

# Terms of Reference for Inquiry into Australia's System of Horizontal Fiscal Equalisation.

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby request that the Productivity Commission 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 inquiry should consider the influence the current system has on productivity, efficiency and economic growth, including the movement of capital and labour across state borders; the incentives for the States to undertake fiscal (expense and revenue) reforms that improve the operation of their own jurisdictions, and on the States' abilities to prepare and deliver annual budgets.

## Background

HFE has been a feature of Commonwealth-State financial relations since Federation. Under the current approach to HFE, the GST is distributed on the basis of relativities recommended by the independent Commonwealth Grants Commission which assesses the capacity of each State to provide its citizens with a comparable level of government services.

In recent years, some States and commentators have suggested Australia's approach to HFE does not sufficiently recognise the differences between states' individual circumstances nor states' efforts to manage those circumstances thereby creating disincentives for reform, including reforms to enhance revenue raising capacities or drive efficiencies in spending. In commissioning this inquiry, the Government seeks an examination of the issues underlying these claims and concerns that any gains from reform are effectively redistributed to other States.

## Scope of the inquiry

The Commission should consider the effect of Australia's system of HFE on productivity, economic growth and budget management for the States and for Australia as a whole. In doing so, the Commission should, in particular, consider:

- Whether the present adoption by the CGC of an HFE aim to equalise states' revenue raising and service delivery capacities is in the best interests of national productivity; or whether there may be preferable alternatives. On this matter the Productivity Commission should enquire as to whether this aspect of the CGC formula or any other aspect of it may restrict the appropriate movement of capital and labour across State borders to more productive regions during times of high labour demand;
- Policies affecting energy and resources, noting the uneven distribution of natural resources across the nation; whether sufficient consideration is given to the different underlying and structural characteristics of different revenue bases;
- Whether the present use by the CGC in its HFE formula of rolling three year averages provides the most appropriate estimate of real state revenue raising abilities, particularly for those states heavily reliant on large and volatile revenue streams. Particular analysis should be given to whether the lagged fiscal impacts that result from averaging and non-contemporary data leads to GST relativities which accentuate rather than moderate peaks and troughs in state economic cycles;
- Whether the present HFE formula, may have the effect of producing a disincentive for a State to develop a potential industry or raise a royalty rate for an existing industry at an appropriate time.;

- Whether the present HFE formula in its stated aim of comprehensively equalising States' fiscal capacities places too great a reliance on broad indicators and insufficient relevance on specific indicators which recognise States' different circumstances; and

The Commission should also consider implications for equity across jurisdictions, efficiency and simplicity.

**Process**

The Commission should undertake appropriate public consultation, including holding hearings, inviting public submissions and releasing a draft report to the public. It should consult widely, including with State and Territory governments and take into account previous reviews of the HFE process, including the 2012 GST Distribution Review report as well as international approaches to fiscal equalisation within federations.

The final report should be provided to the Government by 31 January 2018.

SCOTT MORRISON

Treasurer