



Inquiry into Horizontal Fiscal Equalisation

The Australian Government has asked the Productivity Commission to undertake an inquiry into Australia's system of horizontal fiscal equalisation (HFE), which underpins the distribution of GST revenue to the States and Territories (States). The terms of reference for the inquiry can be found on the Commission's website: www.pc.gov.au/inquiries/current/horizontal-fiscal-equalisation

The Commission invites interested people and organisations to make a written submission addressing the issues and questions raised by the terms of reference. The terms of reference are both broad and reform oriented. This inquiry is not a detailed review of the Commonwealth Grant Commission's (CGC) formula for calculating GST relativities. This circular provides guidance as to the questions the Commission will seek to ask and answer to meet the terms of reference. In doing this inquiry, the Commission will be guided by the *Productivity Commission Act 1998* and the objective of achieving higher living standards for all members of the Australian community.

The Commission is aware of the CGC's 2020 Methodology Review, which is underway. The CGC has indicated that it will publish its views on the HFE objective, supporting principles and their implementation by the end of September 2017. This work will be a timely input to the Commission's inquiry, albeit its focus is based on the current *Intergovernmental Agreement on Federal Financial Relations* and its own terms of reference. While this results in parallel consultation processes, the CGC review and the Commission's inquiry are complementary.

Our consultation questions

Broadly, the terms of reference ask the Commission to inquire into the economic impacts of the current HFE system, and whether there are preferable alternatives to the current system. Effectively, there are two broad questions for this inquiry to ask and answer. These are identified below and supported with subsidiary questions to guide submissions.

The Commission asks for submissions to be 'evidence heavy'. As far as possible, submissions should identify and detail evidence in support of views and arguments. Submissions are required by **30 June 2017**. There will be further opportunities for interested parties to provide input to the inquiry following the release of the draft report in early October.



Further information on the inquiry and how to provide a submission is available at www.pc.gov.au/inquiries/current/horizontal-fiscal-equalisation or by contacting Mary Cavar on 03 9653 2187.



1 How does the current HFE system impact the Australian community, economy and State and Territory governments?

- a. Is the current HFE system getting in the way of States pursuing higher economic growth and productivity, and at the expense of higher national prosperity? If so, how?
- b. What evidence is available on whether and how the current HFE system affects the movement of labour and capital across State borders, particularly if a region is experiencing high labour demand?
- c. Does the current HFE system create perverse incentives or unintended consequences for reform at the State level? What evidence is there on how these incentives affect State policies and ultimately outcomes for the Australian community?
 - Does the HFE system impede State tax reform over time, including States' decisions on developing their revenue bases and rates? If so, how and to what extent?
 - Does the HFE system impede the efficiency of State service delivery, infrastructure investment and policies affecting where people live? If so, how and to what extent?
 - Is policy neutrality adequately addressed under the average state policy approach? Why or why not?
- d. Does the current HFE system influence State policies to facilitate, restrict or tax the development of economic activity, and in particular energy and mineral resources?
 - What evidence is there for the HFE system affecting State policy choices relating to resource extraction (including regulatory restrictions on development)?
- e. How does the current CGC relativity process affect States' fiscal management from year to year and over time? How does this affect policy outcomes and economic activity in each State?
 - Does the current process impact the ability and propensity for States to manage budgets through cycles, especially for those states relatively more reliant on large and volatile revenue streams?
 - How does data reliability and the three-year averaging process affect fiscal management? Is there a better trade-off between GST relativity precision and timeliness?
 - What is the ability (and track record to date) of States to project and anticipate their own GST relativities, including any impacts of major State initiatives?
 - What resources do individual States expend dealing with HFE matters?



2 What preferable alternatives are there to the current HFE system (as adopted by the CGC in its calculation of GST relativities) of equalising States' fiscal capacities?

- a. What should be the objective of HFE?
 - Should HFE address fiscal divergences across States due to both structural factors (beyond State influence) and cyclical factors (beyond State influence)? If so, over what time period should this be achieved?
 - Should HFE compensate States for fiscal divergences where a State has by choice diverged from efficient tax arrangements and service delivery?
 - Should past State policy decisions (such as on economic development, revenue bases and rates, or budget provisioning) influence the form or degree of fiscal equalisation? If so, how?
 - What are the advantages and disadvantages of targeting full versus partial fiscal equalisation across States?
 - To what extent should States be held accountable for how they use funds received via equalisation?
- b. What are some alternatives to the current system and how would they affect States' incentives to pursue higher prosperity? How would the alternatives perform, relative to the current system, in terms of efficiency, equity and simplicity, and ultimately which approach is best for national productivity and wellbeing?
- c. How do these alternative approaches fit within the wider scheme of federal financial relations? Are some inequalities across States better dealt with outside the HFE system?
- d. What practices in other federations offer pertinent evidence for the Commission's considerations?