

# Approach to horizontal fiscal equalisation

## Overview

- 1 This chapter provides the Commission’s approach to horizontal fiscal equalisation, supporting principles and assessment guidelines. It also outlines the legislative requirements for finalising GST relativities.

## Horizontal fiscal equalisation objective

- 2 The Commission provides independent advice to the Australian Government on how GST revenue should be distributed among the states and territories (states). The distribution of GST revenue is governed by legislation and terms of reference issued by the Commonwealth Treasurer.
- 3 The terms of reference require the Commission, in making its recommendations, to take into account the *Intergovernmental Agreement on Federal Financial Relations*.<sup>1</sup> This agreement provides that GST revenue will be distributed in accordance with the principle of horizontal fiscal equalisation.
- 4 States have different relative fiscal capacities given their different service delivery needs and costs, along with different revenue raising capacities. The distribution of GST in accordance with horizontal fiscal equalisation seeks to provide each state with sufficient GST such that it has the potential to provide similar services and infrastructure to its residents.
- 5 The objective of horizontal fiscal equalisation is that:

‘after allowing for material factors affecting revenues and expenditures, each state would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own-sources and operated at the same level of efficiency.’<sup>2</sup>
- 6 In assessing each state's relative fiscal capacity, the Commission assesses the amount the 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. The Commission also takes into account payments other than GST that each state receives from the Commonwealth.<sup>3</sup>

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<sup>1</sup> Council on Federal Financial Relations, [The Intergovernmental Agreement on Federal Financial Relations](#), Federal Financial Relations, 2009.

<sup>2</sup> Commonwealth Grants Commission (CGC), [Commission’s position on fiscal equalisation, supporting principles and guidelines](#), CGC, Australian Government, 2023, p5.

<sup>3</sup> Not all Commonwealth payments are taken into account. Some payments are excluded by the Treasurer’s terms of reference (‘quarantined payments’). In the case of payments that are not quarantined, the Commission includes those that relate to state-type services for which the Commission assesses states’ expenditure needs.

- 7 Equalisation is not an exact science — it depends on the availability of appropriate data and requires the Commission to undertake estimates, apply judgements, and make trade-offs. In doing so, the Commission follows the processes outlined in its supporting principles and assessment guidelines.

## **GST distribution legislation**

- 8 Changes to the GST distribution arrangements were legislated by the Australian Parliament in 2018. The key elements are:
- a new equalisation benchmark linked to the fiscally stronger of New South Wales or Victoria
  - a GST relativity floor
  - Commonwealth funded top-ups to the GST pool
  - transitional arrangements to phase in the new benchmark and give states a no worse off guarantee.
- 9 The Commission's calculation of states' relative fiscal capacities is necessary to identify the fiscally stronger of New South Wales or Victoria, which is the benchmark set by the legislation.
- 10 The legislation includes a guarantee that no state will be worse off under the new arrangements – that is, without GST pool top-up payments, a GST relativity floor or the phasing in of the new standard state benchmark. The legislated no worse off guarantee operates from 2021–22 until 2026–27, with no worse off payments calculated and provided by the Commonwealth in accordance with the legislation. Under an agreement between the Commonwealth and the states, no worse off payments will continue until 2029–30.<sup>4</sup>
- 11 Attachment A outlines the Commission's approach to horizontal fiscal equalisation and the additional steps required by the 2018 GST distribution legislation.

## **Supporting principles**

- 12 The Commission's core task is to identify influences, referred to as 'drivers', beyond the direct control of states that cause their relative fiscal capacities to diverge. By quantifying these influences, the Commission seeks to estimate the GST share each state requires to provide the same (average) level of services — that is, each state's relative fiscal capacity as represented by its 'assessed relativity'.<sup>5</sup>

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<sup>4</sup> Commonwealth Treasury, [Extension of the GST No Worse Off Guarantee](#), Federal Financial Relations, 2024, accessed 4 February 2025.

<sup>5</sup> Assessed relativities are calculated for each assessment year by comparing each state's relative ability to raise revenue with its relative cost of providing services.

- 13 To assist in designing and evaluating alternative assessment methods, the Commission has 4 supporting principles: 'what states do', policy neutrality, practicality, and contemporaneity. They are subsidiary to the objective of horizontal fiscal equalisation.
- 14 Ideally, assessment methods would embody each of the supporting principles. In practice, alternative assessment methods often involve trade-offs between supporting principles, with the objective of fiscal equalisation always being the primary consideration. The Commission has not established a relative weighting or hierarchy of supporting principles. Instead, it uses its judgement to determine the most appropriate measure of states' relative fiscal capacities.

## **'What states do'**

- 15 The Commission bases its assessments on the average policies of all states. It does not make judgements about what states could, or should, do.
- 16 To determine the average policy, the Commission uses a 'weighted average approach' as a benchmark for an assessment. Average policy reflects the average of what all states do, recognising that some states may choose not to impose a tax or provide a service.<sup>6</sup>
- 17 Under this approach, if even one state raises revenue (or provides a service), it becomes part of what states collectively do. A differential assessment will be made if it has a material effect on GST distribution.<sup>7</sup> Average policy is a continuum, where:
  - the average effective tax rate for a particular tax base reflects the total amount of revenue collected by all states from that tax as a proportion of the total tax base
  - the average per capita spending on a service depends on the total amount of money spent on that service, regardless of the states in which that money is spent.
- 18 In applying the 'what states do' supporting principle:
  - assessments reflect the average range of services provided collectively by states and the average range of revenues raised
  - the level of services and associated infrastructure states are funded to provide, and the revenue raising efforts they are presumed to make, are an average of those actually provided or made
  - drivers reflect the material factors beyond a state's control that affect service delivery costs and revenue raising capacities.

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<sup>6</sup> Under this approach, each state contributes to the average policy in proportion to its share of the total revenue base or total service population. The approach uses the data on 'what states do' to inform the decisions on what assessments are made and how those assessments are made.

<sup>7</sup> A differential assessment is an assessment of states' costs of providing services or their revenue raising capacity that is not an equal per capita assessment. Materiality thresholds represent the minimum change from an equal per capita assessment of a revenue or expense that must occur for the Commission to recognise a driver. Materiality thresholds are discussed in the section on Assessment Guidelines.

- 19 The 'what states do' principle ensures that assessments reflect the full range of state expenditures and revenues.<sup>8</sup> As the roles, functions, priorities and circumstances of states change, so does the assessment of their relative fiscal capacities.

## Policy neutrality

- 20 The policy neutrality supporting principle has 2 related aspects. First, a state's policy choices (in relation to the revenue it raises or the services it provides) should not directly influence its GST share. Second, the Commission's assessments should not create incentives or disincentives for states to choose one policy over another.
- 21 In most cases, the Commission broadly achieves policy-neutral assessments through its weighted average policy approach. Under this approach, a state's policy choice will only affect the assessment to the extent it affects the average revenue or expenditure (that is, it cannot 'directly' influence its GST share).
- 22 An exception arises where a revenue base is concentrated in one state, for example iron ore production in Western Australia. In this case, the policy of Western Australia has a dominant role in determining average state policy, which can raise issues if the dominant state changes its royalty rate.<sup>9</sup>

## Practicality

- 23 The terms of reference for the review of the Commission's assessment methodology requires that it should 'aim to have assessments that are simple and consistent with the quality and fitness for purpose of the available data'.<sup>10</sup> The practicality supporting principle seeks to ensure that assessment methods are sound, as simple as possible and based on reliable and fit-for-purpose data.
- 24 This principle recognises that, while state fiscal capacities are affected by a variety of factors, the suitability of the recommended GST relativities may not be improved by including drivers when sufficient data are not available to measure their effects or when those effects are small. The principle is supported by the inclusion of materiality and reliability criteria in the assessment guidelines.

## Contemporaneity

- 25 The contemporaneity supporting principle aims to ensure that, to the extent reliable data will allow, the distribution of GST provided to states in a year should reflect state circumstances in that year. A fully contemporaneous approach would equalise state fiscal capacities in the application year. However, robust data are not available

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<sup>8</sup> Differential assessments of those expenditures and revenues are only made where those assessments are material and are supported by reliable methods and data.

<sup>9</sup> Further detail on the issue of dominant state royalty rates can be found in the mining chapter of *Review Outcomes*.

<sup>10</sup> Commonwealth Treasurer, [Terms of Reference for the 2025 Methodology Review](#), Commonwealth Grants Commission website, 2023, accessed 14 February 2025.

until the application year has passed. In the absence of such data, the Commission bases its recommendations on historical data. The 3-year lagged, moving average provides an appropriate balance between contemporaneity, predictability and smoothing the impact of fiscal shocks.

## **Assessment guidelines**

- 26 The Commission's guidelines support a consistent approach to developing assessment methods, and ensure that methods are conceptually sound and reliable, and as transparent and simple as possible.
- 27 The guidelines are also a key part of the Commission's quality assurance process. They ensure all relevant steps in the decision-making process are followed and that this process is transparent.
- 28 As previously noted, equalisation is not an exact science; it relies on the availability of appropriate data and requires the Commission to make estimates, exercise judgement and navigate trade-offs. Box 1 outlines the assessment guidelines.

## Box 1 Assessment guidelines

The Commission organises its work by making assessments for individual categories. Separate assessments will be made when they are materially different from other assessments or if the assessment is easier to understand if undertaken in a separate category. The Commission will include a driver in a category when:

- a case for the driver is established, namely:
  - a sound conceptual basis for different assessments exist
  - there is sufficient empirical evidence that material differences exist between states in the levels of service use or unit costs, or both, or in their capacities to raise revenues.
- a reliable method has been devised that is:
  - conceptually rigorous — for example, it measures what is intended to be measured, is based on internal standards and is policy neutral
  - implementable — the driver can be measured satisfactorily
  - consistent with external review outcomes where used.
- data are available that are:
  - fit for purpose — they capture the influence the Commission is trying to measure and provide a valid measure of state circumstances
  - of suitable quality — the collection process and sampling techniques are appropriate, the data are consistent across the states and over time, and are not subject to large revisions.

The Commission will adjust data where necessary to improve interstate comparability. However, the Commission will only make data adjustments if they redistribute more than \$12 per capita for any state in the assessment period.

The Commission will include a driver in its final assessments if:

- it redistributes more than \$40 per capita for any state in the assessment period (the materiality test will be applied to the total effect the driver has on the redistribution from an equal per capita assessment of revenue or expenditure, averaged over the 3 assessment years)
- removing the driver has a significant effect on the conceptual rigour and reliability of assessments.

Where a case for assessing a driver in a category is established, but the Commission has concerns with the underlying data or assessment method, a uniform set of discounts will be used — low (12.5%), medium (25%), high (50%) or no assessment (100%). The Commission will use higher discounts when the Commission has greater concerns with the underlying data or assessment method.

## Discounting assessments

- 29 For some assessments, the Commission accepts the conceptual case for including a driver, but it has concerns with the data or the assessment method. In these cases, the Commission can decide whether to use the data or method with a discount, or to not assess the driver.

## Discounting framework

- 30 Discounts are used for concerns or uncertainty with respect to specific data or methods but are not applied in cases of general uncertainty or to address policy neutrality.
- 31 The types of data or method concerns that may result in discounting include:
- the comparability of state data
  - where data are only available for a few states and may not represent the situation in all states
  - the use of proxy data that may not capture the full influence of a driver.
- 32 There are times the Commission considers the application of a discount is inappropriate.
- The Commission makes judgement-based estimates (such as the proportion of expenses to which a driver should apply). Discounting is not applied as the Commission has already incorporated relevant information in applying its judgement.
  - There may be concerns about policy neutrality, general uncertainty, or the strength of the conceptual case. These factors are taken into account in the decisions on whether the conceptual case is accepted or how the driver is best measured.
  - There may be concerns about the quality of estimates of national spending or revenue, such as those derived from ABS Government Finance Statistics or state revenue office data for measuring component revenue and expenses. Adjustments to ensure budget data are fit for purpose are made, so no discounts are necessary.
- 33 There are 4 levels of discount — low (12.5%), medium (25%), high (50%) and no assessment (100%). The level of discount applied depends on the Commission's judgement about the reliability of the data or method.
- 34 The Commission reviews its use of discounts at each methodology review, ensuring that discounts are appropriately applied, the size of the discount reflects the degree of concern with the data or assessment method, and there is consistency in the application of discounts across assessments. Where discounts are applied to an assessment, the Commission provides a clear explanation for their use.

35 Table 1 shows the assessments where the Commission has applied a discount, including the rationale and the level.

**Table 1 Discounts in the 2025 Review**

Assessment	Rationale for discount	Level of discount
Land tax	Uncertainty about the reliability and comparability of taxable land value data.	12.5%
Health – community health socio-demographic	Reliance on a proxy measure of activity for a significant share of community and public health expenses.	12.5%
Health – non-state sector adjustments	Uncertainty about the reliability of data and the robustness of the methods for determining the adjustments.	12.5%
Roads	Uncertainty about the reliability of data included in several aspects of the assessment, including the reliability of the rural road synthetic network as a proxy measure of what states do.	12.5%
Wage costs	Uncertainty about the reliability of private sector wages as a proxy for public sector wage pressures, and the capacity of the model to control for all differences in employee productivity.	12.5%
Geography – regional costs general gradient	Uncertainty about the reliability of the gradient, given it is applied where a gradient cannot be directly measured.	25.0%



## Attachment A: Calculating GST relativities

- 36 GST relativities are the weights used by the Commission to recommend the GST distribution to the Commonwealth Treasurer. They are calculated in a series of steps, which are described below and visualised in Figure 1.
- 37 A state with a GST relativity of above 1 will receive an above-average amount of GST per person, and a state with a relativity below 1 will receive a below-average amount of GST per person.
- 38 The steps outline how the Commission gathers and standardises data, assesses GST needs and gives effect to the 2018 GST distribution legislation.

### Step 1. Establish the adjusted budget

- 39 The Commission develops an ‘adjusted budget’ for each assessment year. This is a comprehensive representation of state budgets, broken down into the Commission’s category and component structure. It provides a comparable and consistent representation of revenues, expenses and investment across the states.
- 40 By collating what states collectively spend on a service, there is a basis to identify what a state’s spending may look like under average policy. The same is true for each source of revenue.
- 41 The adjusted budget uses data from the ABS final Government Finance Statistics (GFS) for the first 2 assessment years in the 3-year assessment period and ABS preliminary GFS data for the most recent assessment year, where available.<sup>11</sup> Data on payments received from the Commonwealth are sourced from the Commonwealth’s Final Budget Outcome publication.
- 42 These data allow the Commission to identify average state spending and revenue raising.

### Step 2. Apply the assessment methods

- 43 The Commission assesses the expenses, investment, revenue and net borrowing of each state as well as the Commonwealth payments received. The assessed amounts differ from states’ actual amounts because they take account of each state’s cost and revenue drivers.
- 44 Drivers are factors beyond the control of a state that affect how much a state needs to spend on providing services and how much revenue it can raise.

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<sup>11</sup> Where ABS preliminary GFS data are not available for a particular state, GFS data from the state will be used instead.

- 45 The Commission estimates the following:
- the revenue a state would raise if it were to apply the average policies to its revenue base and raise revenue at the average level of efficiency (assessed revenue)
  - the expenses a state would incur if it were to follow average expense policies, allowing for the drivers it faces and assuming it provides services at the average level of efficiency (assessed expenses)
  - the expenditure on new and replacement infrastructure a state would incur if it were to follow average policies, allowing for the drivers it faces in providing infrastructure and assuming it requires the average level of infrastructure to deliver the average level of services (assessed investment)
  - the borrowing a state would require to achieve the average net financial worth at the end of each year (assessed net borrowing)
  - payments of financial assistance (excluding GST) made by the Commonwealth that add to a state's fiscal capacity (Commonwealth payments).

### Step 3. Calculate each state's assessed GST need

- 46 A state's assessed GST need is the amount of GST required to bridge the gap between its assessed expenses and assessed investment, and its assessed revenues, assessed net borrowing and Commonwealth payments.

$$\text{Assessed GST need} = (\text{assessed expenses} + \text{assessed investment}) - (\text{assessed revenues} + \text{assessed net borrowing} + \text{Commonwealth payments})$$

- 47 A state's population share of GST (the amount required if it received the per capita national average share of GST) is also calculated in this step.

### Step 4. Calculate each state's assessed relativity

- 48 The assessed relativity reflects a state's assessed GST needs relative to its population share of GST.

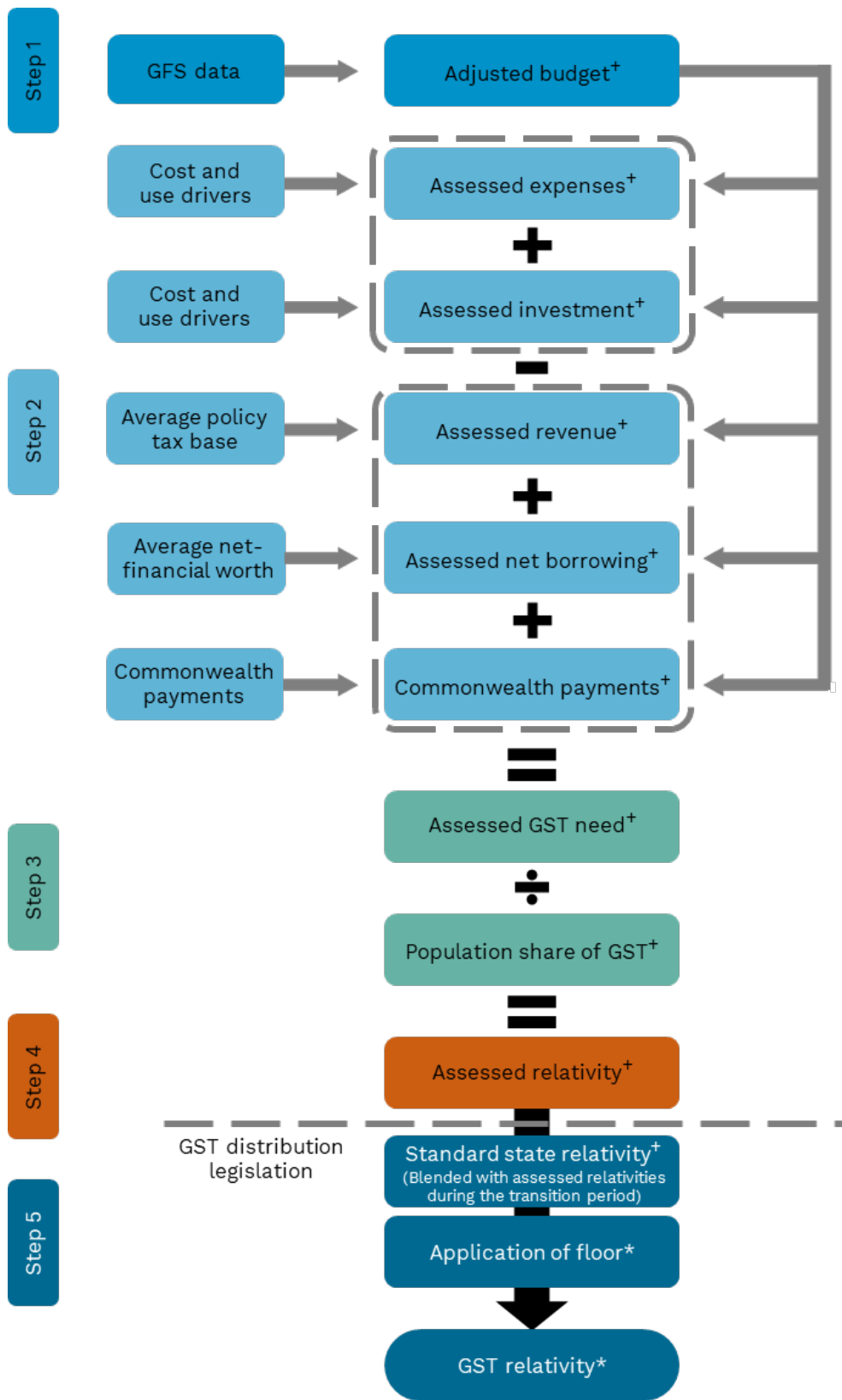
$$\text{Assessed relativity} = \frac{\text{assessed GST need}}{\text{population share of GST}}$$

- 49 An assessed relativity above 1 indicates that a state requires more than the average GST per person.
- 50 Prior to the 2018 GST distribution legislation, the average of a state's assessed relativity over the 3 assessment years was equal to its GST relativity. Step 4 was the end of the equalisation process.
- 51 This share of the GST balanced the requirements of each state to meet the difference between their assessed expense and investment needs, and their assessed revenue, net borrowing and Commonwealth payments.

## Step 5. Calculate each state's GST relativity

- 52 Since the 2018 GST distribution legislation, additional steps are involved in calculating a state's GST relativity.
- 53 The legislation introduced:
- standard state relativities, including temporary blended relativities to 2026-27
  - a GST relativity floor.
- 54 No state can have a relativity lower than that of the fiscally stronger of New South Wales or Victoria, which serves as the standard state, in any of the 3 assessment years. If a state's relativity is increased to match the standard, the relativities of all other states will be adjusted downward on a population share basis. The resulting relativities from these adjustments are the standard state relativities.
- 55 Over the 6-year transition period, the assessed relativities are blended with the standard state relativities. The weighting that each receives is specified in the legislation. The new arrangements form a growing proportion of the calculation of GST relativities until 2026-27, when they will be fully implemented.
- 56 Each state's final relativity must remain at or above the GST relativity floor. This is 0.75. If the average of a state's 3 assessment year blended relativities is below the floor, it is lifted to the floor and all other states are adjusted down on a population-share basis.
- 57 These final numbers are called GST relativities.

**Figure 1 Calculating GST relativities (excludes no worse off relativities)**



<sup>+</sup>Based on single year of data

\*Based on 3-year average

## **No worse off relativities**

- 58 Under the 2018 GST distribution legislation, the Commonwealth provided a guarantee that states would not be worse off than they were under previous arrangements. The no worse off guarantee was legislated to conclude in 2026–27, however it has been extended until 2029–30.
- 59 Each year the Commission is asked through terms of reference to provide relativities that would have applied had the 2018 GST distribution legislation not been enacted. These ‘no worse off relativities’ are used by the Commonwealth to determine whether to make a no worse off payment to a state.
- 60 No worse off relativities are broadly calculated in the same way as assessed relativities but include adjustments to remove the impact of the Commonwealth’s legislated top-ups to the GST pool.