Chapter Five

W(h)ither Federalism?[1]

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When the Howard Government promoted A New Tax System (ANTS), it claimed the reforms would address Australia's over-reliance on direct taxation, particularly income taxes, by introducing a broad based consumption tax. It also claimed the reforms, with the Goods and Services Tax (GST) as their core, would enhance the financial capacity of Australia's States and Territories by arresting the century-long erosion of their fiscal capacity by a central government that had expanded its role in the social and economic affairs of the nation.

The reality has been very different. The implementation of ANTS and the complex set of financial relations at the heart of Australian federalism has diminished the fiscal autonomy of the States and Territories whilst simultaneously delivering substantially enhanced revenue streams to their Treasuries. To explain this paradox, and to ascertain the health of the Australian federation, it is necessary to understand the context in which the federation has evolved—an analysis that will also provide insight into the issues and challenges which lie ahead.

The federal state and state capacity

Whilst conventional definitions of the state generally identify it with the central or national governmental authority, these do not adequately describe the state as it pertains to a federation. With the central and sub-national governments sharing the range of legislative, executive and judicial powers and functions constitutionally available to government, the concept of the state in federations should not be limited to that part of the state which is the central authority but, rather, it must also embrace the constitutional authority residing with the sub-national governments.

Each of the national and sub-national governments in a federation will enjoy a measure of state authority and state autonomy, and each will have its own political, legislative, administrative, judicial, coercive and fiscal capabilities. A state's capacity waxes and wanes; and the political and institutional reality of federation means that the state capacity of each of the governmental entities within the federation is constantly being shaped by its interaction with the other entities, as well as with the various political, judicial and bureaucratic actors and institutions from both within the federation and external to it.

This interaction amongst different tiers of government and their various institutions, ensures that federal political systems are dynamic. However, they are neither inherently centralising nor decentralising. Whereas some federations have demonstrated a trend towards greater centralisation, others have disintegrated. Some erstwhile unitary states have become federations and have continued to decentralise, some federations have evolved into unitary states. It is important to note that the dynamic will not only vary with the circumstances of the particular federation but also across time, with the prevailing dynamic being centralising, decentralising or neither.

The Australian experience

Structural factors, such as the geographical isolation of the European settlements in early 19th Century Australia, shaped the governance choices of the political leaders of the day. Initially, this produced a decentralising dynamic that found its expression in the separation of new colonies from New South Wales. However, economic and technological changes in the late 19th Century led to new governance choices, with federation advanced as a policy response to a shared concern for security and the growing economic intercourse amongst the colonies. Thus the earlier decentralising dynamic yielded to the new centralising dynamic, that saw its expression in a federation with a new central government to which the six Australian colonies would cede part of their capacity as states.

Notwithstanding the desire to centralise the exercise of certain powers in the new central government, Australia's constitutional draftsmen sought to devise a framework for the new federation in which its centrepiece, the Constitution, contained various formal institutional constraints on its state capacity. However, over the course of the ensuing century, with the impact of two World Wars and other factors, including changing international and domestic economic conditions, there was an expansion in the role of government in general, and of central governments in particular.

The result of these influences has been the circumvention of many of those constitutional constraints on central government agreed by the delegates to the Constitutional Conventions of the 1890s.[2] Nowhere has this been more evident than in respect of the expansion of the central government's fiscal capability. Those who framed the Constitution did not foresee the Commonwealth circumventing the distribution of its surplus revenue amongst the States by using trust accounts; nor the action of the Commonwealth in excluding the States from their income tax revenue base; nor the High Court's actions that denied the States access to sales taxes, on the grounds that these were "duties of excise" and therefore exclusive to the Commonwealth.[3]

Ha, ANTS and fiscal federalism

When the High Court handed down its decision in *Ha's Case*, it reaffirmed earlier decisions that defined the Commonwealth's exclusive power to levy "a duty of excise" in such a way that States were precluded from taxing the manufacture, production and distribution of goods.[4] It concluded that State-imposed business licensing fees on tobacco products were excise duties and, therefore, invalid. Although the decision was specific to the New South Wales legislation, the High Court effectively invalidated similar legislation in all the Australian States and Territories and, by inference, questioned the validity of their fuel and liquor taxes. The decision, whilst not unexpected, sent shock waves through State and Territory governments, as $4.9 billion or 16 per cent of the total State and Territory own-source revenue base was immediately placed in jeopardy.[5]

In the wake of *Ha*, the States and Territories were anxious to restore their fiscal capability to at least that which they enjoyed before the High Court struck down their business licensing fees. However, they agreed to an arrangement that would restore their budgetary capability, rather than the autonomy that is fundamental to fiscal capacity. In what was acknowledged by the Commonwealth and the States as a temporary measure pending the implementation of wider tax reform, the States and Territories agreed to the Commonwealth imposing additional excise duty, the proceeds of which would be distributed amongst the States and Territories in the form of conditional grants known as Revenue Replacement Payments (RRPs).

When the Commonwealth announced its proposals for tax reform, it maintained that significant benefits would accrue to the States and Territories, as they would access all of the revenue generated by a GST. However, at the November, 1998 and April, 1999 Special Premiers' Conferences (SPCs), the Commonwealth made it clear, through the terms of its proposed Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA), that State and Territory access to GST revenue would be conditional upon their agreement to a timetable for the abolition of various State taxes and the implementation of other measures, including a First Home Owner Subsidy Scheme.

It was also clear from the IGA that it was not the Commonwealth's intention for GST to replace all of its payments to the States and Territories; tied grants or Specific Purpose Payments (SPPs) would be maintained. Whilst the GST revenue would replace the RRPs, the major significance of the new financial arrangement was that the GST revenue would replace the States' and Territories' general revenue assistance (Financial Assistance Grants or FAGs), and like FAGs, the share of the GST pool received by each State and Territory would be determined by the Commonwealth Grants Commission (CGC). However, unlike the FAGs pool, the size of which was determined unilaterally by the Commonwealth, the GST pool would simply be the quantum of revenue generated by the tax, less the cost of collection and administration by the Australian Tax Office (ATO).

This was familiar territory for the State Premiers, Chief Ministers, their Treasurers and their bureaucrats. Since the Curtin government introduced uniform income taxation during the Second World War, successive Commonwealth Governments had maintained their monopoly of this important revenue source, and compensated the States for their loss of revenue by way of general revenue assistance in the form of untied grants. Would the rules governing the distribution of GST be any different?

The Premiers, their Treasurers and senior bureaucrats did not think so. Apart from the requirements of the IGA, they believed that the manner in which distributions would be made from the GST pool would mirror the arrangements that had applied to the distribution of general revenue assistance in the past. This

view was borne out in comments from the Queensland Premier, Peter Beattie, who recalled his participation in the SPC negotiations on the IGA in the following terms:

> "When I sat down and signed the GST deal with the Prime Minister and Peter Costello, the deal said—and the wording of it's very clear—that the States can use this for any purpose. We gave up untied grants, and they've been around since the States gave up their taxing power after World War II. We've given up a whole lot of taxes. This money is Queensland money, and we're gonna [sic] spend it in the areas where necessary".[6]

Furthermore, at neither SPC was there was any suggestion from either the Prime Minister or his Treasurer that the Commonwealth intended to depart from its long-established practices with respect to the provision of general revenue assistance to the States. However, by placing conditions on how States and Territories *spend* GST revenue, the Commonwealth would simultaneously enhance its capacity to control State and Territory budgetary policy, whilst further diminishing the state capacity of the States and Territories as they become increasingly reliant on GST as a source of State revenue.[7] That the Commonwealth could unilaterally redefine the institutional framework for Australian fiscal federalism demonstrates the level of its ascendancy over the States and Territories. It also provides a useful insight into the conduct of federalism in Australia's second century as a federation.

Coercive federalism

Australia's Constitution provides for the Commonwealth and the States to exercise their legislative authority concurrently across a wide range of heads of power. However, a centralising dynamic has been at work within the federation, such that the conduct of federal-State relations has witnessed many examples of politicians, bureaucrats and the judiciary enhancing the power and influence of the central government at the expense of the States. Furthermore, it has occurred in the conduct of federal-State relations and, in particular, federal-State financial relations, under both Labor and non-Labor governments.

In the period since the Second World War, successive Commonwealth governments have assumed greater fiscal influence within the federation by pursuing policy objectives in areas traditionally within the policy preserve of the States. Under Chifley, the fiscal dominance of the Commonwealth achieved through the wartime uniform tax legislation was used to expand its activities in social welfare provision. Despite professing their support for federalism, Liberal-dominated governments under Menzies, Holt, Gorton and McMahon also strengthened the Commonwealth's fiscal domination of the States, and presided over an expansion of Commonwealth activity in areas such as education, health and transport through the increased use of SPPs.[8] This means of extending the Commonwealth's policy influence over the States intensified during the Whitlam years, and again under Hawke and Keating, and the Commonwealth's use of SPPs for this purpose has remained a canker within federal-State relations to the present day.[9]

Partisan debate in Australia over federalism is by no means polarised between Labor centralists and conservative federalists. Conservative central governments in Australia have contributed to the cause of centralism within the Australian federation just as surely as their Labor counterparts. Similarly, Labor administrations at a State level have been no less enthusiastic than their conservative counterparts in defending their State capacity and autonomy in the face of expansionist central governments of whatever political complexion.[10]

During its first two terms of office, the Howard Government's approach to federalism was broadly consistent with that of its post-War conservative predecessors. However, there were events from its early period in office, such as the Prime Minister's push for a national approach to firearms control, that suggest a preparedness on behalf of the Prime Minister and his government to identify national priorities and require the participation of the States and Territories in the policy directions it prescribes.

Furthermore, in what has become the great tradition of Australian federal-State financial relations, the Prime Minister has often used financial inducements to stiffen the resolve of the States to act in concert and embrace Commonwealth initiatives. Although this strategy was adopted in respect of the national gun buy-back scheme,[11] and more recently with respect to the proposal for the States to hand over their powers with respect to water in the Murray River catchment, the development and implementation of ANTS provides a clear demonstration of the Howard Government's coercive approach to federal-State relations in action.

The Commonwealth presented the final form of the IGA to the States and Territories as a *fait accompli*.[12] Despite claiming the new arrangements as a significant reform of federal-State financial relations, the IGA's terms were steeped in the way Australian fiscal federalism had been conducted since the passage of the uniform

tax legislation in 1942. Indeed, the Commonwealth's plan was virtually identical to that of 1942. That is, in return for their relinquishing the ability to raise certain of their own-source taxes, compliant States would be rewarded through their participation in the pool of revenue generated by uniform Commonwealth taxation. With the States again ceding a measure of their fiscal autonomy, and hence their fiscal capability, in return for a share of a growing revenue stream, albeit liable to conditions imposed by the Commonwealth, the ANTS package and its implementation should be seen as the Australian federation taking yet another step along the path of centralism.

Under ANTS, the distribution of GST revenue would replace the Commonwealth's FAGs and RRPs to the States and Territories. Whereas RRPs had been provided to the States on condition that any revenue they received in excess of that generated by the business licensing fees they replaced would be returned to taxpayers, FAGs were untied grants, and the direct successors to the untied compensation payments made to the States in return for their withdrawal from imposing income taxes in 1942. Regardless of whether there were conditions imposed on the use of a grant or not, it is important to note that the provision of both of these types of payments is authorised by s. 96 of the Constitution and, as such, can be made subject to whatever conditions the Commonwealth deems suitable or appropriate. This constitutional point would assume particular significance in June, 2000 on the eve of the introduction of the GST, and provide further evidence of the creeping centralisation within the Australian federation and Australian fiscal federalism in particular.

Regardless of their political allegiances, the States and Territories saw the introduction of GST and the abolition of RRPs as offering them an opportunity to abandon the subsidies they had been forced to introduce on liquor and fuel products in return for RRPs in 1997. There were clear financial incentives for the States to act, both in terms of enhancing their revenue and reducing their outlays by saving the costs of administering the various subsidy schemes. It was in this context that Tasmania, Victoria, South Australia, Western Australia and New South Wales resolved to withdraw their subsidies on low alcohol beer, whilst the Northern Territory, Western Australia, Victoria and Queensland prepared to withdraw their fuel subsidies.[13]

Although it was in the interests of the States and Territories to remove the subsidies and reallocate the funds to other, higher priorities, the Commonwealth viewed the prospect of the removal of these subsidies with alarm. Recognising that there would be an inflationary "spike" in prices as a consequence of the introduction of the GST, and conscious of public sensitivity to rising fuel prices, the Howard Government was fearful that it would be blamed for any price rises by voters who could not distinguish the price impact of GST from that caused by State and Territory governments removing their fuel and liquor subsidies.

The actions of the Commonwealth in response to the States' and Territories' threat to remove liquor and fuel subsidies remove any doubt that the Commonwealth considers the distribution of GST to be a s. 96 grant, and hence subject to conditions which it may unilaterally impose. In a series of media releases and letters to the State and Territory governments, Treasurer Costello and the then Finance and Administration Minister Fahey announced that, as any government threatening to remove fuel and liquor subsidies would be seeking an "unjustified financial windfall", it would face financial penalties in the form of deductions from its share of GST revenue.[14] At this time, the Queensland Treasurer also received correspondence from his federal counterpart demanding Queensland provide subsidies for low alcohol beer in line with those provided by other States. This intervention by the Commonwealth into the jurisdiction of the Queensland Government was made more extraordinary by the fact that no similar subsidy had previously been provided for such purposes in Queensland!

If there had been any doubt that the Commonwealth had the constitutional teeth to put these threats into effect, one had only to read the judgements in the *Uniform Tax* cases to learn how s. 96 of the Constitution was available for this purpose.[15] Furthermore, with the introduction of GST, and the States and Territories having become more reliant than ever on the munificence of the Commonwealth, it should come as no surprise to learn that, in the face of a threat to such a large portion of their revenue, the States and Territories relented. By this action, the States and Territories clearly demonstrated they lacked the political and fiscal capability to resist a central government with the fiscal clout to support its demands.

The Commonwealth's use of its fiscal dominance to achieve its policy objectives, regardless of whether it has the constitutional authority to legislate in that area, is well documented. As the Constitution provides a wide area of shared legislative competence for the Commonwealth and the States, and the Commonwealth has extensive powers to appropriate funds and provide grants as it thinks fit, there is ample opportunity for the Commonwealth to shape policy and budgetary outcomes at both the State and local government level.

Under the Howard Government, the Commonwealth has continued to expand its influence in the States' key service delivery areas such as education and health. Whilst the use of SPPs in these areas by successive Commonwealth governments has been a feature of Australian fiscal federalism since the Menzies years, Commonwealth policy and administrative interventionism has intensified under Prime Minister Howard.

There have been various ways in which the Commonwealth has used SPPs to shape the policy and spending outcomes of other tiers of government. In some cases the funds have been allocated to a specific project, in other cases they are allocated subject to matching funds being provided from the recipient. Some SPPs are passed through the States for distribution to third parties including community groups, as occurs with Commonwealth funding for non-government schools and local government. However, in all these cases, the conditions under which funds are being made available are becoming more prescriptive.

In the area of schools funding, the Commonwealth had concentrated its resources on the non-government sector and a range of specific programs for general application across the education system. Under these arrangements, the States dedicate the bulk of their education budgets to the State-run government sector. In March, 2004 the Prime Minister and his Education Minister announced a four-year funding program that included, *inter alia*, specific allocations for capital works, literacy and numeracy programs and remote area education. In what would otherwise have been a relatively unremarkable announcement in the tradition of earlier federal government education policy pronouncements, the 11th March statement foreshadowed an unprecedented degree of Commonwealth involvement in the *minutiae* of schools administration. The *Courier Mail* reported the Prime Minister as claiming that "the funding was, for the first time, conditional on agreement to a series of benchmarks for educational basics and guarantees to report in plain English to parents", adding that amongst these benchmarks would be the requirement that "schools will have to spell out to parents such things as absentee rates, where students go upon leaving and what professional qualifications are held by teachers".[16]

Three months later, the Prime Minister and the Education Minister amplified their March announcement, stating that schools funding was conditional on school authorities embracing "values-based" conditions, which would include the States implementing a uniform starting age by 2010, and developing common teaching and testing methods for English, maths, science and civics. In addition, schools would be required to supply information on their educational outcomes, including academic results, university entry rates along with student and teacher attendance records and teachers' formal qualifications.

In a further significant challenge to the institutional arrangements within the school systems, the Commonwealth stated that it would give principals greater autonomy to make decisions about staff recruitment and dismissal.[17] In what one newspaper editorial described as "an over-the-top threat" and "an unfortunate precedent that subsequent governments should avoid following", the Prime Minister and his Education Minister added that no school would be able to share in the government's four-year funding package unless it had a "working flagpole" and flew the Australian flag.[18]

Over the last three years, the Howard Government's focus on education, and in particular schools, has intensified as the number of public servants within the federal education bureaucracy has grown rapidly.[19] In a more recent series of announcements in relation to the next four-year schools funding agreement, the Howard Government agenda for school education has widened to embrace discipline and bullying, the introduction of a core national curriculum, as well as the previously canvassed intention to devolve greater managerial discretion and decision-making responsibilities to school principals.[20]

Universities also received attention from the Howard Government, with funding for new higher education places made conditional upon the reform of industrial relations practices and governance structures.[21] The Commonwealth's actions in linking funding levels to changes in university governance structures provide another example of the central government flexing its fiscal capacity in an area generally within State jurisdiction. Although the Commonwealth has borne the primary funding responsibility for the university sector since the 1970s, most Australian universities and their governance structures remain subject to legislation enacted by State Parliaments. In order to access the enhanced level of funding pledged by the Howard Government, universities have been obliged to convince State and Territory legislators to amend their governing legislation to comply with Commonwealth demands.

Although the Commonwealth's use of SPPs to achieve its policy ends has long been a source of aggravation in Australian federal-State relations, the Howard Government's use of tied grants to obtain policy leverage on issues outside of its legislative competence has only served to heighten tensions between the Commonwealth

and the States. However, for all of their complaints about the Commonwealth's use of SPPs to establish policy and fiscal hegemony within the federation, the States' fiscal dependence upon the Commonwealth is such that their budgets have little tolerance for any reduction in the level of their SPP funding.

Commonwealth SPPs have often been made conditional upon States providing matching funding. However, in agreements covering the provision of services in the health and disability sectors, Commonwealth funding has been made conditional on States agreeing to both a range of new performance measures as well as substantial real increases in their contributions to public hospitals over the life of the agreement.[22] Spending on health and education comprise about half of the States' budget outlays. As these service delivery areas are highly labour intensive and, in the case of health services, already facing increasing demands from an ageing population, this combination of structural and institutional factors places the States in the dilemma of having to meet the rapidly escalating cost of providing services, whilst at the same time operating within a tightly constrained fiscal environment.

With such heavy reliance on Commonwealth funding to support their activities in major service delivery areas such as health, education and disability services, the States are not only vitally concerned with the changes in the aggregate level of SPP funding, but also with changes in the ratio of SPP funds that pass "through" them to local governments and entities such as non-government schools, as opposed to grants "to" the States for their use. These concerns are summarised in the following extract from the Queensland State Budget 2004-05:

> "In the IGA, the Australian Government undertook to not reduce aggregate SPPs as a result of national tax reform. The Australian Government has met this undertaking in real per capita terms when current payments are compared with the level of SPPs in 1999-2000. However, SPPs 'through' States have increased more than SPPs 'to' States over this time.
>
> "The position taken by the Australian Government in negotiating SPPs with the States represents a significant risk to the provision of essential services, particularly health and disability services in Queensland".[23]

The risks to service delivery to which this passage refers are indeed palpable. It has always been easier for governments to introduce new programs or expand existing services than withdraw from a program and manage the public and institutional fall-out from such decisions. Consequently, there have been numerous examples of States accepting SPPs to fund new programs, only to find themselves left with an on-going commitment long after the Commonwealth's priorities had moved to another area and the SPP had been discontinued.

Furthermore, the Commonwealth mantra that under ANTS, the States' existing and emergent fiscal requirements should be satisfied from the "free cash" generated by a rapidly expanding GST pool rings hollow, when much of that future revenue stream is either being locked up in long-term Commonwealth-State funding agreements, or identified by the Commonwealth as offsetting revenue that will be forgone by the States from the abolition of other taxes. In this vein, the comments of Treasurer Costello have been particularly interesting, as he has criticised States and Territories for spending too much of their GST revenue on improving services rather than reducing the tax burden. Apparently, Treasurer Costello considers it inappropriate for States to use their share of GST revenue to pursue a State policy agenda of service delivery in preference to the Commonwealth's policy agenda for the States, *i.e.*, the abolition of State taxes.[24]

It has been stated that, contrary to the portrayal of the GST as a tax in lieu of States' taxes, the introduction of the GST had a greater impact on the composition of Australian taxation at the national level.[25] Whilst this may be so in a strictly mathematical sense, the fact that an increasing proportion of State and Territory revenues is being derived from GST means that ANTS has enhanced the influence of a central government agency, the CGC, over State and Territory finances, with implications for the fiscal capabilities of States and Territories relative to each other.[26] Under these circumstances, the various attempts of the donor States to seek changes to the horizontal fiscal equalisation (HFE) formula applied by the CGC to the distribution of GST should be seen not simply as an attempt to limit the extent of fiscal equalisation within the federation, but also as a bid to arrest the growing institutional constraint of the CGC on their future fiscal capability.

Whilst there are those who would argue that the mere existence of intergovernmental transfers demonstrates the existence of fiscal imbalance, others point to fiscal imbalance being the result of a structural imbalance between the revenue raising and the spending needs of different tiers of government.[27] However, the fact that there are intergovernmental transfers, or that a level of government raises more revenue than it

needs, tells us very little about the relative fiscal capabilities of States within a federation. It is therefore more important to know whether, and to what extent, the respective levels of government have the ability to control both the source and the quantity of funds they require to meet *their* spending priorities, and to what extent one level of government can exercise control over the source of revenue and the spending priorities of other levels of government within a federation. On this test, whilst ANTS has enhanced the flow of revenue to the States and Territories, it has simultaneously exacerbated vertical fiscal imbalance (VFI)[28] within the federation and diminished the fiscal, as opposed to the budgetary, capacity of Australia's States and Territories.

Whereas the implementation of ANTS has only enhanced the budgetary capacity of the States and Territories, it has enhanced both the budgetary and fiscal capacity of the Commonwealth. As GST revenue has grown more rapidly than the Commonwealth had forecast at the 1999 SPC, it has delivered a budgetary windfall to the States and Territories, and an indirect windfall to the Commonwealth. As the enhanced cash flow to the States alleviated the Commonwealth's budgetary obligation to fund budget balancing assistance for States like New South Wales, which would have otherwise required such transitional financial support from the Commonwealth until 2007, the Commonwealth has enjoyed the budgetary freedom to reallocate this funding to other purposes.[29] Furthermore, as the funds that the Commonwealth would have otherwise had to allocate to the States are obtained from other sources under the Commonwealth's control, the burgeoning of GST revenue has enhanced both the budgetary and fiscal capacity of the Commonwealth.

A changing political paradigm

In February, 2002 South Australian voters elected a Labor government. This event ushered in a unique situation in the history of Australian federalism, with the same political party controlling all eight State and Territory governments, whilst its political opponents held office at the national level. Moreover, this one party monopoly on State and Territory government has persisted for an unprecedented period. Whilst there had been a short period in 1969-1970 when the Liberal and Country Parties dominated all six States and the federal government, there were differences from State to State in the composition of the governments.[30] Some were coalitions, some were not, and in the case of Queensland, it was the Country Party that dominated the coalition. Furthermore, the political capacity of the federal government of 1969-1970 was tempered by the fact that it did not command a Senate majority, whereas since 2005, its political successor has not been similarly constrained.

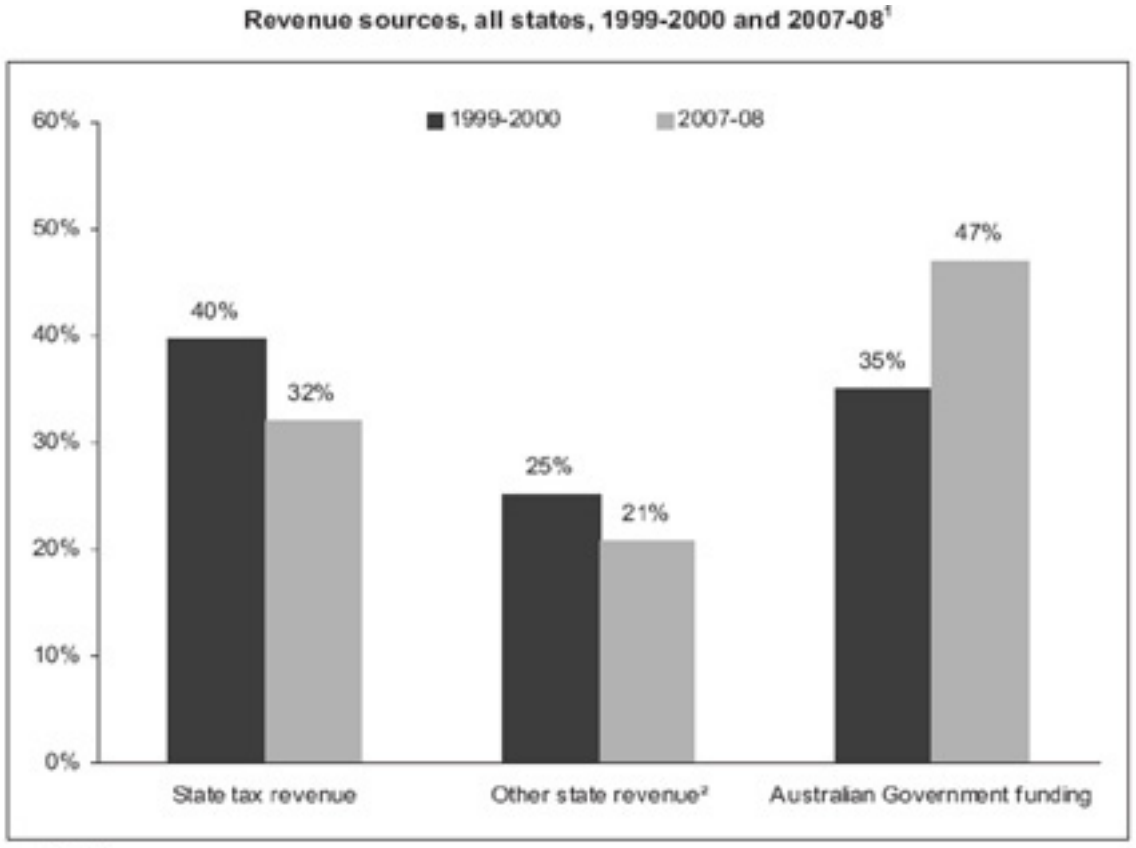
There is a double irony in the Labor monopoly of State and Territory government at a time when the Liberal-National Party coalition dominates both houses of the Federal Parliament. Whereas the ALP had traditionally opposed Australia's federal structure and, until the 1970s, was formally pledged to the abolition of the States, the Liberals had traditionally represented themselves as staunch advocates of federalism.[31] However, as Galligan has observed, the institutional environment in which the ALP has operated, contesting elections and holding government at both the State and federal level, has shaped its policy and the structure, enmeshing it in Australia's federal system of government.[32]

Whereas federal Labor governments have been compelled to engage with one or more Labor-controlled States or Territories as well as governments controlled by its political opponents, this institutional environment has not been the third and fourth term experience of the Liberal-National Party government of Prime Minister Howard. Indeed, the increasingly strident centralism of the Howard Government is probably as much a product of its strategic policy agenda, and the fact that it contains few influential members who have had first-hand experience and empathy with State politics, as it is the product of political partisanship in an environment untempered by the presence of political allies on the Treasury benches in State and Territory assemblies.

It is certainly an interesting twist in the history of Australian federal politics that it is a once avowedly federalist Liberal Party at the national level that is seeking to diminish the legislative and fiscal capability of the States, and that the once avowedly centralist Labor Party, at least at a State level, has fought to maintain the jurisdiction of the States in industrial relations, education and health systems. Furthermore, the absence of conservative State or Territory governments arguing the case for the States within Coalition party circles has meant that a political constraint on the Commonwealth, which may have sustained the States against the Commonwealth's centralism, is now effectively absent.

The creeping centralism of the 1970s, 1980s and 1990s witnessed the Commonwealth's use of s. 96 to shape States' spending priorities and make the States' delivery of Commonwealth funded programs subject to the administrative oversight of the relevant Commonwealth departments and agencies. Under ANTS, all

Commonwealth transfers to the States and Territories, explicit SPPs and GST revenue alike, have become conditional grants under s. 96, with the Commonwealth now threatening to make the States and Territories accountable for their spending decisions in respect of both tranches of funds.[33]



Source: Queensland Government, *Budget Strategy and Outlook*, *Budget Paper No2,* 2007 p. 145.

Prior to the election of the Howard Government, the Commonwealth's use of SPPs had reached its zenith in 1993-1994, when SPPs comprised 53 per cent of total Commonwealth transfers to the States and Territories.[34] With Commonwealth payments now comprising almost one-half of all State and Territory revenue, and with the prospect of that proportion increasing through the combination of the abolition of other State taxes and growth in the GST pool (see above), the prospect of the Commonwealth determining the appropriateness of State government spending priorities represents a serious challenge to State capacity at a sub-national level.

The increasing interventionism of the Howard Government in the activities of the States and Territories has accompanied a sea change in the way the Commonwealth views the role of the States in service delivery. Rather than treating the States as partners in the delivery of public goods and services, the Howard Government has increasingly characterised them as simply another category of service provider that must be made accountable to the Commonwealth in return for the Commonwealth funds they administer. Not only does this foreshadow a level of Commonwealth intervention in the activities of State governments and their administrative arrangements that is unprecedented in the history of peace-time Australian federal-State relations, it may also presage a greater preparedness on the part of the Commonwealth to allocate funds straight to private service providers in direct competition with State agencies.[35]

Federalism not only requires the States and the Commonwealth to have the capacity to fulfil their responsibilities, but it also requires them to have actual responsibilities to fulfil. It also requires the States and the Commonwealth to enjoy and exercise a degree of autonomy when determining their respective policy

objectives and program priorities. The danger for Australian federalism lies in the fact that, as the access of States and Territories to own-source revenue diminishes, their budgets become increasingly dependent upon Commonwealth munificence. Moreover, the Commonwealth will similarly diminish the capacity of States and Territories when it allocates funds to them subject to the condition that they comply with increasingly prescriptive policy and administrative requirements.

In a scenario in which they are effectively deprived of any real fiscal, administrative or legislative capability in areas of major public spending, and with ever-diminishing autonomy with respect to their revenue raising, the States face the prospect of being reduced to mere agents of the Commonwealth with little state capacity of their own. Clearly, this is not co-operative federalism or partnership between the Commonwealth and the States but, rather, a highly coercive form of federalism in which the Commonwealth uses whatever means it has at its disposal to impose its will on the States. Such a scenario raises a fundamental question about the future of Australia as a federation. That is, in circumstances where the capacity of the States is progressively denied, at what point does Australia cease to be a federation?

Australia's State and local governments were collectively responsible for 46 per cent of the nation's total taxation effort in 1938-39, but for only 12 per cent in 1948-49.[36] Over the following half century, the proportion of total taxation collected by Australia's States, Territories and local governments gradually rose, such that by the late 1960s and through the 1970s, the figure had reached 18 per cent, increasing to 21 per cent by the early 1990s.[37] Whilst State and Territory governments were responsible for 19 per cent of total taxation in 1999-2000, falling to 15 per cent following the introduction of the GST, local governments have maintained their three per cent share of total taxation revenue.

Notwithstanding the impact of ANTS, the States and Territories, through their own-source revenue, are still contributing a significantly greater share of the national taxation collection than they did in the years immediately following the introduction of uniform income taxes. However, this situation may change significantly if the Commonwealth makes the receipt of GST revenue conditional upon the States' abolition of certain stamp duties and other State taxes imposed upon business, such as land tax and payroll taxes, in addition to those taxes identified for abolition under the IGA.

Although the *Uniform Tax Cases* upheld the Commonwealth's power to make conditional grants, even in circumstances where the States' compliance with the condition precluded them from exercising their constitutional powers, there is a body of High Court jurisprudence that suggests that it would be unconstitutional for the Commonwealth to totally remove the fiscal capability of the States and Territories. Citing Dixon CJ in the *State Banking Case*[38] and Menzies J in the *Payroll Tax Case*,[39] Zines concluded:

> "The present position seems to be that the Commonwealth may not make a law discriminating against a State unless the nature of the power indicates otherwise. The Commonwealth may not even under a general law threaten the existence of the State or its capacity to function. This, however, would seem to be a somewhat narrow restriction, which does not in itself prevent a Commonwealth law from taxing a State, or from controlling the prerogatives of the Crown in the right of a State. Section 106 may provide a restriction on Commonwealth power to affect a State Constitution, but the only restrictions that have been suggested so far have been that the Commonwealth cannot impose a liability on a State to pay money which has not been appropriated by the State Parliament (except where the liability is under the Financial Agreement *Garnishee (No 1) Case* (1932) 46 CLR 155) or deprive State courts of State jurisdiction: *Re Tracey; Ex parte Ryan* (1989) 166 CLR 518; 84 ALR 1".[40]

More recent support for the proposition that the Constitution, by its federal nature, would prevent the Commonwealth from acting in such a way as would strip the States of their capacity as states can be found in the *Australian Education Union Case*.[41] In this case, a majority of the High Court found that any attempt to bring a State's higher level employees, such as Ministers and their advisers, heads of departments, high level statutory office holders, judges and officers of the Parliament, under a Commonwealth industrial award would be unconstitutional as it would violate the States' constitutional integrity. Whilst the High Court majority stated that the Constitution contained an implied limitation that safeguarded the States' autonomy and constitutional integrity against encroachment by the Commonwealth, the decision in the *Australian Education Union Case* indicates that this exclusive State jurisdiction is preserved only in relation to a very small group of the States' employees, comprising only the most senior State political, bureaucratic and judicial figures.[42]

It would appear that whilst the High Court would move to preserve a modicum of a State or Territory's state capacity in the face of an attempt by the Commonwealth to totally remove such capacity, the Court could

only be relied upon to act in the most extreme circumstances, *i.e.*, where the Commonwealth reduced a State to total fiscal dependence upon sources of funding over which it had no control, or where the Commonwealth sought to assume control of the State's core constitutional, political, bureaucratic and judicial functions. Whilst the institutional and structural factors shaping the revenue base of each State and Territory vary considerably from State to State, as does their level of financial dependence upon Commonwealth largesse, even those States and Territories with the highest levels of fiscal dependence upon the Commonwealth have some way to go before they could be described as wholly dependent. Under these circumstances, it is highly unlikely that a State could successfully mount a High Court challenge to a Commonwealth strategy that linked the abolition of State taxes to a share of GST unless virtually all of the State's own-source revenue was at risk.

Conclusion

Whilst centralisation has occurred under both Labor and non-Labor governments, the Howard Government has become increasingly interventionist, and has used its fiscal dominance and s. 96 to aggressively pursue its policy priorities in areas such as water, health, education and industrial relations. The Howard Government's embrace of this "coercive federalism" is also reflected in its increasing tendency to view the States and Territories as agencies for the delivery of services, and in competition with private service providers.

Whilst there are numerous examples of the Howard Government using the carrot and stick approach in its dealings with the States and Territories, the Labor monopoly of State and Territory government since 2002 may be one of several factors contributing to the increasingly interventionist approach taken by the Howard Government in federal-State relations during its third and fourth terms in office. In addition to a decline in empathy among federal parliamentarians for the role of State government,[43] and the traditional rivalry existing between the two tiers of government, the State and Territory Labor monopoly has left federal Liberals and Nationals unconstrained by State-based colleagues and party structures seeking to maintain the capacity and their control of State or Territory governments.

Whereas it was claimed that ANTS would reform federal-State financial relations by enhancing the capacity of State and Territory governments, the implementation of ANTS and the GST has actually exacerbated VFI. It has also eroded the fiscal capacity of the States and Territories, whilst enhancing their budgetary capacity. Furthermore, through the application of HFE, it has enhanced the budgetary capacity of some States and Territories at the expense of others. With a greater proportion of State and Territory revenue being derived from GST and therefore being subject to HFE, the implementation of ANTS is also enhancing the ability of a central government agency, the CGC, to shape the budgetary capacity of the States and Territories.

As the Commonwealth's fiscal, legislative and administrative capabilities, have been enhanced over the course of the last century, it has often been at the expense of the States' capabilities, with the result that they have limited access to own-source revenue and a diminishing scope for autonomous action or the independent exercise of their authority.[44] Although the High Court has recognised that Australia's federal Constitution contains an implied protection of the States' constitutional capacity, the scope of this protection is extremely limited. Furthermore, the fact that the States and Territories do not have exclusive access to substantial own-source revenue underscores the vulnerability of their fiscal capacity from a Commonwealth willing and capable of dictating the scope and source of State government finance.

In the institutional environment of coercive federalism, the Commonwealth is striking at one of the fundamental features of a federation, *i.e.*, that the central and sub-national tiers of government are neither superior nor subordinate to each other.[45] In such circumstances, the fiscal capability of the respective tiers of government can only be maintained where each tier of government has both exclusive access to specific revenue sources and can exercise control over those sources of revenue. It is immaterial that the diminution of fiscal capacity occurs over a short or extended period, for the outcome will be similar. The erosion of the state capacity of the States and Territories will reduce them to little more than agents or service providers engaged by the Commonwealth. Under these circumstances, States and Territories would have little scope for policy or administrative autonomy, and meagre fiscal capability to support it.

Whilst this is a likely scenario, it is not inevitable. If the Commonwealth were to eschew coercion and embrace a more co-operative federalism in its dealings with the States and Territories, there is a chance that the degeneration of the States and Territories may be halted. If this sea change extended to the way in which the High Court views the role of the States within the federation, and interpreted the Constitution as

preserving, by implication, a substantially broader range of powers and responsibilities for the States, again the centralising dynamic which has eroded the capacity of the States might abate. However, a failure to address the area where the creeping centralism has been most evident, *i.e.*, in Australian fiscal federalism, would almost certainly mean that any reprieve for the States would at best be temporary.

Although the High Court could revisit its interpretation of "a duty of excise", and empower the States and Territories to legislate with respect to taxes on the distribution and sale of goods and services, this alone would not constitute a solution to what is potentially a fatal flaw in the institutional design of the Australian federation. As this enhancement of the States' legislative capability would occur in respect of a concurrent power under the Constitution, the Commonwealth could still exclude the States from exercising their powers in the same way that it has excluded them from the collection of income tax, Financial Institutions Duty and certain stamp duties. Unless the High Court resolves to preserve a discrete revenue source for the States in order that they can discharge the core responsibilities implied by Australia's federal Constitution, or unless there is a constitutional amendment to provide the States and Territories with exclusive access to an own-source revenue stream, the centralising dynamic that has been dominant within the Australian federation will undermine the characteristics that define Australia's system of government as a federation.

In the absence of such fundamental change in the institutional framework of Australian fiscal federalism, future studies of state capacity in the Australian federation will find the States reduced to little more than agents or service providers for the Commonwealth, and reliant on whatever residual political capability they possess to represent their interests.[46] Under these circumstances, enquiries into the state of the Australian federation will be more fruitfully focused upon the implications for state capacity in Australia's interaction with the institutions of the international community, rather than with domestic federal-State relations, where States and Territories will have been subordinated to the central government and stripped of the capacity essential to the essence of federation.

Endnotes:

1. This paper draws extensively from Hamill, DJ, *The Impact of the New Tax System on Australian Federalism*, thesis submitted for the Degree of Doctor of Philosophy, University of Queensland, 2005; and Hamill, D, *The Impact of the New Tax System on Australian Federalism,* Research Study 45, Australian Tax Research Foundation, 2006.

2. Warden, J, *Federalism and the Design of the Australian Constitution*, *Australian Journal of Political Science*, vol. 27, 1992, p. 157.

3. Mason, Hon Sir A, *The Australian Constitution in Retrospect and Prospect*, French, R, G Lindell, C Saunders (eds), *Reflections on the Australian Constitution*, Federation Press, Sydney, 2003, p. 14.

4. *Ha and anor v. State of New South Wales & ors; Walter Hammond & Associates v. State of New South Wales & ors* (1997) 189 CLR 465.

5. Mathews, R and B Grewal, *The Public Sector in Jeopardy: Australian Fiscal Federalism from Whitlam to Keating*, Centre for Strategic Economic Studies, Victoria University, Melbourne, 1997, p. 49; French, Lindell and Saunders, *op. cit.*, p. 103.

6. Australian Broadcasting Corporation, *Beattie warns Costello against GST spending controls*, *AM*, 1 March, 2005.

7. Wardill, S, *Canberra won't keep GST without a fight, pledges Mackenroth*, in *The Courier Mail,* 28 February, 2005.

8. Haward, M and G Smith, *What's New About the "New Federalism"?*, *Australian Journal of Political Science*, vol. 27, 1992, p. 41.

9. James, D, *Federal-State Financial Relations: The Deakin Prophecy*, Research Paper No. 17 1999-2001, Department of the Parliamentary Library, 2001, p. 24. Accessed 13 July, 2004. Available at http://www.aph.gov.au/library/pubs /rp/1999-2000/2000rp17.htm.

10. Parkin, A and J Summers, *The States, South Australia and the Australian Federal System*, in Parkin, A, (ed.) *South Australia, Federalism and Public Policy*, Federalism Research Centre, Australian National University, Canberra, 1996, p. 66; Parkin, A, *The States, Federalism and Political Science: A Fifty-Year Appraisal*, *Australian Journal of Public Administration*, vol. 62, no.2, 2003, p. 104.

11. Department of the Parliamentary Library.1996. *Bills Digest 104 1995-96: Medicare Levy Amendment Bill 1996,* accessed 15 February 2005. Available at http://www.aph. gov.au/library/pubs/bd/1995-96/96bd104.htm. The Bill increased the Medicare Levy in order to raise the funds necessary to finance the Howard Government's national gun buy-back scheme—that is, provide the fiscal incentive for the States and Territories to administer the scheme.

12. Although the Premiers and Chief Ministers had signed an earlier version of the IGA at the April, 1999 SPC, the terms of that agreement were unilaterally amended by the Commonwealth following concessions it made in negotiations with Australian Democrat Senators in order to secure their support for the GST legislation.

13. Fahey, J, *Removal of State and Territory Fuel Subsidies*, Press Release, 26 June, 2000; Costello, P, *Low Alcohol Beer Subsidies—NSW Isolated*, Press Release, 8 June, 2000.

14. Fahey, *ibid.*.

15. *South Australia v. Commonwealth* (1942) 65 CLR 373; *Victoria and New South Wales v. Commonwealth* (1957) 99 CLR 575.

16. Atkins, D, *PM sets school standards: Record spending tied to performance*, *The Courier Mail,* 12 March, 2004.

17. Cole, M, *Schools to teach values for money*, *The Courier Mail*, 23 June, 2004; Howard, J, *Australian Schools Agenda*, Media Release, 22 June, 2004.

18. Cole, *ibid.*; Editorial, *Hoisting politics up the flagpole*, *The Courier Mail*, 24 June, 2004.

19. The number of bureaucrats in the Commonwealth Government's Department of Education, Science and Training was reported as having risen from 1,469 in June, 2001 to 2,379 in June, 2006. Morris, S, *Howard widens bid for control of schools*, *The Australian Financial Review,* 15 May, 2007.

20. *Ibid.*.

21. Dullroy, J and T Livingstone, *Academics warn reform benefits still years away*, *The Courier Mail,* 14 May, 2003.

22. Howard, J, *Australian Health Care Agreements 2003-2008*, Media Release, 23 April, 2003.

23. Queensland Government, *State Budget 2004-05: Budget Paper No.2,* Government Printer, Brisbane, 2004, p. 122.

24. Jones, C, *Costello in tax attack*, *The Courier Mail,* 8 July, 2004.

25. Sixty per cent of the revenue generated by the new tax equated to Commonwealth revenue forgone from abolishing WST, whilst the remaining forty per cent related to other revenue forgone by the States. This includes the additional excise collected by the Commonwealth and transferred to the

States and Territories as RRPs. As these replaced State business licensing fees, this revenue was officially recorded as State and Territory revenue despite being collected on their behalf by the Commonwealth. See also Collins, D J, *The 2000 Reform of Intergovernmental Fiscal Arrangements in Australia*, in *Texts submitted for the International Symposium on Fiscal Imbalance,* Report—Supporting document 3, Quebec Commission on Fiscal Imbalance, 2002, p. 124.

26. *Ibid.*, pp. 134, 137.

27. Quebec Commission on Fiscal Imbalance, *A new division of Canada's Financial Resources*, *Report*, 2002, p. 17.

28. Vertical Fiscal Imbalance refers to the extent to which the various tiers of government do not have access to sufficient revenue to enable them to deliver the goods and services for which they are responsible. As the achievement of vertical fiscal balance is generally considered fundamental to the achievement of governmental accountability, governments making decisions about their spending priorities should not only be responsible for raising the funds they require to support those expenditures, but also have control over the source of those funds. (See also Walsh, C, *Federal Reform and the Politics of Vertical Fiscal Imbalance*, *Australian Journal of Political Science,* vol. 27, p. 31).

29. Parliament of New South Wales, *Debates (Legislative Council),* vol. 287, 2001, p. 17244; Queensland Parliament, *Parliamentary Debates*, vol. 370, 2003, p. 3139.

30. Since the emergence of the modern system of party politics in Australia, this was the only time that the same parties have simultaneously controlled government in all States and the Commonwealth.

31. Galligan, B and C Walsh, *Australian Federalism Yes or No,* Federalism Research Centre, Research School of Social Sciences, Australian National University, Canberra, 1991, p. 3.

32. Galligan, B, *A Federal Republic: Australia's Constitutional System of Government,* Cambridge University Press, Melbourne, 1995, p. 97.

33. *The Courier Mail, Costello steps up GST attack on States*, 2 March, 2005; Wardill, *op cit*..

34. Mathews and Grewal, *op cit.*, p. 549.

35. Howard, J, *Australian Schools Agenda*, *op cit.*; Wilkins, R B, *Federalism: Distance and Devolution*, *Australian Journal of Politics and History,* vol. 50, no.1, 2004, p. 100.

36. Smith, J, *Fiscal Federalism in Australia: A Twentieth Century Chronology,* Federalism Research Centre, Research School of Social Sciences, Australian National University, Canberra, 1992, pp. 18, 24.

37. *Ibid.*, pp. 30, 34, 38, 40.

38. *Melbourne Corporation v. Commonwealth* (*State Banking Case*) (1947) 74 CLR 31.

39. *Victoria v. Commonwealth* (*Payroll Tax Case*) (1971) 122 CLR 353.

40. Zines, L, *The High Court and the Constitution*, Butterworths Australia, 1992, pp. 277-282.

41. *Re Australian Education Union: Ex parte Victoria* (*Australian Education Union Case*) (1995) 184 CLR 188.

42. This is further confirmed by the implications for State industrial jurisdiction in the wake of the recent High Court decision in *New South Wales v. Commonwealth (Work Choices Case)* (2006) 231 ALR 1, which upheld legislation enacted under the Commonwealth's corporations power that extended

Commonwealth jurisdiction over a large section of the workforce who were previously subject to State-based industrial laws.

43. Whereas three-quarters of those who took their seats in the first federal Parliament had prior State parliamentary service, one hundred years later less than nine per cent of federal parliamentarians had similar State or Territory parliamentary experience. There were no former State or Territory Ministers amongst the membership of the 2004—2007 Howard Ministries. In this context it is worth noting that Ministries in the 1990s generally included one or two former State Ministers, e.g., former Western Australian Premier Carmen Lawrence and former New South Wales Minister Laurie Brereton served as Ministers in the Keating Government, and former New South Wales Premier John Fahey served as a Minister in the Howard Government.

44. Galligan, B, *Parliament's Development of Federalism*, Research Paper 26 2000-2001, Parliamentary Library. Accessed 17 February, 2005. Available at http://www.aph .gov.au/library/pubs/rp/2000-01/01rp26.htm.

45. Parkin, A (ed), *South Australia, Federalism and Public Policy*, *op. cit.*, p. 1.

46. Hamill, Hon D, *Taxing Federalism: The Australian Federation in its Second Century*, Australian Fabian Society (Queensland Branch), 2004.