistribution of GST to other states (Garnaut & Fitzgerald 2002, p. 136). If this disincentive is sufficient to influence policy decisions (e.g. underinvestment in public service innovation), the GST distribution system could result in economic inefficiency.

The dominant state problem

Where a state is completely dominant in a specific revenue source, any changes to their tax rate will result in an equivalent change to the average tax rate as assessed by the CGC. The state will subsequently see only their population share of the change in revenue retained in the state. This effect diminishes as a state becomes less dominant. The data lag and averaging also applied by the CGC will mean this redistribution will occur some years after the policy change.

The dominant state problem is clearly shown in the context of Australia's mining sector. Australia's mining sector has several commodities with production highly concentrated across one or two states. Most notably, iron ore is almost exclusively produced in Western Australia (PC 2018, p. 121), while Queensland produces more than half of Australia's black coal production (and a greater proportion by value), with most of the remainder attributable to New South Wales. The CGC separately assesses revenue raising capacity for eight groups of minerals (including iron ore and coal in their own categories), in addition to separate categorisations for high and low value coal (CGC 2025b, p. 60; PC 2018, p. 204).⁹

Due to the disaggregation of the CGC's mining assessment and the dominance of individual states as producers of some commodities, there are instances where one or two states have a significant influence on the average policy across all states (CGC 2025b, p. 52). Where a state has significant influence over the average policy, the policy neutrality of the GST distribution system becomes more compromised since a state's GST share will be directly and more acutely affected by the policy change.

Due to the high concentration of mineral production in specific states, the PC (2018, p. 121) has argued the GST distribution system has the potential to distort policy, especially within the mineral and energy resource sectors. This is due to the high concentration of mineral production in a small number of states, as such no averaging is applied. Rather, the small collection of states with a high concentration of minerals effectively set the average, and hence see most of the revenue from an increase in royalty rates equalised away (PC 2018, pp. 167–168).

Differential treatment of government policies

The CGC assessment methodology aims to adjust for material factors that impact states' revenue raising capacity or expenditure needs (CGC 2025d, p. 230). However, where a material factor influencing revenue raising capacity or expenditure needs cannot be identified, it usually does not undertake an adjustment. Even when expenditure or revenue patterns differ.

There are instances where insufficient information has resulted in the CGC deviating from their preferred policy – that is the neutral treatment of government policy when assessing revenue raising capacity or expenditure needs. This has resulted in some state government policies being treated differently.

This is clearly shown in the context of restrictive gas extraction policies (for example, historical restrictions in New South Wales and Victoria). Currently the CGC do not make an adjustment for state mining restrictions in their mining assessment. According to the CGC, this is because the CGC is unable to estimate the level of production if a state were to lift its mining restrictions (CGC 2025b, pp. 53–55).

⁹ This separate categorisation of high and low value coal was first introduced in the 2025–26 GST relativities assessment as it was introduced as an outcome of the 2025 Methodology Review. The CGC's change in methodology to differentiate by high and low value coal further increases states' dominance in these minerals.

Restrictive policies artificially lower the tax base for gas royalties, thus impacting assessed revenue raising capacity. Without a more policy neutral assessment approach, states are incentivised to adopt policies that favour economically inefficient outcomes.

The effect of the methodology in relation to gas royalties is that states can restrict or ban gas extraction while nevertheless benefitting from gas royalties through the GST redistribution. States do not bear the full cost or receive the full benefit of their policy choices.

Impeding reform

Where states experience distorted incentives to implement policy (such as through the tax rate and tax base effects or dominant state problem), there may be impediments to reform. This can have economy-wide consequences for economic efficiency and hinder productivity growth and long-term economic progress. Apart from the Australian Capital Territory Government's move to replace stamp duty with land tax, which is ongoing, there has been no significant, sustained state tax reform since the GST was introduced.

There is a distinct disadvantage to being a first mover when it comes to reducing or abolishing taxes, as the first mover has limited influence over the average tax rate, which is used to assess revenue raising capacity (PC 2018, pp. 328–329). As more states implement reform, the average tax rate will fall to a greater extent on a cumulative basis. This would then reduce the overall revenue raising capacity of the tax and therefore reduce the amount of GST redistributed to states with a smaller assessed revenue raising capacity (or reduce the amount distributed away from states with a higher assessed revenue raising capacity). As a result, the first state to reduce or abolish a tax will experience the greatest relative loss in their GST distribution, while also reducing their own-source revenue. Box 4.3 provides an overview of NSW's proposal to replace stamp duty and land taxes.

A similar effect is present on the expenditure side, as the first state to introduce cost-reducing innovations is likely to see GST distributed away from them for expenditure measures. This will be the case where the state's expenditure needs are assessed by the CGC based on actual expenses. In such instances, the assessed expenditure needs of the state implementing reform would decline, while the needs of other states would be unchanged.

Box 4.3 New South Wales' proposal to replace stamp duty and land tax with a broad-based property tax

In its 2020–21 budget, the New South Wales Government proposed to gradually replace stamp duty and land tax with a broad-based property tax (New South Wales Government 2020, p. 11). In considering this tax reform, the New South Wales Government was concerned with what this would mean for their share of the GST distribution (New South Wales Government 2021, p. 53).

To understand the GST impact of the proposal, the New South Wales Government engaged in discussions with the CGC (New South Wales Government 2021, p. 53). However, the CGC typically refrains from providing more detailed estimates of what policy proposals may mean for GST since (1) the CGC makes their assessments using historical data, and (2) the CGC cannot guarantee what other states will do or what revenues they will collect.

The New South Wales Government (2021, p. 53) stated that:

Without progress in this area [New South Wales] stands to lose up to \$1 billion of GST revenue per year in the long run, which would materially affect the Government's capacity to proceed with the reform.

When the reform was implemented in 2023, it was modified to extend only to first home buyers (New South Wales Government 2022, p. 64, 2023a); however the New South Wales Government intended to eventually make it available to all home buyers (New South Wales Government 2021, p. 8).

While there is no public evidence stating that potential GST impacts influenced this decision, the modified reform would have reduced the expected decline in New South Wales' GST distribution. This scheme was implemented only for a short timeframe of six months before being replaced with a stamp duty exemption for first home buyers on properties valued at up to \$800,000 (or a reduced rate for properties valued at up to \$1,000,000) (New South Wales Government 2023b).

Interactions with other Australian Government payments

The Australian Government provides both tied and untied funding to the states. This is through the form of specific purpose payments for the former and general revenue assistance for the latter.

Most specific purpose payments are treated as impacting states' fiscal capacities and consequently they are accounted for in the outcomes of the GST distribution system. However, some payments are treated as having no influence on GST distribution outcomes. Each of these treatments has efficiency implications.

In the Australian context, tied and untied funds interact because the CGC treats most specific purpose payments as impacting states' revenue raising capacities in the GST distribution process. This treatment effectively overrides the needs of each state as determined by the specific purpose funding agreements between the Australian and state governments (PC 2018, p. 274).

Specific purpose payments are developed through the expert agreement of Australian and state government officials for the purpose of improving social welfare (such as through health or school expenses) outcomes. The nature of specific purpose funding agreements means that governments continue to deliver funding and actions to deliver these agreements. However, there is potential for inefficiencies to arise through either:

- states making poorer choices concerning funding agreements due to the knowledge that the funding agreement will be overridden by the GST distribution system
- poorer welfare outcomes if the specific purpose funding agreement would result in a better distribution of fiscal resources to address the identified need than the CGC's assessment of the identified need.

In summary, the CGC's methodology involves a wide range of assessments, many of which may have adverse or perverse consequent impacts on the level and adoption of expenditure, revenue and tax reform policies. These incremental decisions to (or not to) undertake policy or tax reform ultimately have economic efficiency impacts. However, the aggregate impact of these decisions is unknown.

4.4 Impeding state responses to economic conditions

Prior to, and for the early years after the introduction of the GST, there was a relatively predictable set of conditions affecting HFE.

Since then, the GST distribution system has been affected by adjustments in the economy arising from structural change, unexpected shocks and commodity price cycles that have underpinned marked swings in state revenues, and in some cases, expenses.

These factors motivated the 2012 GST Distribution Review, 2018 PC Inquiry into Horizontal Fiscal Equalisation and 2026 PC Inquiry into GST Distribution Reforms. For example, the Terms of Reference for the 2012 GST Distribution Review highlighted:

Australia is facing a number of long-term trends that are driving pronounced and challenging structural change in the economy. (Australian Government 2011b)

The interaction between the GST distribution system and commodity price cycles have presented a material challenge, particularly for the resource states (see Box 4.4).

Box 4.4 The GST distribution and commodity price cycles

The significance of the mining industry in specific states is interacting with the GST distribution system with potential implications for economic efficiency.

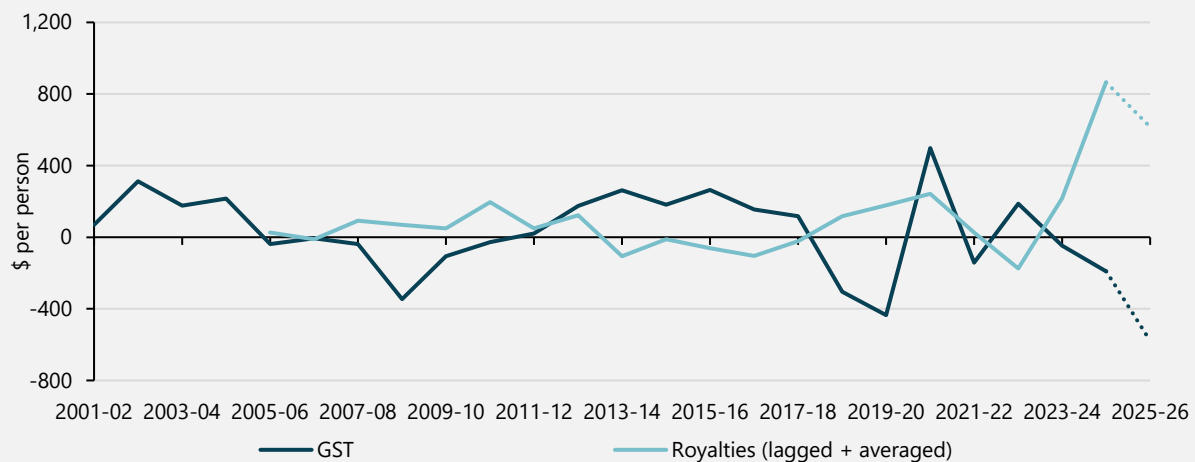
This interaction affects the GST distribution through fluctuations in commodity prices that flow through to royalties. Royalties provide a clear fiscal benefit to Queensland and other states (through redistribution), allowing the community to derive value from Queensland's natural resources. However, they also bring volatility to Queensland's (and other resource-exposed states) GST grant revenue because the GST distribution system acts to redistribute above-average own-source revenues, such as royalties (CGC 2025f, p. 67).

The data lag and three-year averaging present in the CGC's methodology also mean fluctuations in royalties are disconnected from the subsequent redistribution of fiscal capacities among states.

Accounting for the two-year data lag and three-year averaging involved in estimating GST needs, growth in royalties moves inversely with growth in Queensland's GST (Figure 4.9). This reflects the intention of the CGC's assessment methodology to balance its supporting principle of contemporaneity, with predictability and smoothing the impact of financial shocks (CGC 2023, p. 15).

Figure 4.9 Royalty revenues are a key driver of Queensland's GST distribution outcome

Change in Queensland's real GST grant revenue per capita and real royalty revenue per capita



Note: Royalty revenue has been lagged by two years and averaged over the preceding three years before calculating the growth rate.

Source: QPC based on ABS 2011a, 2015a, 2019, 2025b, 2026; Australian Government 2001 to 2025b, 2025a; CGC 2025f; Queensland Government 2004 to 2010, 2025a.

A consequence of the lagged and averaged nature of GST distributions is that changes from up to five years prior can impact current GST grant revenue.

The GST distribution system may impede structural change

Where the overall effect of the GST distribution system is to slow down resource reallocation (by enabling fiscally weaker states to better provide services and thereby retain labour and capital) dynamic efficiency may be impeded in the presence of structural change.

Australia has faced structural change, most notably through the onset of the mining boom. When structural change occurs patterns of demand for labour and capital, from both interstate and international sources, also change.

Where the GST distribution results in fiscal resources being redistributed away from states experiencing positive structural change (or toward states experiencing negative structural change), it will also reduce the incentives for the efficient reallocation of labour and capital. There are costs to the reallocation of labour and capital that mean it takes time for economic resources to move to take advantage of positive structural change. The GST distribution could exacerbate these costs. As described by Pincus and Ergas (2012, p. 2), in relation to labour:

there are sunk costs of moving, which hamper interstate movements. These include the psychological cost of disruption of social and family life, and the costs of finding new suppliers of goods and services, including a new school for children. Uncertainty about the outcomes of such moves makes them risky, requiring offsetting compensation if a move is to be made. But there are also artificial costs, like stamp duties on property transactions. These artificial costs mean that the flow of interstate migrants is too low and too slow, which is costly to dynamic economic efficiency.

In such instances, costs to efficiency (and household welfare) arise where the GST distribution means states advantaged by structural change are also receiving a lower share of the GST distribution pool and there is consequently less incentive to move to these states. This will mean the federation is unable to adapt to or take advantage of structural change as quickly as possible.

Garnaut and Fitzgerald (2002, p. 149) also suggest the systematic transfer of resources from highly productive regions makes Australia a less attractive destination for foreign capital and quality labour (that is highly skilled migrants).

While the GST distribution system acts to equalise and smooth states' fiscal capacities over the long term, it can also have the unintended consequence of exacerbating fluctuations in fiscal capacity in the short term. A specific state's GST grant revenue can be pro-cyclical in the short term (CGC 2022a, p. 18; PC 2018, pp. 134–135) when a state experiences a structural shift or a sudden change in its fiscal capacity (CGC 2017, p. 3).

Queensland's current experience is of pro-cyclical GST grant revenue. Short-term pro-cyclicity results in a timing mismatch between a state's GST requirements and actual GST grant revenue. This can have consequences for the state's ability to manage fluctuations in both economic conditions and revenue. The effect of pro-cyclical GST grant revenue means states experiencing a strengthening (or weakening) fiscal or economic position do not immediately have access to lower (or higher) GST grant revenue.

Between 2000–01 and 2014–15, Queensland's GST grant revenue was inversely correlated with total revenue excluding GST grants (with a correlation coefficient of -0.34).¹⁰ This indicates GST grant revenue was assisting with smoothing out revenue volatility over this period.

Since 2015–16, GST grant revenue has been positively correlated with total revenue excluding GST grants (with a correlation coefficient of 0.27), indicating GST grant revenue is not acting to smooth movements in state own-source revenue.

GST grant revenue has also become somewhat more correlated with real Gross State Product (GSP) over this period (with the correlation coefficient increasing from 0.23 to 0.44), indicating GST grant revenue is less available when it is most needed to manage fluctuations in real economic activity (although the effect is modest).

The recent pro-cyclical nature of Queensland's GST grant revenue has the potential to reduce economic efficiency where it contributes to suboptimal government decision-making. Impacts to economic efficiency can arise depending on the treatment of revenue windfalls.

There is empirical evidence that state governments overspend revenue windfalls from higher-than-expected royalties (Freebairn & Griffiths 2023).

¹⁰ Correlation was measured as the first differences of logged GST, total revenue excluding GST, and GSP.

GST grant revenue (and royalty windfalls) has also been pro-cyclical¹¹ in Queensland. Therefore, the result of any induced spending can also be to over-stimulate the economy during periods where it is already operating at capacity, thereby exacerbating economic cycles as well as future budget pressures when revenue declines. In general, there are very limited circumstances in which pro-cyclical spending will be welfare enhancing (Abbott & Jones 2013, p. 245).

In summary, while the GST distribution system may equalise and smooth states' fiscal capacities over the long term, it can also have the unintended consequence of exacerbating fluctuations in fiscal capacity in the short term. This has been the case during periods of significant economic growth, such as the mining boom.

4.5 Efficiency continues to be compromised under distribution system changes

As discussed in Section 1, the 2018 changes move Australia's GST distribution system from seeking to provide 'full' equalisation to 'reasonable' equalisation. While these changes have affected Queensland's GST relativity over the last five years, they have not directly affected Queensland's GST grant revenue relative to what would have been received under the previous system. This is due to the operation of transition arrangements, including the No Worse Off (NoWO) guarantee.

The NoWO guarantee means that a state will not receive less GST than they would have under the previous system. However, a state's estimated relativity may still rise or fall year-on-year, which can contribute to a rise or fall in a state's share of the GST distribution.

Given GST is drawn from a fixed pool, any change to how GST is distributed among states implies some states will be made better-off in fiscal terms at the expense of other states.

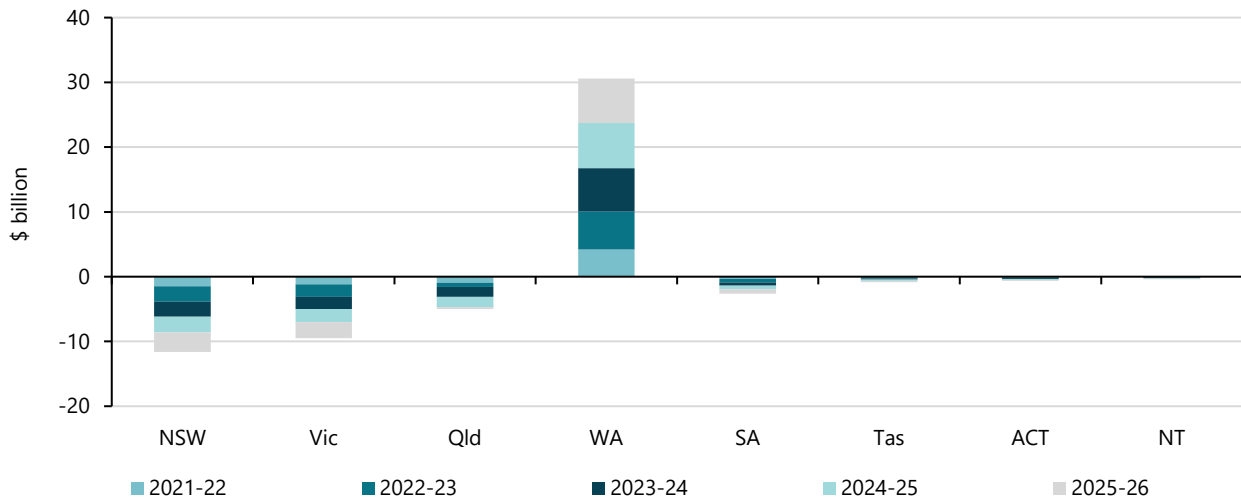
Murphy (2021) and Eslake (2024) note the 'reasonable' equalisation system means any state that is consistently fiscally stronger than the 'standard state' is always advantaged. That is, as long as they remain fiscally stronger than the standard state, they benefit from a higher fiscal capacity than other states. Should they become fiscally weaker than the standard state, they will benefit from equalisation to the standard state. Western Australia is expected to be the main or only beneficiary from this arrangement.

The NoWO payments provide one estimate of the overall effect of the 2018 changes. However, these transfers are slightly lower than the true effect due to other transitional arrangements that have gradually implemented the 2018 changes. Had the transitional arrangements not been in place, the 2018 changes would have resulted in Western Australia retaining an additional \$30 billion in GST revenue over the five years to 2025–26, at the expense of other states (see Figure 4.10).

¹¹ While Figure 4.9 shows an inverse relationship between GST grant revenue and lagged royalties, this inverse relationship does not necessarily hold when these revenues are viewed contemporaneously. Indeed, the use of lagged and averaged data in calculating GST relativities is what can lead to pro-cyclicality over the short term when a region is experiencing a structural shift or economic shock (CGC 2022a, p. 18; PC 2018, pp. 134–135).

Figure 4.10 The 2018 changes would result in Western Australia retaining an estimated additional \$30 billion in GST revenue had transitional arrangements not been in place

Cumulative fiscal impact from the 2018 reforms had transitional arrangements not been in place



Note: To estimate the effect of the 2018 reform, GST was estimated using the standard state relativities (removing the effect of the transition period) and using GST collections before the GST top-up was added. These effects are, therefore, larger than the sum of the NoWO transfer payments and better reflect the true impact of the reform.

Source: QPC based on Australian Government 2022 to 2025b, 2025a; CGC 2025f.

As a result of these transfers, Western Australia has received more GST than its CGC-assessed expenditure needs since the 2018 changes were implemented.

In the short term, the NoWO payments mean states' GST grant revenue over the period 2021–22 to 2025–26 was not directly affected by the 2018 GST distribution changes, despite their effect on relativities. Nevertheless, the 2018 changes have a fiscal impact on the Australian Government (in paying for the NoWO transfers), which affects taxpayers across all states.

The fiscal impact on states other than Western Australia will increase once the NoWO payments cease, assuming they are fully implemented as currently proposed (Australian Government 2024a). These payments are currently planned to cease from 2030–31.

In summary, while the 2018 changes are leading to a redirection of fiscal resources to Western Australia, they have not resolved the underlying efficiency impacts of the GST distribution system.

These issues will be further explored in the Final Report.

Appendix A: Terms of Reference

QUEENSLAND PRODUCTIVITY COMMISSION ACT 2025

Section 38

DIRECTION

Direction

Under sections 9(1)(b), 9(1)(d) and 38 of the *Queensland Productivity Commission Act 2025*, I direct the Commission to undertake research and provide advice in accordance with the request set out below.

TERMS OF REFERENCE

ECONOMIC IMPACTS OF AUSTRALIA'S GST DISTRIBUTION SYSTEM ON QUEENSLAND

Context

Australia is a federation of eight states and territories with diverse economic, social and geographic circumstances. This often leads to differences in the cost of providing services to residents and different capacities to raise revenue.

Yet, all Australians, regardless of the state in which they live, should be able to receive comparable levels of health, education, justice, welfare, public housing and other services.

Australia's Goods and Services Tax (GST) distribution system was originally designed to help ensure all states and territories could provide comparable services, if they all made a similar effort to raise revenue from their own taxes. In this regard, a greater share of the GST collected nationally by the Australian Government should theoretically go towards states or territories with growing populations and higher need.

GST is the single largest revenue stream for the Queensland Government, and it therefore plays an integral part in the State's ability to deliver essential services to all Queenslanders across our regions, where they need it and when they need it.

Concerningly, over the 10 years from 2015-16 to 2025-26, Queensland's GST revenue has only grown by 28 per cent, well below national GST growth of 75 per cent and even below consumer price index (CPI) growth of 33 per cent. In real terms, Queensland is receiving less GST revenue today than it did 10 years ago and is the only jurisdiction to face this highly detrimental outcome.

Over the same period, Queensland's population has grown significantly above Australia's population growth, while the underlying demand, complexity and cost of delivering essential services has also risen significantly.

The fact that Queensland will receive less GST revenue in 2025-26 than it did in 2015-16 in real terms, despite the continued growth of the national GST pool and the significant increase in Queensland's need, suggests the current GST distribution framework is not meeting Queensland's growing expenditure needs adequately or sustainably.

Additionally, there are public concerns around whether the GST distribution system creates fiscal disincentives for states to make good policy decisions or undertake helpful policy reforms. For example:

- Queensland is effectively paying other jurisdictions \$8.7 billion of GST in 2025-26 because it has successfully supported the development of Queensland's coal and gas industries while ensuring Queenslanders receive a fair share of royalties for the natural endowment that belongs to them and future generations
- current GST arrangements will redistribute up to around \$3 billion of the \$7.2 billion in funding committed by the Australian Government to deliver critical safety improvements to the national Bruce Highway, meaning that Queensland will effectively need to raise \$3 billion more in revenue to fund that shortfall

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- Queensland is effectively paying Victoria and New South Wales around \$800 million of GST in 2025-26 because those states had less effective COVID-19 policies and implemented more costly business support measures.

Queensland is the only jurisdiction to face a year-on-year decline in GST revenue in 2025-26, with the \$2.3 billion reduction being the largest in the history of the GST. In contrast, Queensland's GST revenue in 2025-26 would have been \$22.7 billion if it had grown in line with national GST payments. The fiscal and economic implications of a \$6.1 billion difference in a single year are profound.

Scope

The Queensland Productivity Commission (the Commission) is therefore directed to analyse and assess the economic impacts of Australia's GST distribution system on Queensland and the implications for the State to deliver essential services and infrastructure.

The Commission should assess the economic impact of GST distribution including on:

- Queensland's economy and the state's capacity to deliver services to support growth and social outcomes, considering that from 2015-16 to 2025-26, Queensland's GST revenue grew by 28 per cent instead of 75 per cent in line with the growth in national GST payments
- other key economic outcomes for Queensland relative to other states and territories, including capital and labour mobility
- Queensland, relative to other states and territories, as a result of the 2018 GST distribution system changes.

The Commission should also assess:

- whether GST distribution outcomes have appropriately incentivised sound policy decisions and reform
- the unintended consequences of the interaction between GST distribution and the broader Commonwealth-State funding and policy framework
- any other relevant matter relating to the economic and equity impacts of GST distribution.

Consultation

The Commission should consult with Queensland Treasury to ensure the analysis is appropriately informed by Treasury's economic, demographic and fiscal forecasts and projections, as well as Treasury's knowledge of data and other matters relating to the Commonwealth Grants Commission's assessment methodology.

The Commission should also consult where appropriate with key stakeholders to incorporate diverse perspectives on the sustainability of Queensland's GST revenue.

Queensland Government agencies should provide data and other information as required for the Commission to complete its analysis, in accordance with section 35 of the *Queensland Productivity Commission Act*.

Reporting

The Commission is to provide an Interim Report on the economic analysis to the Treasurer by 4 February 2026.

The Commission is to provide the Final Report to the Treasurer by 17 April 2026.

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