# Chapter 4

# In re Revenue Taxation & the Federation
# The States v The Commonwealth

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The thesis of my address is in two parts. First, it is that the Constitution has served Australia well in its division of legislative and executive power between the States and the Commonwealth. This is because the terms of the Constitution have allowed for a construction which has empowered the governments of Australia to deal with, first, the nationalisation of socio-economic forces, capital, labour and communications and, then, the internationalisation of those forces.

The second part of my thesis is not so Panglossian. It is that Australia's State and Commonwealth governments have failed the Constitution by not making efficient and fair arrangements for the Australia-wide provision of government services and by not implementing coherent and efficient taxation and regulatory regimes.

## I

### Constitutional adaptation

I shall first deal with the successful adaptation of 19th century ideas of federation and government, on which the Constitution was based, to the 21st century. For most of the first two decades of the 20th century, a conservative State-based construction of the Constitution prevailed. That is not surprising. The first High Court judges were drawn from the establishment of diverse and disparate colonies who were not experienced in the workings of a federated nation.

In *D'Emden v Pedder* (1904 1 CLR 91) and the line of cases which followed it, the Constitution was construed on the assumption, which had no textual basis, that the States and the Commonwealth had discrete areas of delineated governmental responsibility which could not be fettered, controlled or interfered with by the other tier of government.

In 1913 there were a number of referenda which sought to expand, among other things, Commonwealth powers in trade, commerce and monopolies. These referenda were narrowly lost despite affirmative majorities in Western Australia, Queensland and South Australia.

The majority judgment in the *Engineers* case ((1920) 28 CLR 129) was, not surprisingly, delivered by Isaacs, J, whose personal and political history predisposed him to the national government agenda. In strong language of the rhetorical kind often employed by Isaacs, the asserted foundation of the inter-governmental immunity doctrine – political necessity – was dismissed as an elusive and inaccurate doctrine.

R. T. E. Latham made the following insightful analysis of the *Engineers* case:

> The fundamental criticism of the decision is that its real ground is nowhere stated in the majority judgment. This real ground was the view held by the majority that the Constitution had been intended to create a nation, and that it had succeeded; that in the Great War the nation had in fact advanced in status while the States stood still and (as was a patent fact) that the peace had not brought a relapse into the status quo ante bellum; that a merely

> contractual view of the Constitution was therefore out of date, and its persistence in the law was stultifying the Commonwealth industrial power, which they believed to be a real and vital power; and finally that the words of the Constitution permitted the view of the Federal relationship which the times demanded.[1]

That assessment of the decision in the *Engineers* case made in 1949 remains true today. The *Engineers* case delivered more power to the Commonwealth than the failed 1913 constitutional referendum could have.

## Tax powers

The Income Tax case which, in 1942, effected a substantial shift in governmental fiscal power from the States to the Commonwealth also demonstrated the adaptability of the constitutional text to modern economic conditions and challenges.

In *South Australia v Commonwealth* the High Court heard a challenge by the States to a suite of *Income Tax* legislation enacted in 1942 for the purpose of funding Australia's war effort ((1942) 65 CLR 373). A statutory sunset clause limited the temporal operation of the legislation to the last day of the first financial year which commenced after the end of World War II. The temporal limitation was thought to be important for both political and constitutional reasons.

The *State Grants (Income Tax Reimbursement) Act* 1942 (Cth) (State Grants Act) provided that in each year in which the Treasurer was satisfied that a State had not imposed income tax, an amount specified in a schedule to the Act would be paid to the State. The *State Grants Act* also provided for making further payments out of consolidated revenue to the States based on the recommendation of the Commonwealth Grants Commission. The schedule provided for repayments to the States of, approximately, the amounts they had collected with what might be described as a war effort commission skimmed off the top.

Despite the Commonwealth's heavy reliance on the defence power, section 51(vi) of the Constitution, and the national emergency created by the war, Latham, CJ, Rich, McTiernan and Williams, JJ, upheld the validity of the Act as coming within the income tax power, section 51(ii). Their Honours held that the *State Grants Act* was not invalid for being directed towards destroying or weakening the constitutional functions or capacities of the States or as involving discrimination contrary to section 51(ii). Thus a war-time measure became the Commonwealth's long-term monopoly of income tax.

The States lost another major revenue source in *Ha v The State of New South Wales & Ors* when the High Court invalidated New South Wales' ad valorem tobacco franchise licensing fees ((1997) 189 CLR 399). The High Court, by majority, held that the licence fees were duties of excise within section 90 of the Constitution.

The decision in *Ha* was not surprising. State sales taxes had been struck down several times. The decision in *Ha* is strongly supported by textual and contextual considerations. Nonetheless, it demonstrates how strongly the Constitution as framed and construed has facilitated the growth of a single national economy.

## Section 96 and expenditure powers of the Commonwealth

The constitutional validity of the conditional payments to a State pursuant to section 96 of the Constitution was upheld as early as 1926 in *Victoria v The Commonwealth* ((1926) 38 CLR 399).

South Australia and Victoria argued unsuccessfully that the Commonwealth could not attach conditions to its grants which were, in substance, an exercise of a legislative power which did not fall within section 51 of the Constitution.

The judgment of the Court, delivered by Knox, CJ, was admirably succinct:

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

The imposition of conditions on section 96 grants was confirmed by the High Court in 1940 and again in 1956-1957.

In W R Moran Pty Ltd v The Deputy Federal Commissioner of Taxation (NSW) ((1940) 63 CLR 338) the Judicial Committee of the Privy Council observed that a "colourable" use of section 96 to overcome limitations on Commonwealth power might well be ultra vires.

However, in South Australia v The Commonwealth (the first uniform tax case), Latham, CJ, acknowledged that the State Grants Act could be used to induce the State parliaments not to exercise their income tax powers notwithstanding their continuing constitutional right to do so ((1942) 65 CLR 373). His Honour explained that the States may or may not yield to the inducement but that there was no legal compulsion to yield. Observing that "temptation is not compulsion", Latham, CJ, held that, just as the Commonwealth may properly induce a State to exercise its powers by offering it a grant of money, it could equally induce a State in the same way to abstain from exercising its powers.

Latham, CJ, then turned to the States' argument that the Commonwealth cannot use its legislative power to destroy or weaken the constitutional functions or capacities or to control the normal activities of the States. He accepted that revenue is essential to the existence of any organised State and that there could be neither reliable nor sufficient revenue without the power of taxation which was therefore an essential function of a State. He went on:

> There is no universal or even general opinion as to what are the essential functions, capacities, powers, or activities of a State. Some would limit them to the administration of justice and police and necessary associated activities. There are those who object to State action in relation to health, education, and the development of natural resources. On the other hand, many would regard the provision of social services as an essential function of government. In a fully self-governing country where a parliament determines legislative policy and an executive government carries it out, any activity may become a function of government if parliament so determines. It is not for a court to impose upon any parliament any political doctrine as to what are and what are not functions of government, or to attempt the impossible task of distinguishing, within functions of government, between essential and non-essential or between normal or abnormal. There is no sure basis for such a distinction. Only the firm establishment of some political doctrine as an obligatory dogma could bring about certainty in such a sphere, and Australia has not come to that. ((1942) 65 CLR 373 at 423)

When I come to address the second part of my thesis, it will be seen that financial arrangements between the tiers of government for the provision of government services depend to a great extent on section 96 of the Constitution.

The power to impose conditions on grants given to the States facilitated the expansion of the Commonwealth taxation. There would not be as much point in the Commonwealth collecting tax for the States if it could not use the resulting fiscal imbalance to control how it is spent.

Such is the Commonwealth's embarrassment of taxation riches that even the broad conduit provided by section 96 is too narrow to accommodate it. For decades the Commonwealth has expended money directly on matters for which it has no constitutional responsibility without even using the States as an intermediary. The Commonwealth has transferred taxation revenue directly to schools, local government and other agencies.

That practice was closely scrutinised in *Pape v Federal Commissioner of Taxation*, however ((2009) 238 CLR 1). In *Pape*, taxpayer bonus payments, which were part of the scheme used to combat the Global Financial Crisis (the GFC), were challenged. The High Court held that the appropriation power in section 81 of the Constitution did not support substantive expenditure but that the payments were justified under the nationhood power because of the economic emergency presented by the Global Financial Crisis.

The Commonwealth took the game points from the decision in *Pape* but failed to heed the warning about its finals prospects. In 2012 Mr Williams challenged the Commonwealth chaplaincy program (*Williams v The Commonwealth* (2012) 248 CLR 156) (*Williams*). The Commonwealth contended that the expenditure was supported by its executive power either because the Commonwealth executive has the capacity of a legal person to spend money on any matter it chooses or on the narrower view that the executive can spend money on subjects that fall within the scope of legislative power.

Both views were rejected by the High Court. Justices Hayne and Kiefel observed that section 96 would be redundant if the Commonwealth executive had power to spend money on whatever subjects it wished and to legislate to enforce conditions. Essentially, in *Williams*, the Court held that unless Commonwealth expenditure was:

- directly authorised by the Constitution;
- made under a prerogative power;
- made in the ordinary administration of the functions of government; or
- made pursuant to the nationhood power;

then it must be authorised by a statutory mandate which is supported by a head of Commonwealth legislative power.

## Regulatory levers

I will now move from financial to regulatory powers and the corporations power in particular. In *Huddart Parker & Co Pty Ltd v Moorehead* in 1909, the High Court invalidated very early trade practices legislation ((1909) 8 CLR 330).

Griffith, CJ, Barton and O'Connor, JJ, held that the Commonwealth had power to decide whether corporations could operate at all or not within a particular area, but could not regulate what they did and how they acted within it.

Isaacs, J, dissented. He held that the power extended to regulate all of the dealings corporations had with natural persons or other corporate entities in whatever activity they were so engaged.

In 1971 another Act regulating trade practices again came before the High Court in *Strickland v Rocla Concrete Pipes Ltd* ((1971) 124 CLR 468). Some sections of the Act, for technical legal reasons, were declared to be invalid but all of the Judges unanimously agreed that the restrictive construction of the corporations power given in *Huddart Parker & Co Ltd v Moorehead* was wrong. Justice Isaacs was vindicated.

The extremely broad reach of the corporations power has been affirmed in a series of cases since that decision, most recently in the *State of New South Wales v The Commonwealth* ((2006) 229 CLR 1). The Commonwealth relied largely on the corporations power to enact the *Workplace Relations Act* 1996. It was challenged by the States of New South Wales, Victoria, Queensland, South Australia and Western Australia and several trade union organisations.

The case was argued over six days by a record 39 counsel. Most of those were for the plaintiffs. I appeared as Solicitor-General for South Australia. One by one the States and territory solicitors-general rose to the lectern to put their arguments only to have them dispatched with barely concealed derision. Just before I rose to my feet the Solicitor-General for the Northern Territory, Mr Pauling, QC, had made a brief submission leaving what I thought was just a scrap bit of paper on the lectern. I soon saw that the scrap of paper had been retrieved from a fortune cookie by Mr Pauling the night before. It read:

> The good thing about being wrong is the joy it brings to others.

The majority confirmed that the corporations power extends to comprehensive regulation of the activities, functions, relationships and the business of a corporation.

The majority found support for its construction by tracing the origins of section 51(xx) through the constitutional debates to the financial difficulties and bank collapses and scandals, particularly in Victoria, of the late 1880s and 1890s. It was a collapse that Justice Isaacs had had direct experience in managing as Attorney-General for Victoria at the time.

Their Honours cited Windeyer, J, in the *Payroll Tax* case:

> 'That is not surprising for the *Constitution* is not an ordinary statute: it is a fundamental law. In any country where the spirit of the common law holds sway the enunciation by courts of constitutional principles based on the interpretation of a written constitution may vary and develop in response to changing circumstances.'
> ((1971) 122 CLR 353 at 396-397)

The majority rejected those of the State submissions which relied on notions of a federal balance of legislative power between the Commonwealth and the States. The majority rhetorically asked:

> Thus when it is said that there is a point at which the legislative powers of the federal Parliament and the legislative powers of the States are to be divided lest the federal balance be disturbed, how is that point to be identified? (*The State of New South Wales v The Commonwealth* (2006) 229 CLR 1 at 120)

Corporations are the vehicles which drive 21st century commercial activity in Australia's single national economy. Regulatory power over corporations is therefore a twin pillar to the taxation power in supporting the Commonwealth's control of the national economy.

# II

## Taxation and revenue storing in the first century of the Federation

I will now survey how the taxation landscape has changed since federation. Before federation the sources of most tax revenues for the Australian colonies were customs duties and excises. Other receipts included stamp duties, stock taxes, land taxes and death duties.

The monopoly granted to the Commonwealth over customs duties and excises was calculated both to give the Commonwealth a source of revenue and to create a national free trade zone. During the last century, these taxes declined in importance as a proportion of tax revenue. In 1909 they accounted for three-quarters of total tax revenue but in 2003-04 for only 8.45 percent of tax revenue.[1]

From the early years of the federation the Commonwealth collected more revenue than its expenditure responsibilities required. From 1908 the Commonwealth placed money into special trust accounts for hypothecated purposes so that no money need be returned pursuant to the obligation imposed by section 94 of the Constitution. When the period of 10 years in which returning three quarters of the customs revenue to the States was mandated by section 84 of the Constitution had elapsed, the Parliament enacted the *Surplus Revenue Act* 1910 to remove the obligation to return excess customs revenue altogether.

State attempts to impose sales taxes were invalidated in 1926, 1938 and 1949. The Commonwealth first imposed wholesale sales taxes in 1930 to offset falls in customs revenues.

By 1901 estate taxes, levied progressively, were adopted by all of the colonies and later by the Commonwealth. Gift duties were introduced to prevent the circumventing of death duties by *inter vivos* gifts. Led by Queensland, other State governments and the Commonwealth abolished death and gift duties in the 1980s.[2]

Commonwealth land taxes were introduced during 1910 as a form of wealth tax but became less effective as the productivity base of the economy diversified away from agriculture and because of the wide exemptions given to primary producers. Land taxes were widely unpopular and were removed by the Commonwealth in 1952. Land taxes, however, remain a significant source of revenue for the States and territories. It is an efficiently levied tax which provides a predictable source of revenue. Indeed, there is some support for a broad-based land tax to replace stamp duty but no State or territory government has implemented that politically fraught reform.

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[1] Excise duties are now imposed on the domestic manufacture of petroleum fuels, certain bio fuels, alcoholic beverages other than wine, tobacco products, crude oil and oils and lubricants. Equivalent duties on identical imported products are imposed through customs duties.

[2] By the early 1970s there was substantial pressure to abolish those taxes. Because the taxation brackets had remained static, many ordinary working people fell within them whereas wealthy people avoided them by estate planning and the use of trusts in particular. Exemptions were granted to large classes. Queensland abolished the tax in 1977. Concerned about a flood of emigrants, the other States followed suit. The Commonwealth Government abolished estate and gift duties in 1979. In 1984 all estate duties had been removed at both the State and Commonwealth levels.

The colonies introduced income taxes in the 1880s. The Commonwealth first imposed personal and company income tax[3] in 1915 to replace declining customs duties and excises which resulted from the disruption to world trade by the First World War.

The Commonwealth's offer in 1934 to vacate the income tax field was rejected by the States, however. The Commonwealth's offer moved the recently retired Solicitor-General of Australia, Sir Robert Garran, GCMG, KC, to poetry:

> We thank you for the offer of the cow,
> But we can't milk, and so we answer now –
> We answer with a loud resounding chorus:
> Please keep the cow, and do the milking for us.

Left to collect the revenue needed by the States, it became necessary for the Commonwealth to devise a formula to redistribute that excess. The Grants Commission was established in 1933 to devise, independently, a formula to determine the level of financial assistance required. The formula adopted was that a grant should be awarded to a claimant State to make it possible for that State, by reasonable efforts, to function at a standard not appreciably below that of other States.

Offers to allow the States to levy income tax were repeated by the then Prime Minister, Robert (later Sir Robert) Menzies in 1952, and by Malcolm Fraser in 1977. The States declined, arguing that the Commonwealth had not allowed them enough taxation space within which to levy their own income tax.

Australia's top personal income tax rate has fallen steeply since 1951. The broadening of personal income tax has meant that by the early 1980s the share of personal income tax paid by the top income quintile fell to around half, a level that has since been broadly maintained. Notwithstanding the increase in the proportion of personal income tax paid by lower income quintiles, Australia's average effective tax rate on the income of a range of household types is in the lowest eight of the 30 countries in the Organization for Economic Co-operation and Development (OECD).

In the period, 1945 to 1957-8, the Commonwealth adjusted the special grant model for the reimbursement to the States to take into account per capita and demographic factors. In 1959, Financial Assistance Grants, which encompassed special grants, replaced tax reimbursements.

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[3] When income tax was introduced in 1915, companies were taxed on their profits after deduction of dividends. From 1922, all company profits were taxed.

From 1940 to 1986 Australia maintained this classical company taxation system under which profits were taxed at the company rate and at personal rates when distributed. In 1987, responding to calls to remove this "double taxation", Australia introduced an imputation system whereby resident shareholders receive a credit for tax paid at the company level thereby eliminating double taxation of dividends and, depending on the circumstances, offsetting taxes on wages and salaries.

Full refundability of excess tax credits for resident shareholders was introduced to the Australian imputation system in 2000.

The company tax rate has been reduced in recent times from a high of 49 percent in 1986 to a rate of 30 percent.

Financial Assistance Grants were calculated on a *per capita* basis, and adjusted for Grants Commission considerations. They were, however, then distorted by political considerations.

In the 1960s excess Commonwealth taxation revenue was directed towards education:

- A school laboratories program was funded in the 1960s
- In the late 1960s the Commonwealth commenced funding private schools on a per capita basis.

Grants increased dramatically between 1973 and 1975, drawn by the national reform agenda of the Whitlam Labor Government between 1973 and 1975. Grants were made directly to regional organisations in local government. Those grants could fairly be described as anti-State, but not anti-federalist, because they were consistent with the subsidiarity principle, which demands devolving power and responsibilities to the lowest practical level of government.

From 1975 to 1981, under the Fraser Coalition Government, there was a move away from centralised authority. A new system of tax-sharing entitlements replaced Financial Assistance Grants, giving States greater control of their revenue. Commonwealth funding to local government was wound back.

The States successfully lobbied for access to payroll tax in 1971. The Federal Government had introduced a 2.5 percent payroll tax in 1941 to finance a national scheme for child endowment. Having lost income tax, payroll tax was the sole growth tax available to the States. Payroll tax revenue accounts for between 24 and 36 percent of each State's total revenue.

Since the 1980s increasing attention has been paid to reforming the tax system to improve equity and efficiency. (In 1987 a petroleum resource rent tax was also introduced to generate an equitable return from off-shore petroleum sources.)

As a result of the Asprey Report, Capital Gains Tax and Fringe Benefit Taxes were introduced in 1987. (It was thought that the lack of a Capital Gains Tax distorted investment towards assets providing the terms in the form of capital gains rather than income streams. In 1999 a capital gains discount was introduced to promote more efficient asset management and improve capital mobility by reducing the tax bias towards asset retention and to make Australia's Capital Gains Tax internationally competitive.)

Consistent with most industrialised countries, Australia's tax take (tax to GDP ratio) grew significantly over the 20th century as the role and functions of government expanded. At the time of federation, it was about five percent. It increased sharply when the Commonwealth introduced Commonwealth Income Tax in 1915 to close to 10 percent, and it grew steadily in the inter-war period and during the Second World War, peaking at just below 25 percent in 1946-47. There was a post-war decline before it climbed relatively steadily to 30 percent in 2000. There was a significant jump between 1973 and 1975 as a result of increased funding of social programs.

Australia remains the eighth lowest taxing nation of the 30 OECD members, however. From the position at the time of federation when 100 percent of the Federal tax revenue was from indirect taxes, by 2000 personal income tax made up about 60 percent of the Commonwealth tax take, company income tax 20 percent and indirect taxes under 20 percent. Australia's reliance on direct and indirect taxation is broadly consistent with other OECD countries.

## Vertical Fiscal Imbalance

Vertical fiscal imbalance is a term used to describe the insufficient revenue raising power of the States to meet their expenditure responsibilities and the conversely excessive revenue raising power of the Commonwealth resulting in the need for inter-governmental transfers to correct the imbalance.

The level of vertical fiscal imbalance in Australia is amongst the highest of any federation. The States collect about 16 percent of all taxation revenue and that share accounts for only 40 percent of their own purpose outlays. Vertical fiscal imbalance is a major cause of substantial constitutional fiscal, and governmental service, dysfunction.

In the constitutional debates Charles Kingston of South Australia referred to one of its more obvious mischiefs when he observed that "there is nothing which conduces more to the reverse of sound finance and good Government than an overflowing Treasury".

Another issue it raises is at the heart of discussion about reforming inter-governmental relations. The relevant question is how do you return the revenue to where it can be spent more cost-effectively. In 2010-11 the Commonwealth Government budgeted to provide the States with $94bn in payments, being an amount equivalent to 6.7 percent of GDP and just under 30 percent of Commonwealth tax revenues.

The States have always been very critical of tied grants given pursuant to section 96 of the Constitution. In 2002, the economists Ross Garnaut and Vince FitzGerald estimated that the imposition of conditions by the Commonwealth wasted $145 million. Estimates for 2007-08 put the costs in the billions.

From a low of about 15 percent in 1950, tied grants reached a high of 50 percent in 1995-96, falling a little to 40 percent after the introduction of the goods and services tax (GST).

In 2006-07 grants tied to expenditure on public hospitals, government schools and roads accounted for close to three quarters of the tied grants made by the Commonwealth to the States. Tied grants are generally calculated to:

- encourage States to undertake projects which have greater benefit to the nation as a whole than they have to the residents of the particular State.
- secure cooperative arrangements to achieve national standards in particular services.
- top-up depleted State revenues to assist with such burgeoning expenditure as hospital running costs.
- effect an assumption of responsibility by the Commonwealth of a traditionally State service whether to promote efficiency or to impose its own policy.

Twenty percent of the grants were paid on condition that the State governments pass the money on to non-government schools and local governments.

The nature of the conditions vary, but include:

- General policy conditions such as requiring States to provide free public hospital access for Medicare patients;
- Expenditure conditions requiring, for example, education money to be spent on teachers' salaries and curriculum development;
- Input control requirement in the form of maintenance of effort requiring State governments to match funding arrangements;
- Performance and financial information reporting by the States; and

- Due recognition conditions whereby the States are required to acknowledge publicly the Commonwealth's funding.

The use of Specific Purpose Payments results in many functions being shared between the Commonwealth and the States. They result in a blurring of government responsibilities from cost and blame shifting among levels of government, wasteful duplication of effort or under-provision of services and a lack of effective policy coordination.

The States have argued that conditions are often poorly designed and, conversely, affect the State's ability to provide services by requiring the States to contribute additional resources to the Commonwealth priorities without giving thought to what the States already do. The States also complain that conditions controlling input limit incentives for service providers to improve efficiency and denies them the flexibility to redirect efficiency savings into other areas of expenditure.

## Horizontal Fiscal Equalisation

Issues around how to allocate funds returned from the Commonwealth to States as between the States are even more difficult. Horizontal fiscal equalisation (HFE) is a feature of many federations. It is a process whereby the central government in a federation makes payments to the sub-national governments. It aims to take account of differences in the ability of States and territories to raise revenue and the cost of service provision arising from differences in geography, demography, natural endowments and economies, thereby reducing disparities in taxation across the States.

In 1950, Buchanan described horizontal fiscal equalisation as a system of transfers between the States to place "all State units in a position which would allow them to provide the national average level of public services at average tax rates". HFE prevents migration to areas of better government services unrelated to underlying economic opportunities and national development. It allows a more ready equilibrium to be reached when migration takes place to areas of greater economic opportunity.

A review in 1981 by the Commonwealth Grants Commission showed that, if pure horizontal fiscal equalisation principles were applied, there would be very large reductions in funding to the less populous States. Part of the reason for the review being initiated was an allegation that Commonwealth governments were favouring payments to States of the same political persuasion.

In 1985 the general revenue grant arrangements were restructured. Tax-sharing entitlements introduced in the late 1970s were replaced and a system of Financial Assistance Grants, unrelated to tax collection, resurrected. The amount of those grants was unilaterally reduced in the face of the economic recession of 1988-89, however.

In 1988 the Commonwealth Grants Commission reviewed efficiency aspects of HFE. The Commission concluded that the inefficiencies were not significant enough to warrant any changes in the manner in which the fiscal equalisation process was carried out.

In the aftermath of the decision in *Ha* the Commonwealth imposed a goods and services tax from 1 July 2000. In accordance with the June 1999 Intergovernmental Agreement on Principles for the Reform of Commonwealth/State financial relations (IGA), all of the GST

revenue is returned to the States and territories. Funding pursuant to the IGA has replaced Financial Assistance Grants. The IGA required that:

- the Commonwealth enact GST at 10 percent.
- the Commonwealth abolish its wholesale sales tax.
- the Commonwealth cease to make Financial Assistance Grants.
- the States abolish bed taxes, financial institution duties, stamp duty on marketable securities and debits tax.
- the States review stamp duty on commercial land.
- the Commonwealth would distribute GST revenue grants among the States and territories in accordance with horizontal fiscal equalisation principles subject to transitional arrangements.
- GST remaining would return to the States in bulk untied grants.

The principle adopted by the Commonwealth Grants Commission for the allocation of GST between the States was described by the former Treasurer of Western Australia, Christian Porter, as a "purist form of redistribution". The essential formula is:

> State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

The detail of the formula by which HFE is deployed is necessarily complicated. From the practical starting point of an equal per capita share of the national GST pool, each State's share is adjusted in accordance with two fundamental principles. First, the States with a higher per capita capacity to raise revenue from their own sources (assuming each applied national average tax/royalty rates) have their GST share reduced; States with low capacity have their GST share increased.

Secondly, States with higher per capita costs of service provision due to factors outside their control have their GST share increased and States with low costs have their GST share reduced.

Revenue capacity assessments are based on the (per capita) size of each State's revenue base (for example: mining value of production for royalties; wages and salaries for payroll tax; and value of properties transferred for stamp duty on conveyances). Expenditure assessments recognise higher costs in providing services to indigenous people, the aged (in health care), younger people (in education) and remote areas, and may reflect higher service usage rates by some population groups and/or higher costs per service.

Recent complaints from Western Australia about the system include:

- That its population has decreased.
- The timing of the assessment (it is based on historical data).
- That there is a high cost for the infrastructure it requires for mining.

Mr Porter argued that the fiscal autonomy of sub-national governments is a *sine qua non* of an effective federal structure. A high degree of financial dependency on central government stifles

federalism. Expenditure responsibility needs to be matched by revenue responsibility if sensible public choices are to be made. Vertical fiscal imbalance breaks the link between expenditure and revenue-raising decisions. It raises a confusion of accountability in the minds of voters and a tendency for the influence of the central government on subnational expenditure choices to grow, resulting in overlapping responsibilities. It works against efficiency and public expenditure. It curtails the flexibility of individual States to carry out their responsibilities differently from other States and to cater to their own residents' different preferences.

All of that can be accepted. But it cannot now be remedied by returning the exercise of extensive revenue powers to the States for two related reasons. First, there is a single national economy. Secondly, Australians rightly expect equal or, at least, equitable access to government services throughout Australia.

## A future for the federation

A regression into 19th century's conceptions of State sovereignty is not necessary in order to entrench the principle of subsidiarity and to capture the benefits a federation can deliver.

Twomey and Withers have argued that, where responsibilities are shared, the appropriate approach is to allocate clear roles and manage shared responsibilities. In *Money and Power and Pork Barrelling – Expenditure of public money without Parliamentary authorisation*, Anne Twomey concluded:

> Governments often bleat about the need for budget savings and the improvement of productivity. One simple way of achieving this within the public sector would be for the Commonwealth to stop spending public money on matters beyond its areas of constitutional responsibility in an attempt to buy public favour and instead transfer this surplus public money to the States so that they can fulfil their responsibilities in a more efficient and effective manner.

In 2002, Garnaut and FitzGerald were commissioned by New South Wales, Western Australia and Victoria to prepare a report on the Horizontal Fiscal Equalisation formula. They criticised it as inefficient and recommended that it be abandoned. In its stead the authors proposed equal per capita distribution of grants including an amount for the minimum cost of State government. The States were to receive broad pooled funding for health and education with no micro-management or input control from the Commonwealth. The funds supporting the program were to be distributed on the basis of demographic based demand but no other factor. That is, the capacity of the States to raise their own revenue was to be ignored. The cost of the new program was $A880 million. The program was to be supervised by a Ministerial Council. Under the proposal the Commonwealth was to maintain control of indigenous programs.

That proposal is no longer actively supported by any State. It has serious difficulties, not the least of which would be great variations in the standards of health and education services throughout the country because money supplied by the Commonwealth could be supplemented by those States with substantial taxing capacity. The proposal for Commonwealth control of indigenous programs is impractical because the bulk of the services to indigenous communities must still be delivered through mainstream health and education services.

In November 2008 the Council of Australian Governments agreed on the Intergovernmental Agreement of Federal Financial Relations (IGAFFR). That agreement was said to provide a robust foundation for collaboration on policy development and service delivery.

Ultimately, the principles behind that agreement were not honoured by the Commonwealth or the States or territories. The States saw the execution of the agreement as a shift towards coercive federalism.

The reform of intergovernmental relations is again on the national political agenda.

The terms of reference for the 2014 White Paper on Reforming the Federation set out six principles:

- financial and political accountability for performance in delivering outcomes;
- subsidiarity – meaning that responsibility for particular areas should rest with the lowest form of social organisation capable of performing the function effectively;
- national interest considerations;
- equity, efficiency and effectiveness of service delivery;
- durability; and
- fiscal sustainability related to capacity of tax revenue to support expenditure.

Government services can be shared in a number of ways between Australia's governments. At a speech to the National Press Club on 8 July 2015, the Premier of South Australia, the Honourable Jay Weatherill, proposed that States and territories take responsibility for education from birth to the end of secondary schools with the Commonwealth Government taking responsibility thereafter. On the other hand, he proposed that the States and Commonwealth governments should continue to share responsibility for health. He also proposed a national heavy vehicle road user charging system managed by the Commonwealth to replace State-based registration fees and federal-based fuel excise, and that the States take responsibility for affordable housing by a transfer of the funds applied by the Commonwealth for rent allowance and first home owners grants.

Any number of alternative distributions of responsibility for government services may be proposed. Whatever their content, a clear delineation of responsibility is fundamentally important.

Before a thorough investigation and close study of the issues raised in the 2014 White Paper could be completed, what can only be described as a storm of thought bubbles from State and Commonwealth leaders was floated in the long *prodrome* to the 2016 Commonwealth election.

Reform of the federation will not be achieved by the political class alone. Civil society, business leaders, senior public servants, organisations such as The Samuel Griffith Society, and many others have a large part to play.

## Some forecasting

I will conclude by trying my hand at forecasting, relying on the strands of constitutional authority, economic development and governmental fiscal positions that I have touched on.

It appears to me that sustainable economic development and management is even more obviously the proper province of the national government than defence. Indeed, it is only the global failure of the world economy that is ever likely to lead to a real defence crisis.

Economic management includes, obviously enough, the regulations of corporations, trade practices, securities, trading and banking. It extends to employment and macro-environmental regulation. Taxation is as much a lever for economic regulation as it is for revenue collection. For that reason the vast bulk of direct and indirect taxation is most efficiently levied, managed and collected nationally.

History is against any proposal to return income taxing powers to the States. Differential taxation rates will allow much room for evasion. For example, how is a place of residence or income generation to be determined? It would distort the national economy and, in any event, would not sufficiently disentangle the joint responsibility for the provision of government services which is the cause of considerable difficulty at the moment.

Minor taxes, such as gambling taxes, may well remain local because of the close connection between gambling and the localised problems gambling leads to.

There will continue to be pressure to reduce stamp duties on land transfers. Stamp duty impedes commercial development. It is an uncertain tax base which is affected greatly by economic downturn. There is good reason to doubt that State or territory governments will ever have the political courage to implement it. The fiscal pressures on all levels of government are, however, likely to sweep political concerns aside. Broad-based land taxes are an efficient and more certain tax base for States. A gradual introduction may well be necessary. Indeed, the process has arguably commenced surreptitiously in South Australia, at least, with the imposition of the Emergency Services Levy and the more recent Council Waste Levy.

The high degree of vertical fiscal imbalance in the Australian federation need not, in itself, be an obstacle to greater governmental efficiency at least if the States are not totally dependent on Commonwealth revenue. For so long as a State must collect the marginal revenue needed to fund its services, the State is politically responsible for the efficient use of that revenue. There must at the same time, however, be a reasonable degree of certainty and equity between the States in the grants provided by the Commonwealth, and a clear delineation of their respective areas of *de facto* responsibility. States can then be judged on their performance on the basis of the degree of marginal taxation they impose to derive the extra revenue they need and on the scope and quality of the services they provide.

Vertical fiscal imbalance is a greater problem than it need be because of the politically charged negotiations which drive an eternal cycle of deal-making and deal-breaking. Whilst horizontal fiscal equalisation allocation continues to be contestable in the political arena, the State, Commonwealth and territory governments can each scapegoat the other for political purposes. The dishonouring of agreements may have its source in the party politics of the governments concerned or because of unexpected, or insufficiently planned for changes, in the underlying economy which affect taxation revenues.

It is here that Australia's governments have failed the Federation. They have failed to strike robust agreements which demand adherence. Their agreements are not sufficiently documented to allow the defaulting government to be clearly enough identified and for political consequences to follow.

If this is to be achieved, intergovernmental institutional change is required. States must collaborate in ways which recognise the necessity of both transfers from the Commonwealth and the reasonably uniform provision of equitable standards of government service delivery throughout the country.

In my view, the Council of Australian Governments could play a strong extra-constitutional role in the Federation. It would need to be strengthened by the establishment of a joint Commonwealth, State and territory budgetary office to provide independent objective advice on funding arrangements. It would advise on appropriate adjustments to agreements over time, depending on changing economic circumstances. That agency must, of course, not be a

duplication of existing bureaucracy and will necessarily rely on data and information from State and federal agencies, and the Reserve Bank, to formulate its advice. It could be constituted by seconded Commonwealth and State Treasury officers and permanent staff. It could incorporate the Commonwealth Parliamentary Budget Office. Its work would necessarily include reports on the efficiencies with which all grant funded services are delivered.

The subsidiarity principle should continue to govern the delivery of services. The advantages of State control, where accountability is more immediate, and promotes greater responsiveness, seem obvious.

The starting point for the delivery of government services in the primary areas of health, education and aged care should be a political and economic decision about the standard of services to which Australians are entitled. Benchmark costings can be established for the delivery of those services, taking into account geographic and demographic factors.

Both State and Commonwealth money available for that purpose should be pooled in accordance with an agreed ratio. More efficient States will provide better service levels or a greater range of services demanded by their residents. Alternatively, those States will have surpluses to redistribute to other areas of need or to construction.

The benefits of a properly functioning federation are not limited to service delivery.

Policy formation and service innovation are best informed by practice. The States should not abdicate those fields to the Commonwealth. Collaboration and interstate co-operation to formulate policy and identify best practice would remove unnecessary, idiosyncratic and inefficient differences.

## Conclusion

There is good reason to doubt the capacity of Australia's political class to make the Federation work. There is no point in despondent inaction, however. Ideological crusades are unlikely to achieve much more success in politics and government requires a careful study of the facts on the ground, sound planning and intense pragmatism.

It is that approach that Australian electors should demand of their governments. There is no need to change the constitutional foundations of the Federation to make it work.

## Endnotes

1. R. T. E. Latham, *The Law and the Commonwealth*, 1949, 563-4.