Chapter Five

Financial Centralisation: The Lion in the Path

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In his musings about his past life, Ulysses says "I am a part of all that I have met". We are all, to a considerable extent, fashioned by our experiences – the people and situations we have encountered along life's path. And so too has been the constitution. It will be my contention this morning that "I am a part of all that I have met" is more true of the document that we have come here today to discuss than it is of all those assembled here to discuss it.

In one sense the constitution is remarkably little altered all these years since its conception. If Barton, or Parkes, Deakin or Samuel Griffith were here present, and we showed him a copy of the document, he would probably be surprised that so much of the document he was engaged in drafting so many years ago is still extant, seemingly resilient to the mighty changes wrought by the twentieth century. But to stop this hypothetical inquiry there would be just too trite.

It is hard to imagine that the Founding Fathers would have been content merely to see the document they devised. Surely, if they were here present, they would want to know how the Australian Federation in the last decade of its first century had worked out in practice. They surely would like to know how their vision of the distribution of powers among their beloved Commonwealth and their beloved States – for they saw no conflict in faithfully serving both – had been translated into reality as it met the rapid succession of social, technological, economic and political challenges of each passing decade.

How close in practice has the Australian constitution come to obtaining the optimal balance between unity and diversity?

Comparing the first and last decades of this century, the centralisation of power at the Commonwealth level is the most astonishing change to the constitutional compact originally entered into by the States. I shall be focusing on the power to tax and to spend, which is not to diminish the importance of other changes, such as the interpretation and exploitation by the Commonwealth of the external affairs power.

The accretion of power at the Commonwealth level has been assisted by those few changes to the constitution that have been approved by the requisite majorities. As early as 1910 the Commonwealth's powers to "take over from the States their public debts existing at the establishment of the Commonwealth" was broadened – infinitely – in terms of the quantity of States' debt that could be taken over by deleting the words "as existing at the establishment of the Commonwealth".

This provision – section 105 – was further dramatically tilted in favour of the Commonwealth by the 1929 amendment, made in the wake of the financial panic which presaged the Great Depression. The powers of the Commonwealth were extended to enable the Commonwealth to make agreements with the States on every aspect of State debt: the taking over of debt, the management of debt, the payment of interest, the provision and management of sinking funds, the consolidation, renewal and redemption of State debts, the indemnification of the Commonwealth by the States in respect of debts taken over by the Commonwealth, even the entering into of new debt by the States.

While the new Section 105A only empowered the Parliament to make agreements with the States about their debts, the fact was that an agreement – the Financial Agreement of 1927 – already existed. The 1929 amendment removed doubt about the constitutional validity of the Loan Council's absolute control over State Government debt and, from 1936, the Loan Council extended its authority to the annual borrowing programs of semi-government and local authorities.

A man who surrenders his right to borrow to another party and receives assistance from that other party in servicing and repaying his existing debt, in effect surrenders his financial sovereignty to that other party. The Financial Agreement was a remarkable abrogation of responsibility by the States. The Financial Agreement was like a neon sign flashing the message to financial markets in Australia and overseas "We States can't be trusted to manage our own affairs".

Outstanding debt at any point in time, in effect, represents the cumulative outcome of spending and revenue decisions taken in the past. The Financial Agreement muddied the waters about responsibility for those decisions. State governments were no longer clearly accountable for their actions. The Commonwealth – to be precise, the Commonwealth Treasury – was thrust into the role of gendarme of the federal financial system – with the task of ensuring, as well as it could, that State debt - and hence State expenditure and revenue decisions - was managed prudently.

The States had put their feet firmly on the sticky paper laid for them by the Commonwealth – Commonwealth assistance in return for Commonwealth control. Once the States had ventured onto the sticky paper, there has been no turning back.

Amendments have been made to two of the Section 51 powers to extend the power of the Commonwealth – the social security power, which was inserted in 1946, and the 1967 amendment that removed the limitation on the power of the Commonwealth to make special laws in respect of aboriginals in any State. The latter is to be the subject of an entire section of this conference tomorrow, so I shan't trespass on that territory.

Under the constitution as originally drafted, the Parliament was empowered to make laws in respect of invalid and old-age pensioners. In 1946 this power was extended to include "The provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services (but not so as to authorise any form of civil conscription), benefits to students and family allowances".

This amendment led to a significant expansion in what are now two of Canberra's largest bureaucracies – the Departments of Social Security and Health, although it should be noted that even the Department of Health predated by a quarter of a century the 1946 amendment.

A surprise, for me at least in preparing this paper, was that it was this head of power - the social security power – that spawned the Commonwealth Office of Education. This Office was brought under the wing of the Prime Minister's Department between 1952 and 1966, at which time a separate Department of Education and Science was established.

As Dr Evatt triumphantly put it to the House in December 1953 – I might say this remark was in the debate in which Evatt was supporting Menzies' 1953 States Grants (University) Bill – "The Commonwealth is marching into the field of education, in which for many years the States had the primary responsibility".

By no means was Evatt's view universally accepted. As late as 1971, none other than the Minister for Education and Science himself, in an address to South Australian teachers, posed the question "Where does the responsibility for educating this ever increasing number of pupils lie?" He answered his own question as follows:

"So far as the taxpayer is concerned, Australia is a Federation under which certain powers have been given to the Federal Government and the remainder have been left with the State

governments. The responsibility for education was a power exercised by the States ever since they took over responsible government in Australia and a power which they retained after Federation. The Commonwealth has no constitutional power in this field ".1

Thirteen years earlier, in 1958, Gordon Bryant - the then representative of the electorate of Wills – in effect recognised the force of David Fairbairn's just quoted remark when he lamented in the House "I realise that the Constitution mentions education not at all" but he went on to postulate "if I had to choose between the Constitution and the children I would support the needs of the children. The dead hand of the 'nineties should no longer be allowed to strangle the education systems of this country". The then Prime Minister joined issue as follows:

"I should like to say to the honourable member that I rather envy the easy way in which he sets the Constitution on one side on the ground that it is out of date. The fact is that it still exists. The fact is that education, except in Commonwealth territories, remains a function of the States ... Therefore we are dealing with a problem in which the Commonwealth does not have power over, or responsibility for education in the States or by the States."

In the same debate Dr Evatt argued "The whole purpose of the constitutional amendment [the 1946 social services power] was to give this Parliament power ... to make educational grants ... it is not, therefore, a question of divided legislative power and responsibility; direct power and responsibility reside in this Parliament".

In the event, Evatt's argument, married with Bryant's emotion and Fairbairn's ever increasing number of children, eventually won the day, so that by the end of 1971, in answer to a question in the House, the then Minister for Education and Science, Malcolm Fraser, cited the Scholarships Act 1969 and the Education Act 1945-46 as legislation enacted by the Commonwealth under the Section 51 (xxiiiA) benefits to students power. The Minister also responded to the question "Why has this power not been used to remedy the lack of educational opportunity throughout Australia" by chronicling the more than seven-fold increase in spending under this head of power over the decade to 1970-71 and the 13.3% increase in prospect in the following year.

So, such constitutional changes as have occurred, have enhanced the power of the Commonwealth; none have enhanced the power of the States.

High Court interpretations have also enhanced the power of the Commonwealth. There are plenty of others more expert than I who are able to comment on the legal issues involved. I will confine myself to three areas in the financial sphere that have proven to be very significant:

first, the High Court's restrictive view of the power of the States to levy excises or consumption taxes on goods in view of the granting of exclusive power to impose customs, excise and bounties to the Commonwealth under Section 90.

That is, the High Court has consistently regarded all taxes on goods, including the consumption of goods, as excise duties. This has not prevented the High Court from countenancing State franchise taxes on tobacco, liquor and petroleum on the grounds that they involve a charge for a licence or permit required to engage in trade in these products (subject to Section 92), rather than a charge on current production or sale;

second, the High Court's expansive view of the Commonwealth's power under Section 96 to influence State policy by granting financial assistance to the States on terms and conditions set by the Commonwealth. According to Else-Mitchell

"The development of a Commonwealth... grants policy in Australia was not possible until the High Court had clarified some aspects of the appropriation power (Section 81) and the nature and extent of the power to grant financial assistance to a State (Section 96). The Founders and early commentators of the constitution held differing views on major aspects of these powers and the relevance to them of the requirements in the constitution that taxes should not discriminate

between States and that laws of trade, commerce or revenue should not give preference to any one State over another".

It was not until 1923 that the Commonwealth government took the first major step towards exploiting the grants power by passing two legislative measures authorising conditional grants to the States – the Main Roads Development Act and the Advance to Settlers Act. Ironically, given his crucial later pronouncements in favour of the Commonwealth in his role as Chief Justice, Latham argued in the House against the latter – the Advance to Settlers Act – on the grounds that if the mere voting of money is to bring a matter within the jurisdiction of the Commonwealth, then the Commonwealth could obtain control of any matter simply by a liberal grant of money. He argued that grants should only be made if the State required assistance.

In the event, it was the Federal Aid Roads Act of 1926 that was challenged by three States in the High Court on the ground, inter alia, that the Act related to road-making, a matter which fell within the powers of the States, and was not, in substance, a grant of financial assistance. In a decision, remarkable for its brevity, especially considering its importance, the High Court pronounced the following judgement:

"The Court is of the opinion that the Federal Aid Roads Act No. 46 of 1926 is a valid enactment. It is plainly warranted by the provisions of section 96 of the constitution, and not affected by those of section 99 or any other provisions of the constitution, so that exposition is unnecessary."

the third major High Court decision in favour of the Commonwealth was the decision to uphold the legislation granting the Commonwealth a monopoly over the income tax base. The legitimacy of the takeover of this last remnant of the States' fiscal independence rested on the High Court's interpretation of the grants power. Under the uniform tax plan, the Commonwealth levied an income tax at a uniform rate throughout Australia and reimbursed the States by grants under Section 96 of the Constitution of the sums they would have collected from their own State income taxes but on condition that they levied no such taxes themselves.

Another factor which has tilted power toward the Commonwealth has been a compositional factor. There could be an accretion of power at the Commonwealth level, even in the absence of constitutional amendment or legal interpretation favouring the Commonwealth, simply because the powers reserved to the Commonwealth have become more important for whatever reason over time. This is, in fact, pretty much what has happened: international trade, taxation, "postal, telegraphic, telephonic, and other like services", banking, naturalisation, immigration, foreign ownership, divorce, invalid and old age pensions, defence, conciliation and arbitration of industrial disputes extending beyond the limits of any one State are all areas I would judge that have been growth areas for the public sector. They are all areas expressly reserved to the Commonwealth. Indeed, looking down the Section 51 powers, the only real "loser" given to the Commonwealth was the power over lighthouses, lightships, beacons and buoys.

Unfortunately for us taxpayers, the Commonwealth didn't have all the luck! The two single largest areas of State expenditure – health and education – also have been growth areas. Shorn of their income tax base and denied access to any other broad based tax, the States have only been able to meet the massive increase in demand for education and health services and to fund the inefficiency that has been part and parcel of the public provision of these services by advancing further onto the sticky paper of financial dependence on the Commonwealth.

At present the Commonwealth is responsible for the collection of 70% of total public sector revenues, whereas its own outlays account for only about 50% of total public sector spending. This situation - known as vertical fiscal imbalance - required the Commonwealth to make available to the States total gross payments estimated to be $29.7 billion in 1991-92 or 30% of Commonwealth outlays. No less than 42% of State revenue is in the form of payments from the Commonwealth.

Of course, this avalanche of dollars doesn't all come with no strings attached, although $14.2 billion is made available to the States in the form of general revenue assistance to spend according to each State's expenditure priorities. The remaining $15.3 billion – or 52% – of payments to the States and Territories in 1991-92 are specific purpose payments – the payments are for purposes designated by the Commonwealth and/or as a condition of the States agreeing to provide particular services or undertake particular projects. The proportion of total Commonwealth payments in the form of specific purpose payments has exactly doubled since 1972-73 – from 26% to 52%. In all, the Commonwealth Treasury has been able to identify 90 different specific purpose payment programs in 1991-92, the vast majority of which are for spending in areas of State responsibility.

A few major programs account for the bulk of this assistance – payments for education, health, housing, roads and financial assistance for local government account for about 88% of total specific purpose payments.

Of this $15.3 billion of specific purpose payments, $5.6 billion is in the form of specific purpose payments through the States – the States are simply the postboxes used to achieve Commonwealth objectives. These include payments for higher education, non-government schools, and general purpose assistance to local government.

The terms and conditions that attach to the remaining $10 billion or so are the result of negotiations between the Commonwealth and the States. The amount of Commonwealth influence on the determination of State expenditure priorities varies from payment to payment.

The upshot of these arrangements is a set of Commonwealth-State financial relations that have diminished the stature of the States to the point where they are virtually unrecognisable from those that existed in the first decade of the century. It is a system which involves great duplication of functions and excessive bureaucracy. It is little wonder that Australians regard themselves as being over-governed.

Our system rewards politicians and public servants at both levels of government that are best able to play the federal game – a game that calls for tacticians, skilled at fighting a kind of inter-regional war. At the Commonwealth level the easiest saving to make from the budget is to cut payments to the States. Indeed, the slide into deficit in the Commonwealth budget would be far worse but for this very process.

From the State perspective, the temptation of accepting Commonwealth payments and surrendering State sovereignty has proven to be irresistible. The attitude of all State governments – but only openly and honestly given voice to by a former long-serving Queensland Premier – is that the only good tax is a Commonwealth tax.

Our system of inter-governmental financial relations has been the subject of numerous inquiries by personages and bodies with varying degrees of authority, right up to the Prime Minister of the day. None have managed to produce a blue-print for reform that has looked even remotely like being adopted. Instead, it is possible to trace the evolution of the institutions and forms of Commonwealth-State financial relations in terms of a series of ad hoc responses to a series of events, developments and crises. Ulysses may have been a part of all that he had met, but our federal financial system is a total reflection of all that it has met – and it mixes in the wrong circles. Our federal financial system reflects the lowest common denominator in State and Federal politics.

Our inter-governmental arrangements are potentially an instrument for achieving better government; for playing a role in fashioning events, rather than being wholly fashioned by events. But what purpose should our constitutional arrangements be designed to achieve? 'Tis at this point, finally, that we come upon the Lion in the Path.

This phrase was uttered by James Service, a former Premier of Victoria and a strong and important Federalist. At a Federal conference in Melbourne in 1890 he said:

"The first question and probably the most difficult is that of a common fiscal policy .. I have no hesitation in saying that this is to me the lion in the path; and I go further and say that the Conference must either kill that lion or the lion will kill it ... To my mind a national government without a uniform fiscal policy is a downright absurdity." 2

The term fiscal policy has assumed a different meaning since 1890, when it referred to the contentious issue of the uniform external tariff and the abolition of inter-State tariffs. Strangely enough, James Service's remark is just as apposite to fiscal policy as it is commonly understood today as it was to its nineteenth century meaning, since most people agree that national economic management is properly the exclusive preserve of the Commonwealth.

Why do people think this way? The explanation – and one I find persuasive – preferred by the Canadian constitutional scholar Anthony Scott3 is that it would be technically feasible to co-ordinate State government spending to achieve any desired fiscal policy outcome at the national level. Such coordination is not impossible. It would simply be so time-consuming and so draining of the energy of the nine governments involved that it is not seriously advocated. If Australia tried to take that route it would be the transactions costs – the negotiation and organisation costs – that would stand in the path and make our Federation an absurdity. The negotiation and co-ordination costs would be greater than the government- organisation costs involved in trying to settle on a national fiscal policy at the Commonwealth level.

This approach can be applied to all the functions that have to be assigned to one or other level of government. The Founding Fathers chose to make communications a Commonwealth power. It would, however, be technically feasible – as is done between adjoining small countries in Europe – for the States through negotiation to enter into a workable agreement on the division of the radio spectrum and sharing the number of broadcast hours of each day. Instead, Australia chose to internalise those costs – and there are costs – of agreeing on and administering a national communications policy.

An example in the other direction is railways. Canada chose to internalise the administrative costs by assigning railways to the national Government. Australia went the other way but, with the establishment of the National Rail Corporation, has recently gone through the negotiation process of having a more closely co-ordinated system for inter-state freight than has been the case hitherto.

Generally speaking, organisational costs increase, the greater the interjurisdictional spillovers – where the costs or benefits of the provision of goods and services in one jurisdiction spill over into other jurisdictions. Generally speaking, section 51 powers are those where there are significant spillover benefits. The Founding Fathers appear to have allocated functions to the Commonwealth or the States as if they were trying, at the time, to minimise the total organisation, administration, co-ordination, signalling and mobility costs of various assignments of functions.

I urge you not to be side-tracked by arguments about centralisation versus decentralisation per se, or debate about great principles (or the lack of them) to guide constitutional change. Rather, I urge you to consider the minimisation of organisation costs as the yardstick by which to measure proposals for constitutional change.

Endnotes:

1 Quoted in I K F Birch, "Constitutional Responsibility for Education in Australia", Australian National University Press, Canberra, 1975, p ix. Original sources for the quotes from the Parliamentary Debates regarding the constitutional status of education cited in the text may also be found in this work.

2 Quoted in Sir Zelman Cowen, "Is It Not Time?", Quadrant, June 1991, p 21.
3 See A Scott, "An Economic Approach to the Federal Structure", Centre for Research on Federal Financial Relations, Australian National University, reprint Series. No.27.