Chapter Nine

Federal Renewal, Tax Reform and the States[1]

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Designing the fiscal provisions of the Constitution was one of the most difficult and, for many commentators at that time and today, the least satisfactory parts of Australia's constitutional design.

Our previous Prime Minister, Paul Keating, championed the virtues of maintaining the Commonwealth's fiscal dominance. In rejecting proposals for sharing the income tax base with the States, Keating claimed that the fiscal primacy of the Commonwealth, or "vertical fiscal imbalance", to use technical jargon which has become current usage, was a design feature rather than a fault of the Constitution. Keating argued:

> "It is not a design fault, and does not require remedying. It was deliberately built into the Constitution by the founders, developed by successive national governments and by the High Court, and bequeathed to us today as something we should prize and fight to keep, rather than something we should throw away in the name of federal-State cooperation. The founders gave to the new Commonwealth the duty to collect the excise and customs, then the main taxes, and return the surplus to the States. The founders forbade States from imposing their own excise taxes, and at that time there was no income tax".[2]

Prime Minister Bob Hawke's New Federalism had entailed reviewing, with a view to redressing, vertical fiscal imbalance through returning some share of the income tax base to the States. For State Premiers, this had been a *sine qua non* of the Special Premiers' Conference process, and a joint Commonwealth and State working party had been examining options. The proposal supported by the State Premiers was relatively modest: the States were to get six per cent of the income tax base in exchange for an equivalent reduction in Commonwealth grants. No variation would be permitted for three years, but after that time the States could vary the income tax rate; and the Commonwealth would remain responsible for administering the national collection scheme.

Keating eventually endorsed "a new partnership" with the States, but insisted that there would be no change to the Commonwealth's uniform taxation, which he called "the glue that holds the federation together".[3] The opposite was asserted by Russell Mathews, the doyen of Australian federal financial relations and an architect of fiscal equalisation. In the inaugural *Russell Mathews Lecture* sponsored by the Australian National University's Federalism Research Centre in May, 1994, in which he praised the system of fiscal equalisation, Mathews said:

> "Australia has one of the most highly centralised, inequitable and inefficient taxation systems of any industrialised country. The equalisation system has to operate within a system of extreme vertical imbalance as between the Commonwealth and the States. Failure to address the problem of vertical imbalance is threatening the stability of the horizontal equalisation system".[4]

In the centenary decade of the making of the Australian Constitution, it is appropriate to review the design of this most contentious part of the Constitution.

Constitutional design

The fiscal parts of the Constitution caused the Australian founders the most difficulty. The single most troublesome issue, which almost caused the breakdown of both federation Conventions, was the power of the Senate over money bills. Even before the Conventions were under way, devising

a common tariff for colonies which championed diverse free trade and protectionist policies was considered the most challenging issue, and was widely billed as the "lion in the path" of federation. This was the way in which James Service, ex-Premier of Victoria, flagged the tariff issue and related fiscal policy at the beginning of the 1890s decade of constitution making:

> "Probably the first question, and the most difficult, which the conference will have to decide, is that referring to a common tariff, or the question of a common fiscal policy. Now I have no hesitation whatever in saying that this to me is the lion in the way; and I go further and say, that the conference must either kill the lion or the lion will kill it. I think a national Constitution for Australasia without providing for a uniform fiscal policy, would be a downright absurdity".[5]

The tariff issue: Slaying the lion

To the extent that a common tariff was Service's lion in the path of federation, it was dealt with surprisingly easily. There soon developed a robust consensus to create a national customs union by giving the Commonwealth an exclusive power over customs and excise. National sentiment aside, this was for many the central purpose of federation — abolishing the colonial border customs houses and setting up a national economic union based on the low but sure ground of commercial free trade within Australia.

"Intercolonial tariffs, and coasting trade" had topped the list of federal matters requiring the national assembly proposed by Wentworth's Constitutional Committee as early as 1853.[6] During the next half century, intercolonial tariffs and trade were leading agenda items for subsequent federation forums. The Australian consensus that emerged, despite sharp differences between protectionist Victoria and free-trading New South Wales over the appropriate purpose and level for a national tariff, was forcefully stated by Robert Garran on the eve of the 1897 Adelaide Convention:

> "But one mode of taxation — duties of customs and excise — must be given to the federal Parliament exclusively. One of the great objects of Federation is to throw down the border custom-houses, and allow perfect commercial freedom from one end of Australia to the other. This will make it impossible for each State to keep its separate provincial tariff against the outside world; seeing that a tariff fence, to be of any use, must be a ring-fence. Scientific protection on the Victorian sea-board would be a farce whilst the New South Wales ports were open and the Murray bridges free. There must, therefore, be one fiscal policy for Australia, and it must obviously be controlled by the federal Parliament. Duties of customs and excise must be imposed and collected by the Commonwealth alone, subject, of course, to the condition that such duties shall be uniform throughout the Commonwealth, and that there shall be no internal customs barriers between the several States of the union. Exclusive federal control of the customs is necessary for the basis of a commercial union without which federation would be a mockery. Complete internal free trade, combined with such external fiscal policy as the Federal Parliament shall determine, is the only possible basis for an effective Federation".[7]

Garran was, in effect, expounding the outcome of the earlier 1891 Sydney Convention which, in the 1891 draft Constitution, had given the Commonwealth Parliament:

> "…..sole power and authority ... to impose Customs duties, and duties of Excise upon goods for the time being the subject of Customs duties, and to grant bounties upon the production or export of goods".[8]
>
> This was reworked by the 1897-98 Convention as an "exclusive" power to read:
>
> "On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and of excise, and to grant bounties on the production or export of goods, shall become exclusive".[9]

The 1897-98 tinkering was hardly an improvement. By broadening the notoriously imprecise "excise" category through breaking the nexus with "goods for the time being the subject

of Customs duties", this later Convention magnified new obstacles and introduced new dangers that were better dealt with in 1891, as Deakin concluded as if foreshadowing the future treatment of this section in the High Court.[10]

Federal finances: Dividing the carcass

If slaying the tariff lion was easy, dividing up its carcass was fiendishly difficult. The more intractable part of the tariff problem was devising satisfactory fiscal arrangements for dealing with the consequences of making customs and excise an exclusive Commonwealth power — in other words, distributing the Commonwealth surplus which would result. Subsequent historians and commentators have been highly critical of the framers' obsession with, and resolution of, this matter. The historian J A La Nauze dismissed Service's early concerns as the "paper tiger of intercolonial fiscal jealousies".[11]

In a recent account, Cheryl Saunders endorses Higgins' negative dismissal of his peers' handiwork in fiscal design as "a general and unholy scramble". In Saunders' view:

> "Considered purely from the standpoint of a federal system, the financial arrangements between the Commonwealth and the Australian States are bizarre. The moneys raised in taxation and other charges by each level of government do not even approximate their respective constitutional expenditure responsibilities. The circumstances in which the actual division of tax powers has come into existence has precluded and continues to preclude any attempt to match types of taxation to the capacity and goals of the level of government by which they are imposed. No adequate framework for co-operation and consensus between the levels of government exists".[12]

The first point that needs to be made in response to such criticisms, particularly La Nauze's dismissal, is the substantial difficulty of the issue. Federal finance was singled out by Garran on the eve of the second round of Constitution-making in 1897 as being "perhaps the most difficult of all questions connected with Australian Federation".[13] Once it was clear that the 1897 Adelaide session had been successful in producing a basic draft for the Constitution, in effect by reworking the 1891 draft bill, the financial sections became the most difficult and contentious matters for the subsequent Sydney and Melbourne sessions. Before considering why that was so, it is worth recalling that the prime difficulty up to this point at both the 1897 Adelaide meeting and the earlier 1891 Sydney Convention — in fact, the real lion in the path of federation — had been the financial powers of the Senate.

The founders created a Senate of virtually co-equal strength to the House of Representatives except that it could not initiate or amend money bills, although it could recommend changes to them and exercise an overall veto. In other words, the Senate was denied the power to develop and fine-tune fiscal policy which, for reasons of preserving responsible government, was left solely with the House of Representatives. The design of the Senate complements that of the fiscal provisions which, in effect, left the long term shape of revenue distribution for Parliament to determine. At this point it is important to keep in mind that the founders' debate over distributing the surplus from customs and excise took place within the context of a re-negotiated "historic compromise" that settled the Senate's financial powers.

Why all the fuss about financial provisions? And was it just a "paper tiger" of intercolonial jealousies as La Nauze claimed? The answer is suggested by the state of colonial finances that were set out in detail by T A Coghlan, New South Wales Government Statistician,[14] giving the revenue and expenditure sides of colonial budgets as well as capital spending and debt payments. Coghlan's tables showed that, for 1886-87, the proportion of taxation in the total revenue of the colonies was 52 per cent, compared with 20 per cent for net operating surplus from railways and tramways, 17 per cent from sale of public lands, and 11 per cent from other sources, including an operating surplus from posts and telegraphs.

Customs and excise was the main component of taxation and yielded 75 per cent of the total. Income tax was very small by comparison, amounting to only 6 per cent of total taxes or 3

per cent of total colonial revenue, and varied considerably between colonies, with Queensland and Western Australia having no income tax at all. Transfer of customs and excise to the Commonwealth would clearly produce acute vertical fiscal imbalance, since it accounted for three-quarters of taxation revenue. This would be exacerbated for some colonies, namely Victoria and South Australia, by the Commonwealth's taking over posts and telegraphs, which generated surpluses in those colonies. It is obvious that federation with a common tariff would destroy the fiscal independence of the colonies by plucking out the heart of their tax base.

Nor could there be any easy basis for distribution of the customs and excise surplus after covering Commonwealth outlays, because of colonial differences. Western Australia and Tasmania, for very different sorts of reasons, presented particular problems. Western Australia, a relatively new colony experiencing a gold mining boom, had extremely high revenue generated by tariffs equivalent to three times the Australasian average, as well as high expenditure on government services. Western Australia's total revenue and expenditure per capita were nearly three times the national average.

Tasmania, at the other extreme, was virtually a basket-case, with a restricted tax base and modest public expenditures of only 4 pounds per head, compared with 20 pounds per head in Western Australia and 7 pounds per head for the national average. Just as importantly, New South Wales was sufficiently different from the other colonies, with relatively low reliance on customs and excise — it had a high revenue tariff, but restricted to a small number of items, mainly intoxicants — and abundant revenue from the sale of public lands.

The colonies also differed markedly in their levels of debt servicing and capital works. Western Australia had only 9 per cent of its total expenditure going to debt servicing, whereas Tasmania had 45 per cent, and South Australia and Queensland more than 35 per cent. With intoxicants providing a significant part of the colonial tax base, it was also significant that Western Australia's thirsty settlers and miners consumed three times as much liquor as Tasmanians and twice that of New South Wales people.

With such substantial differences in the structure of colonial budgets, the task of devising a distribution formula for returning surplus customs and excise revenues to the States was well nigh impossible. The surplus from a national tariff had to cover reimbursements to the colonies-cum-States to compensate them for surrendering this revenue source, as well as meeting the expenditures of the Commonwealth.

But what should be the basis for such reimbursements? Basically, there were two formulas between which the troubled founders wavered: distribution on a *per capita* basis, or distribution on a contribution basis. Each alternative would have had a major impact on the financial positions of the colonies.

Per capita distribution was simple, but out of the question for Western Australia, which would lose nearly two-thirds of its pre-federation revenues. Tasmania would also have a major deficit problem and have to be bailed out by the Commonwealth, or otherwise the national tariff set considerably higher than would be agreeable to New South Wales. Even without that, the people of New South Wales, a low tariff colony, would be slugged for almost double their colonial payments to support what was clearly an unacceptable scheme.

Distribution of the surplus on the basis of contribution, or handing back to each State the balance of revenue collected on goods consumed by the people of that State, would produce rather different, but equally unacceptable, results and involve complex book-keeping arrangements. According to this method, Western Australia would be little affected. New South Wales, on balance, would likewise not be seriously affected, although the people of that State would be paying higher tariffs but getting most of it back in grants. Under this formula, however, Victoria, South Australia and Tasmania would be left with large shortfalls in State revenues.

There was no ready formula that would in any way approach some criterion of Pareto optimality. After much to-ing and fro-ing, the founders stitched together a short-term

compromise that confined aspects of contribution and per capita distribution, as well as making special terms for Western Australia. This was contained in ss. 81 to 105 of the Constitution. There was still a problem because, whichever way the deal was cut, Tasmania would fare badly.

To allow the Commonwealth to provide special assistance for Tasmania and perhaps other States, the ubiquitous s.96 was added to enable the Commonwealth to make financial grants to any of the States on the terms and conditions it saw fit. Better to allow for the Commonwealth to provide special assistance for one particular State, parsimonious New South Wales insisted, rather than have a rigidly uniform system which would require a higher tariff to ensure the fiscal viability of the weakest member of the federation. In view of the extent of diversity among the colonies, which was reflected in their quite different budgetary requirements, the fact that an agreement could be reached and the Constitution adopted was a considerable achievement.

The financial sections: What was done

The complicated story of the making of the fiscal provisions of the Constitution, ss. 81 through 105 which make up Chapter IV, has been well documented by Cheryl Saunders,[15] so can be briefly presented here. As Josiah Symon put it in 1897, the financial question was "the hardest nut to crack", and achieving justice all round for the colonies seemed a task beyond "even an archangel from heaven".[16]

The Finance Committee was the least satisfactory of the specialised committees, producing an incomprehensible report that led to unseemly brawling among its members when its recommendations were debated on the floor of the Convention. Within the Committee, the wily George Reid, Premier of New South Wales and "master of the convention at Adelaide", according to Deakin, totally outmanoeuvred Turner, his stodgy Victorian counterpart:

> "…..the whole scheme elaborated by Turner was upset by Reid, who rollicked in this privacy as a hippopotamus might if he climbed into a ferry boat and was determined to upset it unless given his own way".[17]

With no obvious solution available, there was a strong push by some delegates — Downer, for example, at the Sydney and Melbourne Conferences — to leave the whole matter for Parliament to work out after federation. But others like Higgins, and representatives from colonies that would be most affected, did not regard that approach as any solution at all. The outcome was a compromise of specification for the shorter term according to a blending of contribution and *per capita* formulas, but then leaving fiscal distribution open-ended in the longer term for Parliament to determine.

The Constitution incorporated a variety of treatments for the initial periods of phasing in and bedding down the national tariff and consequent distribution of surplus to the States. Immediately on federation the collection and control of customs and excise passed to the Commonwealth.[18] For a period of ten years only, one quarter of the net revenue generated could be spent by the Commonwealth, according to the "Braddon" clause.[19] The balance had to be paid to the States, or applied towards payment of State debts taken over by the Commonwealth and provided for by s. 105. The Commonwealth was obliged to impose a uniform tariff within two years,[20] and as soon as it did, the two key provisions for fiscal union, exclusive Commonwealth power over customs and excise[21] and absolute freedom of trade, commerce and intercourse among the States,[22] would take effect.

The distribution of the surplus to the States was highly specified for the two periods up to the imposition of a uniform tariff and for five years thereafter. For the first of these periods the Commonwealth was obliged to pay the surplus to the States, calculated on the basis of contribution or source of revenues less (a) any expenditure of the Commonwealth incurred in a department taken over by the Commonwealth in the particular State, and (b) a proportion of other Commonwealth expenditure calculated on a proportionate population basis.[23] For the second period, during the five years after a uniform tariff, the same formula was to apply, with the additional refinement of taking account of relevant duties in the State where the goods were

consumed rather than collected.[24] After that five years, it was left for Parliament to "provide, on such basis as it deems fair".[25]

Several important additional clauses rounded out the Chapter. An exception was made for Western Australia, which was allowed to phase out its own lucrative tariffs over five years.[26] The Commonwealth was empowered "to grant financial assistance to any State on such terms and conditions as the Parliament thinks fit" by s.96. Curiously, this section was notionally tied to the Braddon clause term of a period of ten years after federation, but then left entirely for Parliament to determine. Section 105 provided for take-over of State public debts "as existing at the establishment of the Commonwealth", a restriction that was struck out by a 1910 referendum. (This whole section was subsequently superseded by embodying the 1929 agreements on taking over State debts in the Constitution.) Finally, there was provision for the ill-fated Inter-State Commission.[27]

The financial provisions incorporated in the Constitution entailed acute vertical fiscal imbalance by transferring the main tax base, customs and excise, exclusively to the Commonwealth and requiring a uniform tariff. During the short term, the Constitution specified formulas for both the vertical and horizontal carve up of the revenues generated, but for the longer term that was left for the Commonwealth Parliament to decide. Special provision was made to allow a phased adjustment by Western Australia, the State most affected by a uniform national tariff, but in addition the Commonwealth was given a completely open-ended power for financial or, indeed, any other form of assistance. Thus, in effect, the long-term provisions gave the Commonwealth Parliament absolute discretion and maximum flexibility to determine surplus revenue distribution, although it needs to be kept in mind that a powerful Senate was an integral part of the Commonwealth Parliament.

What was intended

Given that the Constitution did not specify allocation of surplus revenues for the longer term, the question naturally arises as to what the founders intended. More particularly, did they deliberately build in vertical fiscal imbalance, as Paul Keating has asserted, or did they intend the development of matched revenue and expenditure sources and responsibilities for the Commonwealth and the States? There are two obvious ways this might have been brought about. The first was by the Commonwealth's taking over colonial debts, as was provided for by s.105 of the Constitution. The second was through the States' boosting their revenues by increasing direct taxes, especially income tax.

Intentionality is a slippery concept at the best of times, but even more so for a protracted constitutional convention of diverse individuals making compromises on particular drafting provisions after broad-ranging debate. All that we can be sure of is what was actually done. We can only say with certainty that the founders collectively, and the Australian people in ratifying the Constitution, intended what was actually specified: namely, that the Commonwealth was to have an exclusive power over customs and excise; that, with this exception, taxing powers were concurrent; that the method for dividing up the surplus from customs and excise was highly specified in the short run; but that subsequently it was left for Parliament to determine. The Commonwealth's taking over State debts was not intended in this strong sense, but such an eventuality was favoured by some and provided for. The second alternative, of the States' substituting for the loss of customs and excise by increasing their direct taxation, was also provided for, in that the States were given concurrent tax powers, but again this was not mandated.

In sum, the fiscal provisions of the Constitution are characterised by maximum concurrency, in giving both the Commonwealth and State governments access to all tax bases except customs and excise, and minimal specification for revenue-sharing in the longer term.

In a sense, therefore, Keating is quite correct in claiming that vertical fiscal imbalance was built into the Constitution by the founders. It was, however, built in as a consequence of making customs and excise an exclusive Commonwealth power, and not as a principle. Nor was it considered a good thing in itself, with leading delegates and commentators warning of the potential danger of leaving such a surplus in the hands of a national Treasurer. These concerns were, however, secondary to the primary purpose of securing a customs union. Nor was the design skewed towards fiscal centralisation in the longer term, as Keating has claimed, but left highly unspecified and to be determined by future actors. In other words, vertical fiscal imbalance of the kind that Keating champions was not intended by the founders, but nor was it precluded by the Constitution.

Evaluation

It is a natural tendency in evaluating institutions to test them against personal preferences, and to praise or disparage them depending on whether they are in accord or not. But this is an unsatisfactory yardstick, since institutions have to accommodate divergent preferences at any one time and dynamic changes over time. Hence, general principles or criteria are required.

Three fairly obvious ones that most would subscribe to are implementability, robustness and reflexivity. *Implementability* is a practical norm concerned with the capability of the institution's being put into practice. This is an obvious requirement for a constitution, but one often ignored by armchair critics and reformers. *Robustness* is the ability to continue functioning when circumstances change from those originally envisaged. *Reflexivity* has to do with the fact that self-conscious individuals operate institutions, and can learn from their mistakes, internalise norms, manage complexity and adapt to change.

The fiscal sections of the Australian Constitution meet these three criteria reasonably satisfactorily. Despite the acknowledged difficulty of the task, interim arrangements for the distribution of the surplus from customs and excise were blended in such a way that all the colonies were sufficiently satisfied to enable federation to go ahead. But no attempt was made to specify the longer term in ways that might have jeopardised flexibility and robustness.

Constitutions which are built to last centuries must be highly unspecific. It was better to leave the distribution of future Commonwealth surpluses to politics within an institutional arrangement which provided an adequate process. This was done by specifying, and thereby limiting, the Commonwealth's powers, and establishing a strong High Court to oversee jurisdictional boundaries, and by injecting the federal principle into a bicameral national legislature with equal State representation in the Senate.

History has demonstrated shortcomings in these institutions, but it is highly unlikely that much more could have been prudently done. More specialised institutions to handle fiscal issues might have been established, as some modern critics prefer, but the fate of the Inter-State Commission, which was included in the Constitution to deal with inter-State trade matters, suggests that secondary institutions lack robustness and ought not to be entrenched in the Constitution.

Robustness was strongly linked with the principle of reflexivity for the Australian founders, who put a good deal of weight upon the good sense of those who would operate the system. The lack of specificity for continuing fiscal arrangements and, except for the Inter-State Commission, specialised institutions of intergovernmental relations, is only one example of this. Other hard issues, such as the rivers question, which required balancing the rights and claims of river navigation and irrigation, could not be settled once and for all, so were left for sorting out by future politics and judicial review.

The prime instance of relying on reflexivity entailed the compromise over the Senate's fiscal powers referred to earlier, where no fail-safe mechanism was provided for deadlocks over supply bills. In working such a system, the founders trusted, political actors in the Anglo-Australian tradition, like themselves, could be expected to reach a compromise rather than

push the system into breakdown. Reflexivity is one of the key principles of Australian constitutional design, but probably the most neglected among Australian constitutional critics, perhaps because of the influence of a literalist legal mindset which would prefer to have everything spelt out.

Finally, I want to look briefly at a rather different set of principles, namely *fairness, finality, elasticity* and *coordinacy,* proposed by Robert Garran in 1897. According to Garran, "the conditions which a perfect system of federal finance should satisfy" were:

> "(1) be fair to all the States — not only at the date of union, but in view of their probable growth and other contingencies; (2) be so far final as to offer no encouragement to constant tinkering or agitation for 'better terms' on behalf of one State or another; (3) be nevertheless so far elastic as to be adaptable to changing conditions; (4) reduce dealings between the federal government and the State governments to the narrowest and the simplest possible basis".[28]

As Garran himself noted, finality and elasticity were inconsistent, but he argued that both were necessary and recommended some "golden mean" which would avoid the extremes of either. Garran's principle of reduced dealings between governments, which I have called coordinacy, is linked with finality.

Fairness, in Garran's view, had mainly to do with horizontal sharing of surplus among the States, of which he wrote:

> "It is only by finding a basis of apportionment which will be fair to each State in the proposed Federation that an acceptable scheme of union can be reached".[29]

Obviously, the Constitution which was subsequently produced did not meet Garran's finality and coordinacy principles for the longer term, since the arrangements were largely unspecified and highly concurrent. Nor was fairness assured. Thus, according to the Garran view, the fiscal sections of the Constitution were not well designed.

The alternative, and in my view preferable, view is that reflexivity is far preferable to finality in the design of constitutional arrangements. That puts the onus on the ongoing political process to devise appropriate institutions of fiscal federalism.

Vertical fiscal imbalance

Unfortunately, since the Second World War, when the Commonwealth ousted the States from income tax, Australian fiscal arrangements have been severely distorted by vertical fiscal imbalance (VFI). The Commonwealth raises the lion's share of revenue, and the State and local sector is heavily reliant on grants. The State and local sector raises only about a quarter of total public sector revenue yet spends about a half, being dependent on Commonwealth grants for the balance. At the same time the State and local sector is responsible for the bulk of public debt; and delivers most of the public services which are people-intensive, such as education, health and policing, employing about three-quarters of all those in public sector employment.

In 1997-98, total Commonwealth grants to the States were just over $30 billion, with $14.7 billion or 48 per cent of the total being "tied grants" or Specific Purpose Payments (Table 1).

From the 1970s the Commonwealth expanded its colonisation of State policy jurisdiction through tied grants. More recently, this has been reflected in the Commonwealth's sub-categorisation of payments as being "to" and "through" the States. For this latter category of payments, the State governments act as post-office boxes for other bodies, mainly universities, non-government schools and local governments. This has given the Commonwealth a very substantial presence in areas of social policy which would otherwise come within the States' jurisdiction.

Table 1
Commonwealth Payments to States 1997-98 and 1998-99
($ billion, estimates)

	1997-98	1998-99
General Revenue Assistance	16.7	17.1
Specific Purpose Payments		
- To	11.2	11.3
- Through	3.5	3.6
	14.7	14.9
Gross Payments to States	31.4	32.0
Less State Final Contribution(a)	0.6	0.3
Total Commonwealth Payments to States	30.8	31.7

(a) Agreed at 1996 Premiers' Conference as a contribution to Commonwealth fiscal deficit reduction program.

The problems with VFI are well known, so need be mentioned only briefly here.[30] Broadly, it induces irresponsibility on the part of both Commonwealth and State governments, as well as dependence and grantsmanship on the part of the States.

Vertical fiscal imbalance leaves the Commonwealth awash with money for which it has no need or policy purpose, inducing it to invent novel programs and generally expand Commonwealth spending for political and bureaucratic purposes. The large Commonwealth Departments of Education and Health are monuments to this tendency. Moreover, when times are tough, rather than prune its own expenditure, the Commonwealth is prone to cut grants to the States in vital policy areas of State jurisdiction for which it has no direct political responsibility. State grants tend to be used as a balancing item in Commonwealth budgets and an obvious source of savings.[31]

The centralisation of revenue-raising in Australia has been supported in the post-War period as being essential to the Commonwealth's capacity to manage the national economy and to preserve equity and efficiency in the overall tax system. These claims have less salience with the demise of Keynesian macro-economics, and in any case such a high degree of VFI is unnecessary for whatever macro policy the Commonwealth might engage in.

The Commonwealth has been reluctant to surrender its fiscal capacity to influence State spending because of the supposed risk of the States undermining Commonwealth macro-economic policy objectives. However, the Commonwealth does not need to control anything like 40 per cent of the funding of State outlays to achieve the degree of influence over State decision-making that it currently has. A system which forces the States to accept greater responsibility for funding their spending from adequate, independent revenue sources is likely to invoke more critical scrutiny of State decision-making by voters, the media and financial markets.

Current VFI arrangements are corrosive of State integrity and responsibility. The States acquire large proportions of their revenue from grants, and fund a proportionate amount of their spending on essential policies from grant dollars. For example, in 1997-98 Victoria derived 42 per cent of its total revenue from Commonwealth grants, with $2.6 billion or 43 per cent of the Commonwealth grants being tied to specific purposes. Those purposes are shown in Table 2 (over). The dependency of smaller States on Commonwealth grants is of course much larger.

Such dependency encourages grantsmanship on the part of the States, or the art of wheedling money out of Canberra, rather than fiscal propriety in funding their own expenditures largely from their own taxes. The system encourages the States to be profligate in spending cheap

grant dollars. By the same token, the States can be caught out in adequately funding necessary programs when the Commonwealth decides to cut funds for its own purposes. It is simply implausible to expect the Commonwealth to have the States' best interests at heart in dictating the ongoing terms and conditions of intergovernmental fiscal relations which it controls.

During the 1980s the States were forced to become some-what less dependent on Commonwealth grants and rely more heavily on their existing tax sources, many of which are narrowly based and inefficient, such as financial transfers, or socially corrosive, such as gambling. State revenue comes from numerous small taxes, fees and fines, as Victoria's own source revenue indicates in Table 3 (below). Victoria has actively promoted gambling, which contributed $1.2 billion to State coffers in 1997-98, equivalent to 15 per cent of the State's own source revenue.

Table 2
Commonwealth Specific Purpose Grants to Victoria by Agency
($ million, estimates)

	1996-97	1997-98
Grants for Government Programs: Current		
Education	417.5	447.5
Human Services	1601.5	1597.7
Infrastructure	0.1	6.2
Justice	141.2	64.8
Natural Resources and Environment	24.1	21.3
State Development	9.6	3.3
Treasury and Finance	101.7	5.9
Total Current Grants	2295.7	2146.7
Grants for Government Programs: Capital		
Education	104.5	95.6
Human Services	278.2	263.1
Infrastructure	139.4	86.6
Natural Resources and Environment	4.7	0.9
Treasury and Finance	0.4	0.1
Total Capital Grants	527.2	446.2
TOTAL SPECIFIC PURPOSE GRANTS	2822.9	2592.9

Source: Victorian Department of Treasury and Finance*: Forward Estimates 1997-98*, p.391.

To sum up, the excessive centralisation of Australia's fiscal federal arrangements enhances the Commonwealth's steering capacity over macro-economic policy. Whether macro-economic steering is practically feasible, given the lags in information combined with constitutional and political inertia, is another matter. Its monopoly over income taxes gives the Commonwealth both the means and the inclination, because of the realities of politics and interest groups, to intrude into key policy areas that would otherwise be solely under State jurisdiction. On the States' side is a corresponding fiscal dependency on the Commonwealth, with consequent lack of responsibility for financial management and an impaired control over policy responsibilities. For the overall system that means a mismatch of fiscal and policy responsibilities for both levels of government, and greater participation by both in many policy areas.

Two broad alternatives for redressing aspects of vertical imbalance were canvassed in the series of Special Premiers' Conferences in the early 1990s. One was to return a proportion of income tax or tax points to the States together with the policy responsibility, as the Canadians did for joint-cost programs in the 1960s. The other was to switch the specific purpose grants to general purpose grants, thus leaving fiscal centralism intact but removing the Commonwealth

from specific policy areas. Keating's accession to the prime ministership, however, derailed the process.

Keating was committed to a view of fiscal centralisation that has strong roots in traditional Labor thinking and motivated Ben Chifley, who was the prime architect of post-War VFI. This view is based on assumptions of Commonwealth superiority for steering the national economy, combined with a distrust of the States. The alternative is a federalist view, which holds that the States ought to have increased fiscal independence and responsibility to enable a greater say in determining policies that affect them. Although the centralist position lacks any coherent defence, given the demise of macho macro-economic management pretensions, there was little apparent commitment to its reform by the Howard Liberal-National Party government until its recent shock decision to give the States all the proceeds of the proposed Goods and Services Tax (GST).

Table 3
Composition of Taxes, Fees and Fines for Victoria
($ million, estimates)

	1996-97	1997-98
Pay-roll Tax	2123.9	2189.6
Taxes on property:		
Land Tax	407.0	427.0
Stamp Duty on Financial Transactions:		
Land Transfers	727.5	727.5
Marketable Securities	145.0	150.4
Other Property Stamp Duty	142.7	151.6
Estate, Inheritance and Gift Duty	0.1	0.1
Financial Institutions Duty	319.0	324.6
Debits Tax	263.5	260.6
Financial Accommodation Levy	15.7	13.4
State Deficit Levy on Rateable Properties(a)	0.5	0.5
Taxes on the Provision of Goods and Services:		
Levies on Statutory Corporations	317.5	333.0
Gambling Tax – Private Lotteries	299.0	282.9
Gambling Tax – Electronic Gaming Machines	589.4	657.4
Gambling Tax – Casino	138.4	174.4
Gambling Tax – Racing	118.1	120.0
Gambling Tax – Other	6.8	4.1
Taxes on Insurance	334.5	342.0
Motor Vehicle Taxes:		
Vehicle Registration Fees and Taxes	406.4	402.5
Stamp Duty on Vehicle Transfers	350.1	371.6
Drivers' Licences	35.5	20.8
Road Transport and Maintenance Taxes	29.3	29.2
Franchise Fees:		
Petroleum	522.3	425.4
Tobacco	623.6	648.2
Liquor	164.8	169.3
Electricity	161.0	171.6
Other Taxes on the Use of Goods and Services	14.4	16.1
Total Taxes	8256.0	8413.8

(a) Now collected by the Commonwealth.

Source: *Victorian Budget Estimates 1997-98*, p. 364.

There is of course one aspect of VFI that is constitutional, and can only be fixed by constitutional change or, preferably, sensible reinterpretation of the relevant clause of the Constitution by the High Court. That is the inability of the States to levy taxes on the sale or production of goods, or, more broadly speaking, a GST.

The States are precluded from levying such a tax, which is common in other federations, because of the High Court's too broad interpretation of "excise duties" which, according to the

Constitution, is an exclusive Commonwealth power. Whereas the Constitution links "duties of customs and excise" in s.90, the High Court has cut it loose and given it a scope and meaning that exceeds economic reason and interpretive sense. According to the High Court's overblown rendering, excise extends to any tax on the production or sale of goods. This was confirmed as recently as 1997 in *Ha and anor v. NSW*,[32] but only by a narrow four-to-three majority.

The better decision in that case was the strong minority dissent led by Justice Dawson. As the dissenting judgment points out, the purpose of s.90 was the sensible and moderate one of protecting the common external tariff and preventing the States from engaging in "discrimination of a protectionist kind against interstate goods". It was not to restrict the revenue-raising capacity of the States, nor to secure an exclusive revenue base for the Commonwealth.

In reaching such a view, the dissenters were influenced by an authoritative statement by Chief Justice Sir Samuel Griffith in one of the earliest cases decided by the High Court, *Peterswald v. Bartley*.[33] It is worth quoting here as a corrective to the current debate over republicanism and the Constitution, as well as the meaning of excise duty:

> "Bearing in mind that the Constitution was framed in Australia by Australians, and for the use of the Australian people, and that the word 'excise' had a distinctive meaning in the popular mind, and that there were in the States many laws in force dealing with the subject, and that when used in the Constitution it is used in connection with the words 'on goods produced or manufactured in the States', the conclusion is almost inevitable that, whenever it is used, it is intended to mean a duty analogous to a customs duty imposed upon goods either in relation to quantity or value when produced or manufactured, and not in the sense of a direct tax or personal tax".

Unfortunately, the *Ha Case* made VFI considerably worse, by correcting one of the absurdities of the High Court's previous decisions that allowed States to levy taxes on cigarettes and fuel provided they called these "franchise fees" and calculated the amount on the sales of the previous period. But in refusing to budge from its too-broad rendering of excise, the Court has swept all GST taxes into the Commonwealth's exclusive domain. Even though the Commonwealth immediately worked out an arrangement for collecting the taxes at issue and returning them to the States, VFI was formally increased because this arrangement depends on the good will of the Commonwealth.

Postscript: Howard's GST as a solution

Shortly after this paper was inititally delivered, Prime Minister Howard announced his long awaited tax reform package, including a new Goods and Services Tax (GST) of 10 per cent on most goods and services, with the proceeds going to the States and Territories. Food and, importantly, services are included in the GST base while health, education, childcare, local government rates and water and sewerage are excluded. The GST replaces the wholesale sales tax and a host of small State taxes — debits tax, stamp duties on a range of financial and commercial transactions including mortgages, and bed taxes, which New South Wales has recently introduced.

The surprise was that the GST is to be collected by the Commonwealth but all of the proceeds handed over to the States. This was unexpected, because it was not the result of any hard bargaining on the part of the States, nor even of consultation between the Commonwealth and the States. Rather, Prime Minister Howard and Treasurer Costello devised the scheme in strict secrecy, informing State Premiers just before public release of the policy. Previously neither Howard nor Costello had shown much interest in federal issues, and no commitment to the reform of fiscal arrangements.

This was no doubt a clever strategy to win the support of outspoken State Premiers, especially Jeff Kennett from Victoria and Richard Court from Western Australia, who had insisted that fiscal imbalance be tackled as the price for their supporting the Howard tax reform package.

Other powerful interest groups, including the Business Coalition for Tax Reform and the Australian Council of Social Service, had also backed such reform.

The proposed change is being touted by Howard and his supporters as "the most significant change to federal-State relations in 50 years".[34] Labor critics, including the New South Wales and Queensland governments, have criticised the measure for further increasing VFI and making the States "administrative agents" of the Commonwealth.[35] The measure does entail a bold and sweeping change to federal fiscal arrangements, giving the States a broad based tax with substantial growth potential as the economy grows. And it is a sound tax move because it replaces a growing host of inferior taxes on commercial transactions. Some oppose any GST-type tax as regressive or unnecessary, while others, including ACOSS with reservations, support the introduction of such a tax because it broadens the tax base.

Technically, the proposed GST does exacerbate VFI because it is a Commonwealth tax that only the Commonwealth can levy. Howard and Costello have gone to great lengths to claim this will be in effect a States' tax that cannot be altered without the unanimous consent of all Premiers, and of course the Senate as well. They insist it is to be a States' tax collected on their behalf by the Commonwealth.

This is an ingenious arrangement, since it does give the States a broad-based growth tax while at the same time leaving the Commonwealth with the final say. Whatever the force of the "gentleman's agreement" requiring unanimous agreement by all the States, the Commonwealth retains the whip hand. My own view is that it is a major practical device for redressing part of the nest of problems inherent in VFI, while at the same time strengthening the Commonwealth's formal fiscal dominance. And of course its implementation is subject to Howard's winning the election, which is likely to be a close call, getting the consent of all the Premiers, including the Labor ones — that should not be too difficult, despite their rhetoric — and having a Senate that the government will most likely not control pass the tax reform package.

If all of that occurs, the reform will have gone some way to reforming fiscal federalism. The next and more significant step will be to restore to the States their legitimate income taxing power, and to give them a proportion of the income tax base sufficient to fund most of their other expenditure needs.

Endnotes:

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6. Quick, J and R R Garran, *The Annotated Constitution of the Australian Commonwealth*, Legal Books, Sydney, 1901, p.91.

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8. Section 4 of Chapter IV, Draft of a *Bill to Constitute the Commonwealth of Australia.*

9. *The Australian Constitution,* s.90.

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12. Saunders, C, *Fiscal Federalism: A General and Unholy Scramble,* in *Australian Federation: Towards the Second Century,* G Craven (Ed.), Melbourne University Press, 1992, pp.101-130.

13. Garran, R R, *op. cit.*, p.157.

14. Coghlan, T A, *A Statistical Account of the Seven Colonies of Australasia 1897-98,* Government Printer, Sydney, 1898.

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16. *Ibid.,* quoted at p.149.

17. Deakin, Alfred, *op. cit.,* p.81.

18. *The Australian Constitution,* s.86.

19. *Ibid.*, s.87.

20. *Ibid.,* s.88.

21. *Ibid*., s.90.

22. *Ibid*., s.92.

23. *Ibid*., s.89.

24. *Ibid*., s.93.

25. *Ibid*., s.94.

26. *Ibid.,* s.95.

27. *Ibid.,* s.103.

28. Garran, R R, *op. cit.*, p.161.

29. *Ibid.,* p.168.

30. See, for example, Walsh, C, *Federalism Australian-style: Towards some new Perspectives*, in *Taxation and Fiscal Federalism: Essays in Honour of Russell Mathews,* Brennan, G, B S

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