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Federal–State Financial Relations: The Deakin Prophecy

The Vision in Hindsight: Parliament and the Constitution: Paper No. 2

Vision in Hindsight

Vision in Hindsight is a Department of the Parliamentary Library (DPL) project for the Centenary of Federation.

The Vision in Hindsight: Parliament and the Constitution will be a collection of essays each of which tells the story of how Parliament has fashioned and reworked the intentions of those who crafted the Constitution. The unifying theme is the importance of identifying Parliament's central role in the development of the Constitution. In the first stage, essays are being commissioned and will be published, as IRS Research Papers, of which this paper is the second.

Stage two will involve the selection of eight to ten of the papers for inclusion in the final volume, to be launched in conjunction with a seminar, in November 2001.

A Steering Committee comprising Professor Geoffrey Lindell (Chair), the Hon. Peter Durack, the Hon. John Bannon and Dr John Uhr assists DPL with the management of the project.

Centenary of Federation 1901–2001

Denis James
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About the Author

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Contents

Glossary of Terms

Advances:

Repayable, interest-bearing loans, often provided on concessional terms.

Australian Loan Council:

A body consisting of the Commonwealth (represented by the Treasurer) and the Premiers of the States (and, in recent years, the Chief Ministers of the two Territories). Loan Council usually convenes in conjunction with the annual Premiers' Conference. The role of the Loan Council has varied over the decades but essentially it is a vehicle for reaching agreement on the size and allocation of the annual borrowing programs of the Commonwealth and the States.

Block grants:

Grants provided by the Commonwealth to the States for very broadly defined purposes. While the States must use the grants for the purposes as broadly specified, they may exercise a considerable amount of autonomy as to how the funds are actually used.

Central borrowing authorities:

Agencies established by the States to undertake borrowing on behalf of State semi-governmental and local authorities. In recent years, the State governments have also tended to borrow from their central borrowing authorities. The NSW Treasury Corporation is an example of a central borrowing authority.

Claimant states:

Those States which, at various times in the past, have been eligible to apply to the Commonwealth Grants Commission for an assessment of their need for a special grant.

Fiscal capacity:

The financial capacity of a State to meet its responsibilities. This will reflect the adequacy of the various tax bases available to that State, as well as the existence of any disabilities or advantages faced by that State in the provision of services.

General government sector:

All of the agencies of government not classified as public trading or financial enterprises. It includes all government departments and offices and other bodies engaged in providing services free of charge or at prices significantly below their cost of production.

General purpose capital assistance:

Prior to 1987–88, general purpose capital assistance comprised capital grants provided by the Commonwealth to the States along with borrowings by the Commonwealth on behalf of the States. Such assistance could be used by the recipient for capital or recurrent purposes. After 1987–88, general purpose capital assistance consisted only of grants. The provision of such grants ceased in 1993–94.

General revenue assistance:

Grants provided by the Commonwealth to the States and local government, to be used for whatever purposes the recipients might choose. The main form of general revenue assistance currently provided to the States is financial assistance grants. Another form of general revenue assistance to the States is special revenue assistance.

General revenue grant relativities:

To achieve fiscal equalisation, the Commonwealth Grants Commission compares the fiscal capacity of each State in turn with a 'standard' which comprises the State concerned plus all of the other States. The revenue needs and expenditure disabilities faced by each State are assessed and the amount of financial assistance required to offset these needs and disabilities is calculated. After subtracting the amount of eligible financial assistance received by each State, the equalisation assistance requirement of each State is determined. These requirements are then expressed as a set of per capita weights, with the per capita weight for Victoria set at unity and all other weights expressed relative to this. The resulting set of per capita weights are referred to as the general revenue grant relativities.

Global borrowing limits:

Limits applied each year by Loan Council to the new money borrowings by the authorities of the Commonwealth and the States. The limits applied to both conventional and 'non-conventional' borrowings, these latter including sale and leaseback arrangements, trade credits, deferred payment arrangements and so forth.

Grants:

Non-repayable, non interest bearing assistance.

Horizontal fiscal equalisation:

The provision of financial assistance to the States which, as assessed by the Commonwealth Grants Commission, is designed to provide each State with the capacity to provide services at a standard comparable with those of the other States but without requiring that State to impose a greater burden of taxation.

Identified road funding:

Since 1991–92, Commonwealth funding for local roads, which used to take the form of a specific purpose payment, has been provided as general revenue assistance to be used as the recipient sees fit. Virtually all of this assistance goes to local government although a small amount also goes to the States. Since the distribution of these funds is not identical to the distribution of the main general revenue assistance grants, the road funding replacement assistance is separately identified. Funding for State arterial roads was also untied as from 1 January 1994. While such funding was provided to the States initially as Identified Roads Grants, from 1997–98 such assistance has been absorbed into the general financial assistance grants pool.

Identified health grants:

Between 1981–82 and 1988–89, funding for hospital running costs, community health and the school dental program, which had been provided as specific purpose assistance, was converted to general revenue assistance, but separately identified. From 1988–89, such assistance has reverted to being a specific purpose payment.

On-passed grants:

Grants provided by the Commonwealth to the States which are then passed on to other bodies, especially local government authorities.

Payments:

Monies paid by the Commonwealth to the States or local government either in the form of grants or advances.

Premiers' Conference:

A meeting of the Premiers of all States (including, in recent years, the Chief Ministers of the two Territories) with the Commonwealth, which is usually represented by the Prime Minister and the Treasurer. These meeting are usually convened annually, a few months prior to the presentation of the Federal Budget. Whilst the main topic for negotiation has traditionally been the amount and distribution of Commonwealth financial assistance to the States and Territories, such Conferences have also provided a venue for discussions in a range of other areas of common policy interest.

Section 96 grants:

Grants provided to the States by the Commonwealth under section 96 of the Constitution, which permits the Commonwealth to provide financial assistance to the States on whatever terms and conditions the Commonwealth Parliament thinks fit. While most of these grants are for specific purposes, conditions have also from time to time been applied by the Commonwealth to the provision of general revenue assistance to the States.

Special grants:

Grants which were assessed by the Commonwealth Grants Commission to enable a State (a so-called claimant State) with a poor fiscal capacity to function at a comparable level as that of the other States. Usually, the fiscal position of the claimant State was compared with that of standard States. It was common for NSW and Victoria combined to be used as the standard States. With the implementation of the per capita relativities approach to fiscal equalisation, special grants have ceased to be provided.

Specific purpose payments:

Payments made to the States, generally under section 96 of the Constitution, for the purposes, and on such terms and conditions, as may be specified by the Commonwealth. All specific purpose assistance of a recurrent nature is in the form of grants while a small amount of assistance of a capital nature takes the form of advances.

Standard states:

Those States which, at various times, were chosen against which to compare the budgetary positions of claimant states which had applied to the Commonwealth Grants Commission for an assessment of a special grant.

Tax base:

The object upon which taxation is levied. Common tax bases are income, value of production or sales of goods, payrolls, land, etc.

Tied grants:

See specific purpose payments.

Uniform taxation:

Under the Constitution, the Commonwealth is required to impose its taxation so as not to discriminate between any States or any parts of States. Prior to 1942, in addition to Commonwealth income taxation, the States also imposed their own income taxes, with quite different tax regimes applying. In 1942, the States vacated the income taxing field in favour of the Commonwealth, thus creating a uniform, national income tax system under the control of the Commonwealth.

Vertical fiscal imbalance:

An imbalance between the expenditure responsibilities of each tier of government and the own-source revenue resources available to that tier. Australia is characterised by significant vertical fiscal imbalance since the Commonwealth raises around 75 per cent of all government revenues but is only responsible for around 60 per cent of all government outlays.

Major Issues

- At Federation, the six Colonies ceded their most important source of revenue—duties of customs and excise—to the Commonwealth. Nevertheless, the States still bore most of the responsibility for the provision of public services. There was thus a pressing need for a workable system of Federal–State financial relations to be developed to ensure that the States were adequately resourced to meet their expenditure responsibilities.

- The Constitution did set out transitional financial arrangements between the Commonwealth and the States. Section 87 provided that, for at least the first ten years after Federation, three-quarters of all customs and excise revenue raised by the Commonwealth should be returned to the States. Section 94 also required that, after five years from the imposition of uniform duties of customs and excise, the Commonwealth should return all revenue surplus to its requirements to the States. Section 96 also permitted the Commonwealth to provide grants of assistance to the States as it saw fit, while section 105 gave the Commonwealth the wherewithal to take over State debt.

- However, the Constitution did not provide for any long-term resolution of Federal-State financial relations. These have thus evolved over time purely as a result of political processes. At least one commentator, Mr Alfred Deakin, foresaw the outcome of these processes. In a 1902 letter in the London *Morning Post*, Deakin argued that 'the rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the central government. Their need will be its opportunity'.

- Over the past 100 years, Parliament has approved a large amount of legislation which has seen the consolidation of financial power in the hands of the Commonwealth. The Commonwealth currently has access to all the major fields of taxation and the States are highly dependent upon financial transfers from the central government. Commonwealth financial power has enabled it to regulate State borrowing and to provide specific purpose grants in order to impose its priorities on the States in a wide range of programs.

- Certain important milestones can be identified, marking various stages of the inexorable progress of Commonwealth financial domination of the States.

  – the Surplus Revenue Bill 1908 permitted the Commonwealth to pay all surplus revenue into trust accounts (initially to finance pensions), thus negating the provisions of section 94

– the Surplus Revenue Bill 1910 terminated the reimbursement of customs and excise revenue to the States under section 87, replacing this with a 25 shillings per capita grant

– the Land Tax Assessment Bill 1910 represented the first Commonwealth move to share an important State tax base

– the introduction, in 1914, of Commonwealth estate duties and, in 1915, of Commonwealth income tax consolidated Commonwealth participation in tax bases previously exploited only by the States. These measures, of course, were initially implemented by the Commonwealth in order to finance the War

– the Main Roads Development Bill 1923 represented the Commonwealth's first foray into the provision of conditional, specific purpose grants

– the Financial Agreement Bill 1927 established the Australian Loan Council and authorised the Commonwealth to raise virtually all loans on behalf of the States. This legislation also saw the 25 shillings per capita grants abolished in favour of annual Commonwealth debt assistance payments to the States

– the establishment of the Commonwealth Grants Commission in 1933 formalised the allocation of special assistance to those States financially unable to provide services at a level comparable to the richer States

– uniform taxation was introduced in 1942, whereby the Commonwealth unilaterally took sole control of the income tax base, ostensibly for the duration of the War and one year thereafter. The States were compensated through annual tax reimbursement grants

– the Commonwealth announced in 1946 that the uniform taxation arrangements would continue indefinitely

– the extremely ad hoc tax reimbursement grants were replaced by financial assistance grants in 1959

– specific purpose payments began to increase, especially after the Second World War but reaching a high plateau in the 1970s, in a range of important fields such as health, education, transport and urban and regional development

– Commonwealth assistance for local government was introduced in 1974, and

– financial assistance grants were replaced by tax sharing grants in 1976, with this process being reversed in 1985. The determination of financial assistance grants, especially in the latter half of the 1980s was often ad hoc, placing financial strain and uncertainty on the States.

• As a result of these initiatives, combined with High Court disallowance of any form of State indirect tax on the production or distribution of goods, Australia is characterised by the highest degree of vertical fiscal imbalance of any other federal system. The Commonwealth raises approximately 75 per cent of total general government revenue but is responsible for only around 60 per cent of total expenditure on government programs.

- There is little doubt that successive Executives have come to embrace the perceived advantages arising from the structure of Federal-State financial relations which has evolved through the decades. These advantages include the administrative simplicity and equity of a nationally uniform tax and social security system, stronger Commonwealth control over macroeconomic policy, more scope for ensuring that national standards and objectives are met and the ability to achieve significant fiscal equalisation amongst the States. On the other hand, however, it might be argued that the divorcement of revenue raising responsibilities (by the Commonwealth) and expenditure responsibilities (by the States) inherent in the existing structure of Federal–State financial arrangements significantly reduces the overall level accountability for the expenditure of public funds.

- No serious attempt has been made by Parliament to reverse this trend. Even those parties which have claimed to be the guardians of States' rights have not introduced legislation which would have significantly altered the pattern of Federal–State financial relations. It is true that a number of governments have attempted to ensure that the States are more adequately resourced to meet their expenditure responsibilities, but Parliament has rarely been prepared to legislate to provide the States with substantially more autonomy in their fiscal affairs.

- A number of factors may explain such apparent acquiescence, albeit grudgingly on many occasions, on the part of Parliament. Many of the most significant changes to Federal–State financial arrangements have been made in periods of great unrest, especially during the wars and the depression. Moreover, many of the measures placed before Parliament by the Executive had already been discussed and agreed with the States beforehand at Premiers' Conferences. Parliament would have had difficulty justifying its opposition to such arrangements. Most importantly Parliament, along with the States themselves, often found that opposition to Executive policies was untenable given the alternatives. Were Parliament to have opposed proposed legislation, the States may well have found themselves in parlous financial circumstances.

Whilst a principal function of the Parliament has been to examine the various pieces of legislation which have moulded the current pattern of Federal-State financial relations, it should be noted that Parliament has also played an on-going role in scrutinising the application of such legislation, especially in relation to programs funded through specific purpose assistance to the States and Territories. This scrutiny has taken the form of Parliamentary questions, Committee reports and the activities, in recent decades, of the various Estimates Committees which have been required to inquire into and report upon the government's annual Budget estimates.

Introduction

When Australia's founding fathers framed the Constitution in the late 1800s, it is unlikely that they could have foreseen the extent to which the Commonwealth would come to financially dominate the States. Essentially, the Constitution was designed to preserve the powers of the States while reaping the benefits which would flow from federation. For this reason, the Constitution did not specify powers for the States. These powers were taken as given. Only the powers available to the Commonwealth were carefully defined and virtually all of these powers were granted on a concurrent basis with those of the States.[1] Only where commonsense dictated that certain functions were unambiguously of a national nature were the requisite powers granted exclusively to the Commonwealth. Some of these functions include the right to raise armies, matters relating to the coinage, power over territories and the seat of government and the power to impose duties of customs and excise.

Thus, the framers of our Constitution viewed the roles of the Commonwealth and the States as coordinate. Each level of government would carry out the tasks for which it was most suited and each would have access to the financial resources necessary for the exercise of those functions. That such an outcome has not eventuated would seem to imply that our founding fathers were perhaps overly optimistic about the political processes which would develop over successive generations. It must have been obvious to them that, as the nation developed, imbalances were bound to occur between the expenditure responsibilities of the various tiers of government and their available financial resources. However, the Constitution gave very little guidance as to the longer term financial mechanisms which could be put into place to handle these developments. The Constitution concerned itself mainly with the financial provisions applying to the early, transitional period of federation. These provisions can be found in sections 86 to 97 of the Constitution.

Three sections in particular deal with intergovernmental financial transfers. Section 87 (the so-called Braddon clause) states:

> During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, of the net revenue of the Commonwealth from duties of customs and excise not more than one-fourth shall be applied annually by the Commonwealth towards its expenditure. The balance shall, in accordance with this Constitution, be paid to the several States, or applied towards the payment of interest on debts of the several States taken over by the Commonwealth.

This section recognised that the main taxation revenue available to the colonies had been customs and excise revenue. The power to raise such revenue was now to be transferred exclusively to the Commonwealth.[2] It was further recognised that the overwhelming bulk of government functions would continue to be performed by the States. In 1909–10, for example, total Commonwealth expenditure was only $9.5 million compared with $65.7 million by the States. There obviously had to be some mechanism for ensuring the continuing financial viability of the States. The Braddon clause was not universally supported by the State Premiers but it was grudgingly accepted as the least objectionable way of ensuring that some financial security was provided to the States during the early years of federation.[3]

Section 94, however, was designed to give longer-term guidance on the matter of intergovernmental financial transfers. This section states:

> After five years from the imposition of uniform duties of customs, the Parliament may provide, on such basis as it deems fair, for the monthly payment to the several States of all surplus revenue of the Commonwealth.

The States saw this clause as establishing a permanent mechanism for ensuring that all revenue surplus to the requirements of the Commonwealth would be returned to the States in the form of grants. While this principle was endorsed by all States, it must be recognised that there were quite divergent views as to how such revenue should be distributed amongst them in the longer term.[4]

Despite the perceived security afforded by section 94, the States still recognised that, from time to time, exceptional difficulties might arise in the financial circumstances of any State. To provide a safety net in such a contingency, section 96 was inserted into the Constitution. This section states:

> During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

One can only wonder if the founding fathers had any inkling at all as to the power that they were providing the Commonwealth under this section. Not only has it been instrumental in allowing the Commonwealth to extend its influence into functional areas which were not assigned to it under the Constitution but it also allowed the Commonwealth, in the early 1940s, to gain sole access to the income tax base and hence consolidate Commonwealth financial domination of the States.

With the Constitution providing such little guidance on the question of intergovernmental fiscal relations, the development of policies and institutions to address this question has been left up to political processes. These processes have not, however, been particularly happy ones. While at times they have reflected genuine attempts at cooperation and coordination, unfortunately they have also all too often reflected political self aggrandisement, suspicion, self-interest (often of a short-sighted nature) and ideological conflicts. There have been many occasions on which the problems of fiscal federalism could have been addressed, only to be thwarted by conflicting objectives on the part of the Commonwealth and the States or, as often happened, between the States themselves.

The potential dangers to the financial independence of the States did not, however, go unnoticed by all early commentators. In a lengthy discourse published in the London

Morning Post in 1902, Mr Alfred Deakin (Protectionist Party, Ballarat, Vic.), the Federal Attorney-General and a leading architect of Federation, wrote:

> Who shall be the master—the States or the Commonwealth? Our Constitution divided the political power of Australia between them but it left quite open the question of ultimate supremacy and, indeed, assumed that there would be nothing of the kind …
>
> Neither [the Canadian Provinces nor the US States] undertake the many risks of State railways, waterworks, or the many minor enterprises which the Australian colonies have provided for their citizens at public expense. The Australian States have thus incurred liabilities the annual interest on which absorbs more revenue than they have been accustomed to raise or are likely to raise by direct taxes. They are therefore dependent upon receipts from the customs, which are now out of their hands, to pay their way; in other words, they are dependent upon the Commonwealth. It is true that for ten years to come they are entitled to a certain proportion of the duties collected by the Commonwealth department, but this is already insufficient to maintain their existing establishments. After the decade they will be able to claim nothing as of right, and must be content with an amount the Federal Parliament chooses to spare them. Subject, therefore, to the consent of the voters of Australia, the independence of our States is doomed …
>
> The Federal Parliament—if its Chambers agree together—having tasted the sweets of supremacy—will not consent to finance the local treasuries except for value received. If it provides money for the States it will exact tribute from them in some shape …
>
> The rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the central government. Their need will be its opportunity …
>
> Our Constitution may remain unaltered but a vital change will have taken place in the relations between the States and the Commonwealth. The Commonwealth will have acquired a general control over the States, while every extension of political power will be made by its means and go to increase its relative superiority.[5]

The course of events since Federation has essentially confirmed the perspicacity of Alfred Deakin. While there have been periods of relative financial harmony between the Commonwealth and the States, during this first century of federation there has developed an inexorably growing vertical fiscal imbalance between them. Over time, the Commonwealth has come to control all the major revenue sources in Australia. The States have found themselves unable to raise sufficient revenue to meet their own expenditure responsibilities and have relied heavily upon financial assistance from the Commonwealth. This power of the purse has allowed the Commonwealth to achieve its objectives in a range of areas (e.g. health and education) for which it has no explicit constitutional head of power.[6] It has also enabled the Commonwealth to influence the distribution of its financial assistance amongst the States and has allowed it to regulate borrowings by State governments and their authorities.

Commonwealth Financial Domination of the States

The First Four Decades

The first ten years after Federation saw some significant developments in the structure of Federal–State financial relations. With the loss of their customs and excise revenues, the States set about strengthening their remaining revenue bases. Prior to Federation, the States had always levied small amounts of income tax and they began to develop this as a primary source of tax revenue. They also expanded their existing estate duties and stamp duties. Of course, the States also derived a reasonable amount of non-tax revenue from other sources, such as railway profits, land sales and royalties. In 1909–10, for example, of total State revenues of $53 million, 15 per cent was derived from taxation and 53 per cent from non-tax sources. However, Commonwealth grants to the States still represented the remaining 31 per cent of their revenues.

Over the first decade, Commonwealth funding to the States initially reflected the provisions of sections 87 and 94 of the Constitution. The Commonwealth not only returned to the States their entitlement to three-quarters of all customs and excise duty raised but, in the first eight years, also returned all surplus revenue. However, by 1908, the Commonwealth had become dissatisfied with these arrangements. Commonwealth revenues had been boosted significantly through the imposition of its new tariff policy in 1906 and it now found itself having to share this and income from other sources, such as postal and telegraph profits, with the States. Moreover, the Commonwealth was becoming aware of the fact that it would need to make adequate provision for its own expenditures in such fields as defence and pensions.

In March 1908, the Treasurer, Sir William Lyne (Protectionist Party, Hume, NSW) introduced the Surplus Revenue Bill 1908.[7] Sir William argued that surplus revenue was not the excess of revenue over actual expenditure in any one year but an excess of revenue over any Parliamentary appropriation for the purposes of the Commonwealth in the present or future years. Already, the *Audit Act 1901* permitted the establishment of trust accounts within the Public Account and it was the Government's contention that the appropriation of monies from Consolidated Revenue into a trust fund for future use represented an expenditure of the Commonwealth. By establishing trust accounts, the Commonwealth could ensure that no surplus revenue ever eventuated. This would not only obviate the need to make surplus revenue payments to the States (although it would still be bound until 1910 by the Braddon clause arrangements) but it would also enable a government to appropriate monies for future use without the need to obtain annual Parliamentary appropriations.

The measures proposed in the Bill were vigorously opposed, especially by Sir John Forrest (Western Australia Party, Swan, WA), who argued that the Bill was virtually an attempt by Parliament to amend section 94 of the Constitution and an unfair attack upon the financial welfare of the States.[8] Nevertheless, Parliament saw fit to pass this legislation, not least of all because the Treasurer linked passage of the legislation with the establishment of a trust fund from which federal old-age and invalid pensions would be paid. From 1908–09 onwards, surplus revenue payments to the States ceased.

With the effective removal of the surplus revenue requirement, the Commonwealth and the Premiers needed to negotiate new arrangements for ensuring adequate funding to the States. With the approaching end of the mandatory Braddon clause period, not only was there a need to determine the level of such funding but also its allocation amongst the States. The 'book-keeping system' approach which had mainly returned funding to the States in proportion to the amount of customs and excise duty raised in each jurisdiction, was administratively unbearable, but certain States, especially NSW, were opposed to a simple per capita distribution.[9]

Several Premiers' Conferences occupied themselves with these issues and, in 1909, it was agreed between the Deakin Government and the States that the provisions of section 87 of the Constitution would cease as soon as possible and that the States would receive 25 shillings per capita for ten years or thereafter until Parliament determined otherwise. Not surprisingly, the States demanded a referendum to enshrine their 25 shillings per capita into the Constitution. Indeed, this matter was put, rather grudgingly, to referendum in April 1910 but in the face of staunch ALP opposition, failed to obtain the required majorities. Nevertheless this agreement found effect in the Surplus Revenue Bill 1910, introduced by the new Prime Minister, Mr Andrew Fisher (ALP, Wide Bay, Qld), in July 1910.[10] With the demise of all the transitional financial provisions of the Constitution (sections 87, 89, 93 and 94), it was clear that Parliament would have an unconstrained capacity to pass laws determining both the amount and distribution of Commonwealth assistance.

The arrangements authorised by the *Surplus Revenue Act 1910* actually implied a reduction in grants to each State compared with the funding received under the Braddon clause. However, most of the States were able to withstand this decline since their own revenue bases were expanding. However, two States in particular, Western Australia and Tasmania, suffered significant financial difficulties. As a result, special grants began to be paid to Western Australia in 1910–11 and to Tasmania in 1912–13. These additional grants, while being the primitive precursors of the current fiscal equalisation system in Australia, did not overcome the financial problems being experienced by these two States. This fact, combined with concerns about the impact of Commonwealth tariff policy and the regulation of coastal shipping, ultimately led to the development of strong secessionist movements in WA and Tasmania in the late 1920s. South Australia also began to receive special grants in 1929–30. However, no systematic approach was taken to the financial problems of the smaller States until the Commonwealth Grants Commission was established in 1933.

During both world wars, the Commonwealth has had to bear major financial burdens which in turn have led to significant changes in its fiscal relations with the States. Certainly, even in the years prior to the First World War, the Australian Labour Party in particular had argued that the Commonwealth should extend its range of functions, thus requiring an extension of its taxation activities beyond the mere collection of customs and excise duties. It also saw a need to introduce taxes which would redistribute income and wealth. Thus, in

1910, the Fisher Government introduced a federal land tax.[11] This was the first major example of the Commonwealth exploiting a tax base which had been a State preserve. However, the onset of the First World War was the impetus for the Commonwealth to impose both an estate duty and an income tax, thus competing with the States for these important revenue sources.

The Estate Duty Bill 1914 and the Estate Duty Assessment Bill 1914 were introduced by the Prime Minister and Treasurer, Mr Andrew Fisher in December 1914, four months after the outbreak of the War.[12] In debates which followed, several speakers referred to the double taxation that would occur with both the Commonwealth and the States accessing the same tax base. Senator Edward Millen (Liberal, NSW), for example, alluded to a need for a more rational approach to the assignment of taxation responsibilities between the Commonwealth and the States to avoid the difficulties arising from the interaction of Commonwealth and State taxes on the same base.[13]

Mr William Hughes (ALP, West Sydney, NSW), Attorney-General in the Fisher Labour Government, introduced the Income Tax Bill 1915 and the Income Tax Assessment Bill 1915 in August 1915.[14] Again, the need to raise revenue was the main justification for introducing the legislation but a strong argument was also made for the imposition of a tax which would more equitably spread the financial burden of the war across the population. Again a number of speakers expressed concern about the double taxation effect of the initiative and the impact the uniform Federal tax would have on the inhabitants of those States already imposing significant rates of tax.[15] However, the pressing wartime needs of the Commonwealth curtailed any real opposition to the legislation.

By the end of the First World War (1918–19), the Commonwealth was raising almost three times as much in taxation as the States ($65.7 million compared with $23.9 million). At $20.8 million, the Commonwealth was also collecting almost twice as much income tax as the States ($12.2 million). Nevertheless, the States were still able to raise a significant amount of non-tax revenue and were reasonably self-sufficient—only 17 per cent of total State revenue was derived from Commonwealth grants.

Throughout the 1920s, the States and the Commonwealth continued to exploit their existing tax bases. With a considerable war debt to service, the Commonwealth increased its taxation revenues as a proportion of GDP, although most of this increase was derived from increased customs revenue (from a post-war import boom) and from the extension of excise duties, especially to petroleum products. However, it was during the early years of this decade that the Commonwealth began to object to the per capita payments it was making to the States. The Commonwealth felt that it was unfair that it should have to make such payments to States which had developed their own, quite lucrative revenue sources, especially when the Commonwealth had its own pressing financial needs. The Commonwealth also baulked at having to be the collector of taxation which would be spent by another tier of government.[16]

As a result, at a number of Premiers' Conferences in the early 1920s, the States were presented with a range of proposals whereby the Commonwealth would abolish the per capita grants and, in return, either completely or partially vacate those fields of taxation which were in competition with the States.[17] For their part, the States were suspicious of such proposals, fearing that they could lose their grants only to see the Commonwealth re-enter these fields of taxation at some future time. Several States also preferred to see the Commonwealth bear the political odium of tax collection—the beginning of the 'only good tax is a Commonwealth tax' syndrome. In exasperation, the Parliament passed the *States Grants Act 1927* which repealed the Surplus Revenue Act 1910 and made no provision for the payment of grants to the States beyond 1927–28.

However, the 1920s were also characterised by a significant infrastructure boom. Both the Commonwealth and the States expanded their public works programs in a wide range of areas—soldier resettlement, roads, railways, electricity, water supply, telecommunications and so forth. Much of this expenditure was financed through borrowing and debt service charges became major elements of government expenditures. Furthermore, the Commonwealth and the States often found themselves competing for borrowed funds in relatively thin capital markets. In 1923, they entered into a 'voluntary loan council' arrangement, mainly to coordinate the timing and conditions of debt issues. This arrangement was formalised with the Commonwealth and the States signing a Financial Agreement in 1927, which established the Australian Loan Council through which all Commonwealth and State borrowings would be regulated. At the Federal level, the provisions of the Agreement were authorised by the *Financial Agreement Act 1928*.

Not only did the Financial Agreement regulate Commonwealth and State borrowings, it also introduced new revenue arrangements between the Commonwealth and the States. The 25 shillings per capita grants were abolished. However, under the terms of the Financial Agreement, the Commonwealth agreed to make sinking fund contributions in respect of State debt outstanding as at 1927 and, more importantly, also pledged to pay to the States over the next 58 years an annual amount of $15.17 million as a contribution towards interest on State debts.

These interest payments were much higher than the per capita grants the States had been receiving (and which, in any event, had a very uncertain future as a result of the States Grants Act 1927). These factors no doubt encouraged the States to put aside any misgivings they might have had about entering the Financial Agreement. In introducing the Financial Agreement Bill 1927, Prime Minister Stanley Bruce (Nationalist Party, Flinders, Vic.), in a moment of boundless, if misguided, optimism stated:

> I think [this Bill] is, without question, the most important financial measure that has ever been submitted to this Parliament. It provides for a permanent and final settlement of the financial relations of the Commonwealth and the States.[18]

The 1920s heralded other ominous signs for the States. Several States had attempted to extend their taxation bases by imposing taxes upon certain commodities. South Australia attempted, in 1925, to impose a tax on petrol sales while New South Wales imposed a tax on newspapers in 1926. Both were subject to High Court challenges during which the Court began to apply a very restrictive interpretation of section 90 of the Constitution.[19] Section 90 states that the power to impose duties of customs and excise rests exclusively with the Commonwealth.

The High Court decided that such taxes on commodities were an excise and thus could not be imposed by the States. This stance has since been consolidated in numerous other cases, leaving the States with virtually no access to taxes on the production or sale of goods. The exclusion of the States from this important tax base—a situation unique amongst all other federal systems in the world—has been another important factor constraining the fiscal autonomy of the Australian States. Of course, the Commonwealth was able to levy such taxes and, in 1930, federal sales tax was imposed for the first time.[20]

The Commonwealth and the States managed to weather the Great Depression, which put great strains on the financial positions of both levels of government and which forced them to deal cooperatively with many difficult issues. The thorny debt problems facing them, for example, were managed through the newly established Australian Loan Council (discussed in more detail in section 5 below). However by the end of the 1930s, their financial situations had improved significantly. The Commonwealth still relied heavily on its indirect tax base, with customs and excise duties and its newly imposed sales tax raising 75 per cent of its taxation revenue. Personal and company income tax accounted for only 16 per cent. For their part, the States were relatively self-sufficient. In 1938–39, for example, total State and local revenues were $216 million. Of this, only 14 per cent was provided in the form of grants from the Commonwealth. Tax receipts represented 61 per cent of revenue, with income taxes making up around one-half of those receipts. Other significant taxes were estate duties and motoring taxes. The States also saw the returns from their business enterprises recovering from the low levels experienced during the depression years.

This apparent financial harmony between the Commonwealth and the States was, however, again to be upset by war. The Uniform Taxation measures introduced in 1942 struck an enormous blow against the financial autonomy of the States, a blow from which they have never recovered.

Uniform Taxation

The Second World War imposed a serious financial burden on the Commonwealth. In order to finance the War, the Commonwealth resorted to large increases in income taxation. Whereas in 1938–39 income taxes represented only 16 per cent of Commonwealth taxation revenues, by 1941, this proportion had risen to 44 per cent. However, in attempting to increase its own income taxes, the Commonwealth found itself in a quandary. At the time, the various States imposed their income taxes at very different levels. If the Commonwealth continued to raise its income taxes, this would impose a serious burden on the inhabitants of those States with high income taxes. Restricting the level of Commonwealth taxes would not yield sufficient revenue. The Constitution required (sections 99 and 51(ii)) that the Commonwealth could only impose taxation which did not discriminate between the States.

This issue was first addressed by the Menzies Government in 1941 when the Treasurer, Mr Arthur Fadden (Country Party, Darling Downs, Qld) proposed to the States that they should vacate the income taxing field for a number of years in return for equal per capita grants from the Commonwealth. This was overwhelmingly rejected by the States. With the resignation of Sir Robert Menzies (United Australia Party, Kooyong, Vic.) in August 1941, the Government, now led by Mr Fadden, proposed a more complicated solution whereby both the Commonwealth and the States would retain their taxing powers but, overall, taxes would rise during the War with this surplus being passed back to taxpayers as tax credits after the War (in effect, treating the increased tax levy more like a compulsory loan from taxpayers). However, the Fadden Government was unable to have its 1941 Budget passed in the Parliament and was replaced by the Curtin Labor Government.

On 23 February 1942 the newly appointed Prime Minister, Mr John Curtin (ALP, Fremantle, WA), established a three-man Committee to consider the question of the Commonwealth becoming the sole income taxing authority for the duration of the War and for reimbursement payments to be made to the States upon their retirement from the income taxing field. The Committee, two members of which were recognised adherents of the uniform taxation model, presented its report on 28 March 1942, recommending that for the duration of the War and one year afterwards, the Commonwealth should be the sole collector of income tax, with the States being duly compensated. In May 1942, legislation was introduced into the Federal Parliament to give effect to this recommendation.

Uniform taxation was imposed through a package of four Bills. The Income Tax (Wartime Arrangements) Bill 1942 authorised the Commonwealth to commandeer all State tax officers, records and offices for the purpose of collecting the Commonwealth tax.[21] The Income Tax Assessment Bill 1942 specified the income tax base upon which Commonwealth tax would be levied. More importantly, however, it also provided that the Commonwealth had priority over the States in the collection of income tax. This provision therefore placed the political onus upon the States for any 'double taxation'. The Income Tax Bill 1942 simply set out the new Commonwealth tax rates. The States Grants (Income Tax Reimbursement) Bill 1942 provided that the States would be entitled to receive grants from the Commonwealth, based upon the average of their previous two years' income tax collections, on condition that they did not impose their own income taxes. This latter provision found force in section 96 of the Constitution, which authorised the Commonwealth Parliament to make conditional grants to the States. It is ironic that this section, which the States wanted included in the Constitution to safeguard their finances, was now being used to exclude them from exercising one of their most important financial powers—the power to impose income tax.

The States had not been consulted on these new arrangements and the Parliamentary debate on these Bills was both lengthy and bitter. In introducing the Bills the Treasurer, Mr Ben Chifley (ALP, Macquarie, NSW), argued that the measures were the only way in which the Commonwealth could raise the revenue it needed for the war effort.[22] He alluded to the fact that the States were benefiting, through their tax collections, from the increased economic activity associated with the war effort at a time when the Commonwealth was financing the War. He also pointed out that the new arrangements would simplify the collection process for all Australian taxpayers. Even though he stated that these arrangements would apply only for the duration of the War and one year afterwards, several speakers were prescient enough to predict that the arrangements would continue after the War

Those speaking against the Bills concentrated upon four main issues—the unilateral abrogation of the States' constitutional power to levy income tax; the constitutional legality of the legislation; the equity of the formula used to compensate the States for their foregone taxation; and the large increase in tax rates paid by the inhabitants of low tax States. One of the most impassioned speeches in opposition to the legislation came from a former member of the ALP, Mr David Riordan (Federal Labor Party, Kennedy, Qld). He enumerated eight grounds for opposition, the most significant of which were:

1. that they impinge upon the sovereignty of the States
2. that they are at variance with the federal pact, which was truly in the nature of a partnership
3. that if the right of taxation, which is an essence of sovereignty and responsible government, be taken from the States as is now proposed, those sovereign bodies will be reduced to a state of vassalage, which was not envisaged by the framers of the constitution and was not so understood by the people
4. that a responsible State Government with no control over its taxation laws would not be empowered to administer for the peace, welfare and good government of the State, or in the interests of the people who had placed it in power to act as their trustee
5. that any policy of state planning…would be in danger of collapse to the detriment of the people of the State as a whole …, and
6. that a wise and foreseeing government … would have its judicious handling of the finances of the State, and its stability, upset in that it would not be able to budget with any degree of certainty from one year to another …[23]

Despite the manifold objections to the legislation, the package was passed by the House of Representatives on 29 May and by the Senate on 4 June. Even though the Government lacked a strong representation in either Chamber, the pressing need to finance the War precluded any entrenched opposition to the measures. The new arrangements took effect from 1 July 1942. Four State Governments[24] challenged the validity of the legislation but it was upheld by the High Court.[25] Interestingly enough, in its 1942 decision the High Court ruled that the Commonwealth did have priority in the imposition of income tax, thus leaving the States with very little room to manoeuvre. By 1957, when the High Court reversed its decision on priority,[26] the Commonwealth had such a grip on the income taxing field and the States were so dependent upon grants that it would have been virtually impossible for the States to have applied their own income taxes.

Having successfully imposed uniform income tax, the Commonwealth also proceeded, in 1942, to establish a uniform entertainments tax on a similar basis and to provide annual reimbursement grants to the five States which had been levying such a tax.

By 1942–43, State and local taxation receipts had fallen from 61 per cent of total revenue just prior to the War to 28 per cent and even then, around one-half of this amount was local government rates. The only two significant tax bases available to the States themselves were estate and gift duties and motor taxation. Around 36 per cent of revenue was derived from Commonwealth grants. They also continued to derive significant income from their business undertakings.

In January 1946, the prediction of a number of speakers during the 1942 Parliamentary debates proved accurate. At the Premiers' Conference at the beginning of 1946, the States were informed by the Prime Minister and Treasurer, Mr Chifley, that the Commonwealth intended to continue uniform taxation indefinitely. The High Court decisions had removed any doubt that the uniform taxation arrangements could be validly applied by the Commonwealth at any time, not just under its defence powers. The States were unanimous in opposing this initiative but, recognising the futility of opposition, concerned themselves with ensuring that, at least, a more equitable reimbursement grant formula would be implemented.

Even though the Commonwealth's action required the amendment of a number of Federal Acts, the main forum for Parliamentary debate on the issue was the introduction of the States Grants (Tax Reimbursement) Bill 1946, which allowed for the overall pool of grants to grow at a rate determined by population growth and half the rate of increase in average wages. The pool was distributed amongst the States on a 'per capita' basis where populations were adjusted for relative density and the relative distribution of school-age children.

Justifying the retention of uniform income and entertainments taxes, Prime Minister Chifley stated, during the second reading speech to the 1946 States Grants legislation, that the Commonwealth not only had continuing expenses to meet consequent upon the War, but also required financial resources to meet its new peace-time responsibilities. As in 1942, the argument was also made that Australian taxpayers would be more equitably treated and less burdened through complying with only one, uniform set of tax rates.

The same sense of futility which had been faced by the States also pervaded Parliamentary debate in both Chambers. Whilst many opposition speakers chided the Government for breaking its 1942 promise to limit the period of uniform taxation, their position on the Bill was succinctly summarised by Mr George Bowden (Country Party, Gippsland, Vic.) when he stated: 'if this measure be not passed the States will receive no money, and if it be passed they will receive what is tantamount to a dole'.[27]

However, several perceptive observations were made during the debate. Mr Fadden argued:

> The direct effect of this Bill is to define, within fairly strict limits, the quantum of tax revenue which each State shall have annually to carry out its sovereign functions. State borrowing is already rigidly controlled through the Loan Council, and consequently the annual expenditure of each State for the future will be largely within Commonwealth control. As money is the lifeblood of any legislature, this Bill completes what is without doubt the widest and most important transfer of sovereign powers from the States to the Commonwealth since the financial agreements were reached about fifteen years ago.[28]

Mr James Guy (Lib., Wilmott, Tas.) alluded to the inefficiencies that the new financial arrangements would create within the Federation. He stated:

> A bad feature of uniform taxation is that the spending of money by the States is divorced from its collection. Taxpayers have only a remote control over State expenditure. A principle which permits

> one government to raise money to be expended by another is unsound, and is likely to induce a feeling of irresponsibility on the part of the expending authority. The refusal of the Commonwealth octopus to relax its hold and restore State control of income tax, drastically affects the powers, functions and responsibilities of the States as instruments of government.[29]

Given the inevitability of the new arrangements, the States Grants (Tax Reimbursement) Bill 1946 was passed by the House of Representatives on 27 March 1946 and by the Senate on 3 April.

Certainly, the continuation of uniform taxation has been the greatest factor which has moulded Federal-State finances during the past century. With the States effectively excluded from every major direct and indirect tax base, its power of the purse strings has enabled the Commonwealth to strictly regulate State borrowings, increase its control over State functions through conditional grants and given it virtually unilateral control over the level of financial assistance it is prepared to give to the States on an annual basis.

Of course, whether the move to a more centralist federation is desirable or not will be a continuing argument. Both advantages and disadvantages can be identified for the model of federalism which was ushered in during the 1940s. The perceived advantages of the current model would include:

- benefits to both governments and taxpayers from having the major taxes collected and administered by only one level of government
- the facilitation of policies aimed at achieving national economic stability and growth
- the existence of adequate scope for the Federal government to provide grants providing a strong horizontal equalisation effect across the States (reflecting the fiscal equalisation principles developed and recommended by the Commonwealth Grants Commission)
- the facilitation of interpersonal horizontal equity through relatively uniform taxation and social welfare payments throughout the nation
- the ability to take a more 'national' approach to resource allocation and the setting of standards, and
- reduced scope for destructive tax competition amongst the States, whereby the States use their tax powers in a competitive way (e.g. to attract industry or promote interstate migration), forcing other States to match these measures, possibly resulting in a 'no-win' situation for any State.[30]

On the other hand, the centralisation of financial power in the hands of the Commonwealth may have the following disadvantages:

- there may be a loss of diversity and responsiveness to regional needs and preferences, especially where the Commonwealth uses conditional grants to impose uniform standards

- divorcing revenue raising and expenditure decisions at each level of government may lead to fiscal inefficiencies. These might arise from (i) a lack of direct accountability to taxpayers for expenditure decisions; (ii) 'buck passing' amongst the various tiers of government; (iii) duplication and overlap in the provision of public services; (iv) attempts by each level of government to organise their affairs so as to shift costs on to another tier,[31] and (v) the waste of resources inherent in bargaining over responsibilities and in the grant negotiation processes

- uncertainty on the part of the States as to future funding levels, especially during those periods when no fixed growth formula has existed

- the need for the States to resort to 'nuisance' taxes, often with a high ratio of compliance and administrative costs relative to revenue, which can be both inequitable and economically inefficient

- reduced scope for 'constructive' competition between the States, whereby an improvement in tax or expenditure performance by one State may form a model for the other States, and

- the diminution of the political power of the sovereign States, whose governments have been directly elected by their inhabitants.

Federal–State Finances From 1946 to 1975

During the 1950s the States moved very slowly to expand their own tax bases. Even when the Commonwealth ceased to impose land tax during 1952–53, the States were very slow to increase their taxes to fill the vacuum. Similarly, only Victoria, Western Australia and Tasmania reintroduced entertainments tax when the Commonwealth withdrew from that field in 1953–54.

However, during the 1950s, there were attempts by the States to regain their unconditional access to the income tax base. In July 1952, the Commonwealth informed the States that it was willing to discuss with them the possibility of their resuming State income taxation. A report entitled *Resumption of Income Tax by the States* was prepared by Commonwealth and State Treasury officers and the matter was discussed at Premiers' Conferences in February and August 1953. However, those States with lower taxable capacity concluded that they would be better off under the current grants regime and, since no agreement could be reached, the proposal was abandoned. Here is but one example of where the States failed to take advantage of a significant opportunity by pursuing their individual self interests. When the States subsequently put their own proposals for a resumption of income taxation in 1970 and 1992, they found the window of opportunity firmly closed.

In 1955 and 1956, Victoria and NSW again challenged the right of the Commonwealth to use section 96 to effectively exclude the States from the imposition of income tax and asked the Court to rule on the matter of Commonwealth priority. As has already been pointed out, the

Court ruled unanimously in 1957 that the Commonwealth could use section 96 to make the provision of financial grants conditional upon the States not levying income tax, but negated the principle of Commonwealth priority.[32]

In September 1964, the Victorian Government announced its intention of introducing a 'marginal' income tax, to be payable by individuals living in Victoria and operating from the beginning of 1965–66, and requested the Commonwealth to collect the tax on its behalf. The Commonwealth refused to accede to this request. Victoria indicated that it would not collect the tax itself but raised the matter at the June 1965 Premiers' Conference. Again, none of the other States supported the idea of a marginal income tax and the matter did not proceed.

On 19 January 1970, the Premiers of all States signed a document entitled *The Financial Relationships of the Commonwealth and the States*. This document, among other things, requested that State and Commonwealth Treasury officers be instructed to devise a scheme whereby the States should have access to income tax, broadly along the lines of the system operating in Canada. At the subsequent Premiers' Conference in February 1970, the Prime Minister, Mr John Gorton (Lib., Higgins, Vic.), rejected this proposal out of hand, citing a number of considerations. These included macroeconomic policy making implications, the equitable treatment of all Australians brought about by uniform taxation, the budgetary problems that would be faced by the States as income tax receipts fluctuated and the problems that would arise in the process of calculating equalisation grants by the Commonwealth Grants Commission.

Nevertheless, the Commonwealth did attempt to assuage the States by increasing their financial assistance, by agreeing to assist with State debt, and by agreeing to cooperate in identifying potential 'growth' taxes that the States might apply. It was this last agreement which, combined with the High Court's invalidation of State receipts duty on certain types of transactions (one of several attempts by the States to experiment with cleverly devised indirect taxes), ultimately led to the transference of payroll tax from the Commonwealth to the States in June 1971.[33]

There were also significant changes to the way in which revenue grants were provided to the States over the period from 1946 to 1975. By 1957–58, Commonwealth grants (including special grants which had been provided to the poorer States) amounted to approximately twice the level of State taxes, despite the efforts of the States to exploit the limited range of tax bases available to them. More importantly, however, the inadequacy of the tax reimbursement grants arrangements can be seen by the fact that ad hoc, supplementary financial grants were provided to the States in every year between 1949 and 1958. Yet even these did not allow the States to function at a reasonable standard. In 1959, for example, five of the six States applied for special grants to be assessed by the Commonwealth Grants Commission.

In the light of the dissatisfaction with the tax reimbursement grant arrangements, the Commonwealth presented the 1959 Premiers' Conference with a new set of funding principles. The main object of the arrangement was to amalgamate the tax reimbursement grants with the large, ad hoc supplementary grants which had been provided in the past, and to establish a more liberal formula for determining grants in the future. The tax reimbursement grants were consequently replaced by financial assistance grants. These were determined under a formula whereby the grant paid to each State in the previous year was escalated by annual movements in each State's population and annual increases in the level of average wages for Australia as a whole. In addition, to enable the States to offer a higher standard and range of services, it was also agreed that a 'betterment factor', equal to 10 per cent of the increase in average wages, would also apply.

While the relevant legislation no longer specified that the provision of such grants would be conditional upon the States continuing to vacate the income tax field, the implication was that this was expected of them. The provision of the grants was also made conditional on the States continuing to meet their payroll tax obligations to the Commonwealth, which was the sole taxer of payrolls at that time. Financial assistance grants continued to paid from 1959 to 1975, the only real changes to the arrangements relating to the betterment factor. In 1965, the size of the betterment factor ceased to be related to the increase in average wages and was simply set as an escalation factor of 1.2 per cent. In 1970, the betterment factor was further increased to 1.8 per cent.

In 1975, the Whitlam Government, in an attempt to appease the States in the face of considerable discontent, pledged to increase the betterment factor to three per cent. The Government lost office before this could be implemented and the financial assistance grants system was replaced by new tax sharing arrangements under the incoming Fraser Government's New Federalism policy. The Whitlam pledge is, however, significant, as the Fraser Government had to offer the States a guarantee that they would fare no worse under the new tax sharing system before they agreed to accept the New Federalism proposals.

One further significant chapter in the history of Federal-State finances began in the mid-1970s. Several States began, rather tentatively, to introduce what they referred to as business franchise fees. These were designed to be imposts or 'licence fees' on the right to purvey various commodities (rather than on the commodities themselves), although they were levied on the turnover value of such commodities in a prior period. These 'fees' were the last major attempt by the States to introduce indirect taxes by clever legislative design. After such fees survived several High Court challenges,[34] over time the States and Territories all began to introduce these fees on the sale of petroleum, alcoholic and tobacco products.[35]

The existence of these taxes certainly boosted State own-source revenue, but they were finally struck down by the High Court in August 1997, the Court having adjudged that they constituted duties of customs and excise.[36] As will be amplified below, the loss of this significant source revenue was a major factor in encouraging the Howard Government to address the problems of Federal-State financial relations as part of its 1998 Tax Reform package.

Another significant change in Federal–State relationships which was initiated by the Whitlam Government was the provision of Commonwealth financial assistance for local government. In 1973, the Grants Commission Bill 1973 was introduced to provide the Commonwealth Grants Commission with a more modern legislative basis but also to enable it to recommend the amount and distribution of general revenue grants to local government.[37]

This measure gave effect to the stated policy of the Whitlam Government that local government should be given a more explicit role in the Federation. On the whole, the proposal received bipartisan support within the Parliament, although Senator Robert Cotton (Lib, NSW) emphasised that local government was a creature of the States and was ultimately their responsibility. He saw the measure as being 'part of a pattern of seeing the responsibilities of the States eroded'.[38] Grants to local government authorities, provided via the States, began to be paid from 1974–75.[39]

The Era of New Federalisms

The Fraser and Hawke Governments both made important changes to the way in which general revenue funding was provided to the States and Territories. These changes, however, were essentially driven by the Commonwealth Executive in consultation with the States. Despite the significance of these various arrangements, Parliamentary debate on the required enabling legislation was frequently brief and subdued in both the Senate and the House of Representatives. Indeed, much of this legislation received bipartisan support in Parliament, even if such support was qualified on occasions.

When the Fraser Government came to power at the end of 1975, it began to implement its New Federalism policy. At Premiers' Conferences in February, April and June 1976, the details of the New Federalism arrangements were fleshed out. Essentially, the new federalism arrangements comprised the following initiatives:

- the financial assistance grants to the States would be replaced by a system of income tax sharing grants. The States would receive a set proportion of net Commonwealth personal income tax collections. A guarantee was given by the Commonwealth that no State would receive an absolute fall in its grant from year to year and for the first four years of the scheme and no State would receive less than it would have received under the financial assistance grants formula negotiated with the Whitlam Government at the June 1975 Premiers' Conference

- the existing relativities relating to the distribution of financial assistance grants would continue to apply to the tax sharing grants for the time being, but thorough, periodic reviews of all State relativities would be undertaken by the Commonwealth Grants Commission

- under the so-called 'Stage two' arrangements, each State would be able to legislate to impose a surcharge on personal income tax in that State additional to that imposed by the Commonwealth or to give a rebate of such tax. The Commonwealth would be authorised to collect the surcharge or grant the rebate

- in so much as changes in Commonwealth government taxation policies might impinge upon the entitlements of the States, the Commonwealth would provide the States with as much relevant information as possible
- specific purpose programs would be restricted to areas of national need, to encourage innovation or to meet special situations. As far as possible, such grants would be reduced in size or absorbed into general revenue or block grants, and
- local government would also receive a share of personal income tax collections.

These proposals were presented to Parliament by the Treasurer, Mr Phillip Lynch (Lib., Flinders, Vic) in a package of Bills. The States (Personal IncomeTax Sharing) Bill 1976 authorised the payment to the States of a fixed share (just over one-third) of Commonwealth personal income tax collections. The Local Government (Personal Income Tax Sharing) Bill 1976 authorised the payment of a fixed share (initially 1.52 per cent but rising to 2 per cent by 1980–81) of Commonwealth personal income tax collections to local government.[40]

Debate on the Bills was reasonably short. Opposition speakers, such as Mr Chris Hurford (ALP, Adelaide, SA), mainly drew attention to the unlikelihood that tax sharing grants would grow substantially under the new arrangements, especially since the Government had also promised to index personal income tax rates to offset the impact of inflation.[41] In fact, tax sharing grants to the States did grow significantly over the initial years but this mainly reflected the operation of the Whitlam guarantee.

The Income Tax (Arrangements with the States) Bill 1978 was introduced by the Treasurer, Mr John Howard (Lib., Bennelong, NSW), to establish a legislative basis for the Stage two arrangements under which the Commonwealth would collect any surcharges (or grant rebates) applied by the States.[42] Opponents of the legislation branded it as a reintroduction of double taxation and an attack on the equity principles inherent in the application of uniform taxation. Mr Ralph Willis (ALP, Gellibrand, Vic.) saw the measure as 'a device to pass to the States the opprobrium of being responsible for increased taxes'.[43] He argued that the Commonwealth, for its part, would aim to reduce its own expenditures in order to demonstrate its fiscal rectitude.

However, no State attempted to levy such surcharges. Part of the reason for this is that the measure was portrayed in a number of States as a form of double taxation and it would have been very difficult for any one State to have applied such taxes unilaterally. On the other hand, it can also be argued that the Fraser Government did not make sufficient 'tax room' for the States to impose marginal income taxes. Had it been truly wedded to the concept, it could well have retreated from the income tax base and reduced States' grants in a carrot and stick approach. Since it did not pursue this course of action, the initiative remained still-born. The authorising legislation was finally repealed by the Hawke Government in 1989.[44]

The tax sharing arrangements continued to apply throughout the remainder of the Fraser Government's period in office and into the early years of the Hawke Government, although from 1982–83 onwards the States' tax sharing grants were calculated as a proportion (just over one-fifth) of total Commonwealth taxation revenue. This change was designed to allow the grants to reflect movements in overall Commonwealth revenues and to smooth out some of the fluctuations seen in personal income tax receipts.

At the May 1985 Premiers' Conference, the Fraser system of providing general revenue assistance in the form of tax sharing entitlements began to be dismantled. The dismantling of these arrangements, however, appears to have been based more on the macroeconomic concerns of the Commonwealth Government rather than upon any major ideological considerations. The Hawke Government, especially through its 'trilogy' promises, had committed itself to restricting the growth of budget outlays and reducing the deficit.[45] A prime candidate for funding cuts was tax sharing grants to the States. The Commonwealth also pointed to the year-to-year variability in the growth of general revenue funding under the tax sharing formula and argued that more stable arrangements would be beneficial both to itself and the States.

Consequently, from 1985, the tax sharing approach was abandoned and a system of financial assistance grants to the States was re-established. From 1986, tax sharing for local government was also abandoned, again being replaced by financial assistance grants whose magnitude was directly linked to the level of financial assistance grants to the States. These financial assistance grant arrangements with both the States and local government have applied to the present day.

The return to a system of financial assistance grants to the States was accompanied by a certain degree of arbitrariness in the determination of the size of their grants pool. The Commonwealth proposed that, for 1985–86, the pool of financial assistance grants would remain the same in real terms as the States had received in tax sharing grants in the previous year. The Commonwealth further pledged that, in each of the years 1986–87 and 1987–88, financial assistance grants would be increased by two per cent in real terms.

At the May 1987 Premiers' Conference, however, the Commonwealth argued that in view of the need to reduce the call of the public sector on the nation's savings, restraint in public spending was required. Instead of granting the two per cent per annum real increase in funding, as agreed in 1985, the Commonwealth ensured that the pool of financial assistance grants and identified health grants for 1987–88 were maintained in real terms only. At the same time, the Commonwealth cut back substantially the general purpose capital assistance it was providing to the States.

For several years following 1987–88, the treatment of financial assistance funding was quite ad hoc. The States were informed what their funding would be for the year in question and no indication was given as to future funding arrangements. This obviously made financial planning difficult for the States. In 1988–89, financial assistance grants were reduced by 2.8 per cent in real terms; in 1989–90 a further real cut of 2.9 per cent was imposed, while for 1990–91, a cut of 3.7 per cent in real terms was experienced.

Interestingly enough, this treatment of the States was generally endorsed by the Federal Opposition. Speaking on the States Grants (General Revenue) Bill 1987, Mr Andrew Peacock (Lib., Kooyong, Vic.) stated: 'I am not criticising the Government for reducing payments to the States. With the economy as it is, that is required'.[46] Mr Peacock did, however, accuse the Commonwealth Government of imposing constraints upon the States without exercising similar restraint in its own financial activities. He and his colleagues took an identical position during debate on the States Grants (General Revenue) Bill 1988,[47] while Mr Alexander Downer (Lib., Mayo, SA), leading the Opposition debate on the States Grants (General Purposes) Bill 1989, again stated that the legislation would not be opposed, but on the grounds that it was a Budget Bill.[48]

At the June 1990 Premiers' Conference, however, the Commonwealth pledged that in each of the three years from 1991–92 to 1993–94, general revenue grants would be maintained in real terms. Even though the real terms guarantees received by the States protected their grants from inflation, they did not provide the States with a 'growth' element of revenue. In order to meet their expenditure commitments, the States were forced to exploit other taxes. The land tax base was widened, motoring taxes were increased and a heavier reliance was placed upon gambling taxes. However, in 1994, the Keating Government provided the States with a much more generous, real per capita guarantee, which escalated the pool of financial assistance grants by not only the rate of inflation but also by the rate of national population growth. The continuation of this guarantee was ultimately made conditional upon the States agreeing to meet specified milestones in implementing the principles of the National Competition Policy.[49] This guarantee currently applies.

The Fraser Government was not alone in formulating a New Federalism policy. In June 1990, Prime Minister Robert Hawke (ALP, Wills, Vic.) pledged that a more enlightened New Federalism would be implemented over the 1990s.[50] Mr Hawke scheduled three Special Premiers' Conferences to give effect to this policy. At the Special Premiers' Conference in October 1990, the various Heads of Government resolved to institute more cooperative arrangements. Among these were:

- an examination of the relative revenue raising capacities of the three tiers of government with a view to achieving greater balance of resources and responsibilities
- an examination of specific purpose assistance with a view to reducing this as a proportion of total assistance
- a greater degree of information interchange on macroeconomic issues, the state of the public finances and future fiscal strategies
- more prior consultation between the Commonwealth and the States when the decisions of the Commonwealth would have an impact directly on State finances
- a recognition that the provision of intergovernmental assistance should be predictable, thus ensuring stability and facilitating forward planning, and
- minimising the duplication of functions.

The Commonwealth demonstrated its good intentions in the area of rationalising access to certain forms of taxation by transferring its bank account debits tax to the States as from 1

January 1991. Furthermore, some financial relief was provided to the States after several years of cutbacks by the introduction of a real terms guarantee on their general revenue funding from 1990–91 to 1993–94. There was also a commitment to converting a substantial amount of road funding from specific to general purpose assistance.

A Working Group of senior Commonwealth and State treasury officials was established to review the distribution of Commonwealth and State government taxation powers. The principles guiding such a review were, among others, that appropriate arrangements should:

- enable each level of government to have access to reliable sources of revenue which would be, so far as possible, commensurate with expenditure responsibilities and national responsibilities for macroeconomic management
- ensure a rational allocation of revenue powers between levels of government which would improve the efficiency, effectiveness, equity and simplicity of the Australian tax system
- maintain revenue neutrality on a national basis, and
- reflect an acceptance of the principle of fiscal equalisation.

The Committee produced a report for consideration at the November 1991 Special Premiers' Conference to be held in Perth.[51] However, just prior to this Conference, the States approached Prime Minister Hawke with a plan for the imposition of a marginal State income tax. This plan was attacked by the former Treasurer, Mr Keating (ALP, Blaxland, NSW),[52] who had recently moved to the backbench and, following considerable political debate within the government, the Prime Minister refused to countenance the proposal. With the Commonwealth being perceived as downgrading its commitment to allow a full and meaningful debate on the problem of vertical fiscal imbalance, the States boycotted the proposed November Special Premiers' Conference and held their own Premiers' and Chief Ministers' Meeting in Adelaide, also in November.

At that meeting, the Premiers and Chief Ministers reiterated their support for a marginal income tax scheme, providing the States and Territories with access to the personal income tax base and with a corresponding reduction in financial assistance grants. The Premiers pointed out that, on the Working Group's own calculations, up to 6 per cent of the personal income tax base could be transferred to the States without restricting the Commonwealth's ability to continue providing fiscal equalisation grants. They also noted that this level of tax sharing would be unlikely to impinge upon Federal macroeconomic policy objectives.

In December 1992, Mr Keating replaced Mr Hawke as Prime Minister, partly due to party concerns at the direction Mr Hawke's New Federalism was taking. It was within this environment that the Premiers met with Mr Keating on 11 May 1992 in Canberra. A position paper by the Premiers and Chief Ministers was circulated prior to this meeting.[53] This paper set out two main options for redressing what the States perceived as the problem of vertical fiscal imbalance. The first option was the States' plan for a six per cent marginal income tax while the second was a return to a tax sharing arrangement. No decision was taken on this subject and the question of vertical fiscal imbalance has remained unaddressed.

In fact, Australia is characterised by the largest degree of vertical fiscal imbalance between its tiers of government than any other federal nation. The Commonwealth currently raises around 75 per cent of total Commonwealth and State general government revenues. On the other hand, Commonwealth outlays for its own purposes are only around 60 per cent of total general government outlays. As a result, the Commonwealth makes grants (both general revenue grants and grants for specific purposes) to the States which represent approximately 45 per cent of State and Territory general government revenue. Furthermore, there is a great variation in the degree of dependence of individual States upon the Commonwealth. Whereas Victoria and New South Wales are the least dependent States (deriving around 42 per cent of their revenues from Commonwealth grants), Tasmania obtains 55 per cent of its revenues from the Commonwealth while 75 per cent of Northern Territory revenues are provided by the Commonwealth.

Australia now faces another new federalism policy—that proposed by Prime Minister John Howard as part of his Tax Reform package. This policy has drawn its impetus from two sources—the desire of the Howard Government to reduce dependence upon income taxation through the introduction of a goods and services tax (GST) and the need to address the financial plight of the States in the aftermath of the High Court decision on business franchise fees.

As mentioned previously, the States began to introduce business franchise taxes on petroleum, tobacco and alcoholic products in the mid-1970s. By the mid-1990s, such taxes were raising around $5 billion annually, or 16 per cent of total State taxation revenue. After a number of decisions which began to throw doubt upon the constitutional validity of such taxes, the High Court ruled, in August 1997, that such taxes were invalid.[54] The Commonwealth responded by introducing 'safety net' measures whereby it increased its own excises or sales taxes on the affected commodities and passed the proceeds on to the States. In turn, the States were required to reimburse those producers who might now be paying higher taxes than those levied by the States prior to the High court decision. It was obvious that such a convoluted mechanism could not really continue to be anything more than a temporary solution to the problem.

On 13 August 1997, the Prime Minister announced the establishment of a Taxation Task Force (of Commonwealth officers) to prepare options for reform of the taxation system.[55] The Task Force was asked to give consideration to a broadly based indirect tax system to replace some or all of the existing indirect tax bases, with any new taxation system involving major reductions in personal income tax. As part of this process, the Prime Minister also directed the Task Force to address the issues of reforming Commonwealth-State financial relations.

The Tax Package, released on 13 August 1998, proposed the introduction of a broadly based goods and services tax to replace the present wholesale sales tax. Substantial reductions would also be made to personal income taxes. As far as the new Federal–State relations are concerned, the States had to abolish nine taxes, mainly financial institutions taxes and stamp duties on the financial and capital transactions of businesses, forgone their financial assistance grants and accepted responsibility for funding local government in return for acquiring the total revenue raised from the GST (less Commonwealth administration costs).

However, in order to secure passage of the enabling legislation in May 1999 the Government had to agree to modify its proposals following negotiations with the Australian Democrats.[56] As a result of these negotiations, basic foodstuffs are to be exempt from the GST, excise reductions on diesel fuel are to be limited and a number of new environmental programs are to be implemented. Since these amendments will reduce the amount of revenue flowing to the States from the GST, the States will need to defer the abolition of their financial institutions duties, their bank account debit taxes and a range of stamp duties on capital transactions. The Commonwealth also agreed to continue funding local government.

For the first few years of this scheme, the States would actually be worse off were it not for bridging grants provided by the Commonwealth but, on all reasonable assumptions, they should eventually be better off financially in the longer term. It should be appreciated, however, that even though these new arrangements could ultimately improve the financial position of the States, they do nothing to restore State fiscal autonomy. Individual States would still not be free to determine their own tax regimes. The amount of revenue received by each State would be determined on the recommendations of the Commonwealth Grants Commission and would not reflect State policy preferences. In fact, the abolition of State taxes and the receipt of the federally raised GST proceeds would actually accentuate the degree of vertical fiscal imbalance to a significant degree.

Specific Purpose Payments

Section 96 of the Constitution provides the Commonwealth with the power to grant financial assistance to any State on such terms and conditions as the Parliament sees fit. As a result, the Commonwealth provides a range of grants and/or advances to the States for both recurrent and capital purposes, subject to conditions specified by the Commonwealth. Generally, specific purpose payments carry the requirement that the funds provided should be expended for a particular purpose, although the States may be given varying degrees of discretion in the use of such funds. In some instances, there may be very broad agreement as to the principles and program delivery mechanisms associated with the grant, while other grants are subject to very detailed conditions relating to project approval and reporting requirements. Some Commonwealth grants are subject to matching requirements on the part of the States.

Section 96 grants have frequently been used by the Commonwealth to impose its priorities on the States, especially where the Constitution does not provide the Commonwealth with a head of power to act directly in particular areas of concern. Often such grants have been used to ensure that national objectives can be attained or national standards set.

Specific purpose payments were first made available in 1923 for the provision of roads. These grants, which carried State matching requirements, were allocated amongst the States according to a formula which took into account State population and area. When the Main

Roads Development Bill 1923, providing grants worth $1 million, was introduced by the Prime Minister, Mr Stanley Bruce (Nationalist Party, Flinders, Vic.), it met with a mixed reception.[57]

In the House of Representatives, Mr Frederick Pratten (Nationalist Party, Martin, NSW), objected that a distinction should be made between Federal and State finances. He argued that 'instead of simplifying and keeping separate State and Federal finances, we are making unnecessary complications'.[58] The concerns voiced in the Senate were even more explicit. Senator Walter Duncan (Nationalist Party, NSW) stated: 'We are establishing a dangerous precedent… What we are now proposing to do is to depart altogether from the provisions of the Constitution. The proposal is … to interfere with matters that are peculiarly the prerogatives of the States'.[59] Senator William Senior (Nationalist Party, SA) was even more forceful. He objected that the Bill established the principle that the Commonwealth could grant certain sums of money to be spent in a specific way. He continued: 'It is certainly establishing the precedent that the Commonwealth Government shall take a very strong hand in dealing with matters that hitherto have been regarded as purely State affairs'.[60]

Despite these objections, the Bill passed both Chambers, mainly because the additional funding was seen to be necessary to address the significant unemployment problem existing at that time.

Nevertheless, a warning bell sounded for the States when the Commonwealth entrenched its position on road funding with the passage of the *Federal Aid Roads Act 1926*. In 1926, Victoria, NSW and South Australia mounted a High Court challenge to Commonwealth road funding legislation, arguing that it breached the allocation of responsibilities under the Constitution and that the distribution of the grants might contravene section 99 of the Constitution.[61] The High Court ruled that the provision of the grants was a valid use of section 96 and, much more importantly, that the exercise of section 96 powers were not bound by the provisions of section 99.[62] This established the principle whereby, even though the Commonwealth could not give preferential treatment to a State through taxation, it could do so through the provision of conditional grants. This has provided the Commonwealth with considerable flexibility in allocating funds amongst the States when implementing its specific purpose programs.

Apart from road funding, there were very few specific purpose payments provided prior to the 1940s. The only instances involved a few ad hoc grants for primary industry assistance, for employment creation and for certain railway capital projects.

The period from 1942 onwards saw the burgeoning of Commonwealth specific purpose assistance to the States. The year 1945–46 saw the first Commonwealth–State Housing Agreement negotiated. Some assistance to universities commenced in 1951–52, while secondary schools, colleges of advanced education and TAFE colleges were assisted from the mid-1960s. Specific purpose funding for mental health institutions commenced in 1955, while assistance for blood transfusion services and tuberculosis control had already begun a few years earlier. Reasonably large amounts of money were also provided to the States in the post-war period to enable railway standardisation and upgrading projects to proceed. Assistance was also given for shipping and harbours, water supply and electricity infrastructure and agricultural programs. Frequently, the provision of such assistance was accompanied by the establishment of advisory or coordinating commissions. The Australian Universities Commission was established in 1959 to advise on grants to the States for universities. This was followed by such other bodies as the Commonwealth Bureau of Roads, the Schools Commission, the Hospitals and Health Services Commission, the Social Welfare Commission, the Cities Commission and many more.

The provision of specific purpose assistance reached its climax during the Whitlam period. Between 1972–73 and 1975–76, such assistance quadrupled, from $931 million (or 25.8 per cent of total assistance) in 1972–73 to $4,153 million (48.5 per cent of assistance) in 1975–76. Specific purpose assistance programs were commenced in such areas as pre-schools and child care, hospitals, community health, urban and regional development, urban public transport and local government. It was also in 1974 that the Commonwealth began to fully fund higher education.

The centralising tendencies of the Whitlam government raised suspicion and considerable opposition on the part of the States. While the States, almost without exception, were quite prepared to accept the additional Commonwealth funding, they began to object to the degree of Commonwealth intervention in matters that had been purely State responsibilities. They also complained that the provision of such a large amount of tied funding seriously reduced their budget flexibility and ability to pursue their own priorities. Concerns also began to be expressed about the growing problem of overlap and duplication of Commonwealth and State activities, with its ramifications of wasted resources, more complicated government and confusion for the users of government services.

As part of its New Federalism policy, the Fraser Government pledged that specific purpose programs would be restricted to areas of national need, to encourage innovation or to meet special situations. As far as possible, such grants would be reduced in size or absorbed into general revenue or 'block' (i.e. less regimented) grants.

Upon gaining power, the Fraser Government began dismantling some of the Whitlam programs, especially those in the area of urban and regional development which had most raised the ire of the States. However, the reduction in specific purpose payments was not great in its first few years of office. Specific purpose assistance to the six States rose from $4152 million in 1975–76 to $5335 million in 1980–81. It is true that the proportion of specific purpose assistance fell from 48.5 per cent of total assistance in 1975–76 to 42.1 per cent in 1980–81 but this was due more to the rapid increase in general revenue funding as a result of the operation of the 'Whitlam guarantee' than to any marked decline in specific purpose assistance. Certainly the proportion in 1980–81 was still much higher than the proportion of 25.8 per cent which had obtained in 1972–73. It should also be realised, however, that general revenue assistance to local government is, in the first instance, paid to State government as a specific purpose payment. The provision of local government assistance since 1974 and especially the rapid growth of such assistance in the late 1970s certainly boosted specific purpose payments.[63]

One major change to specific purpose funding occurred in 1981–82 in relation to health funding. Originally the Commonwealth provided specific purpose assistance to the States to aid in meeting public hospital running costs, community health programs and the school dental program. However, the Commonwealth announced in April 1981 that specific purpose funding for the above purposes would be terminated, being replaced by additional general revenue grants (referred to as identified health grants) which, while being in lieu of health funding, could be utilised by the States in whatever manner they saw fit. This arrangement initially applied only to Victoria, NSW, Queensland and Western Australia but with the termination of their hospital funding agreements in 1984, South Australia and Tasmania also entered into these arrangements. The impact of absorbing health grants into general revenue had the effect of reducing the proportion of specific purpose assistance in 1981–82 to 33 per cent of six-State total assistance.

This measure was given effect through the *States (Tax Sharing and Health Grants) Act 1981*. In introducing the legislation the Treasurer, John Howard, stated:

> The Government sees this change as a move towards ending divided control over the provision of health care services in the States and the Northern Territory and thus eliminating potential costs and inefficiencies that can be involved in such duplication … The States should assume their full constitutional responsibilities for the provision of health services and should be free to determine their own priorities ...[64]

While the Fraser Government reduced the significance of specific purpose grants to some extent, such grants again expanded under the Hawke Government. Whereas in 1982–83, specific purpose payments to the six States and the Northern Territory represented 35.8 per cent of total payments, by 1991–92, such payments comprised 52.6 per cent.

A significant reason for this growth was the about-turn by the Hawke Government on the absorption of health funds into general revenue funds. Although it was initially the intention of the Hawke Government to continue the Fraser policy of ultimately absorbing such funds into financial assistance grants, this process was abandoned in 1988–89, when health funding was again provided as specific purpose grants. Apart from the obvious political advantages for the Commonwealth in being seen to be funding health in the States, at a practical level, the link between health funding and financial assistance grants had to be broken to protect health funding levels from the erosion, in real terms, of the financial assistance grants. The formula for setting hospital funding grants, based on changes in award wages, the CPI and an age-sex weighted population factor, ensured that such grants fared better than financial assistance grants.

The question of specific purpose payments was also revisited during the series of Special Premiers' Conferences convened by Prime Minister Hawke. At the Special Premiers' Conference in October 1990, it was agreed that the question of the impact of specific purpose funding on the management of State budgets would be addressed. A Working Group on Tied Grants was formed to consider the desirability and method of reducing specific purpose payments as a proportion of total Commonwealth Grants. In addition, Ministerial Councils were encouraged to examine the role of tied grants in their functional areas of concern.

At the July 1991 Special Premiers' Conference, Heads of Government again restated their commitment to significant reform of tied grants and agreed that all options should be considered. However, the prospect of decentralising control over a range of important functions generated considerable dissent within Government ranks. As a result, even though there has been greater effort put into ensuring that the activities of the two tiers of government are better coordinated in several areas and that more flexibility exists for the States to use the grants provided, there has not been any significant untying of specific purpose funding.[65] The most visible initiative in reducing tied grants was the decision to hand greater financial responsibility to local government and the States for roads. In 1991–92, local road funds were converted into general revenue assistance grants (identified roads grants), mostly to local government. Similarly, from 1 January 1994, arterial road funding to the States was untied, leaving the Commonwealth financially responsible only for the National Highway System and selected Roads of National Importance.

The level of specific purpose assistance to the States remains high. In 1998–99, 49 per cent of overall Commonwealth assistance is specific purpose. Even though the changed treatment of health grants explains the majority of the growth in specific purpose grants between the 1980s and the 1990s, there have also been significant increases in other Commonwealth programs, such as home and community care and housing assistance. The current level of specific purpose assistance is, moreover, somewhat biased downwards compared with earlier years since funding for higher education, which previously had been paid through the States, is now being paid directly to tertiary institutions.

Even though the Tax Reform Package proposed by the Howard Government has attempted to address the issue of longer-term State financing, it has not attempted to address the question of specific purpose assistance. In fact, the Government has made it clear that, even though the proposed arrangements are designed to improve the financial viability of the States, the Commonwealth will ensure that this will not be offset by any change in the overall level of specific purpose assistance.[66]

The plethora of programs funded by the Commonwealth through specific purpose payments to the States has, of course, required the passage of a huge amount of legislation through Parliament over many decades. Whereas it might be argued that Parliament has frequently faced constraints in its handling of general revenue grants legislation, the same cannot be said for legislation relating to programs in the fields of health, education, transport, the environment and so forth. Such legislation has frequently been the subject of heated debate and amendment. Moreover, the funding and administration of such programs has much more frequently been subject to the processes of Parliamentary scrutiny. Not only have individual programs often been the subject of Parliamentary questions and significant Parliamentary Committee reports but the effectiveness of such programs has also been a major area of investigation by the various Parliamentary Estimates Committees, which have been required to inquire into and report upon the government's annual Budget estimates.[67]

Horizontal Fiscal Equalisation

Australia has developed a somewhat unique attitude among the various Federal countries to the provision of general revenue assistance to the States in that it has, for quite some time, attempted to ensure that such grants are not only designed to offset the vertical fiscal imbalance between the tiers of government but also aim to yield some form of horizontal balance or 'fiscal equalisation' amongst the States.

Virtually from the moment of Federation, a number of smaller States argued that they were being disadvantaged by the new political and economic structure. In 1910, Western Australia sought and obtained special financial grants from the Commonwealth to assist it in overcoming particular budgetary problems which it claimed were accentuated by federation and various federal policies. Similar grants began to be paid to Tasmania in 1912 and to South Australia in 1929. These poorer States expressed concerns about the financial impact upon them of a range of Commonwealth initiatives including tariff policy, protection of the coastal shipping industry and the operation of the Federal Court of Conciliation and Arbitration. They further argued that the inadequacy of their resources constrained their ability to provide services at a standard comparable to that of the richer States.

The special grants which were provided to the smaller States to offset these pressures were very ad hoc, and did not really provide a good basis for horizontal balance. Strong secessionist movements developed and, in 1933, a Western Australian referendum proposing secession was successful, although legal action was taken to prevent secession from actually occurring.

It was in this environment that the Commonwealth Grants Commission was established and given the task of inquiring into and reporting on applications by the States for special financial assistance. In introducing the Commonwealth Grants Commission Bill 1933, the Prime Minister, Mr Joseph Lyons (United Australia Party, Wilmott, Tas.) asserted that there was a 'need to address the needs of the States on the basis of principles rather than expediency'.[68] The legislation was welcomed by all parties.

After investigating various approaches to the provision of special assistance, the Commission decided, in 1936 to provided additional assistance whenever a State, through financial stress from any cause, was unable to efficiently discharge its functions as a member of the federation at a standard not appreciably below that of the other States, providing that the State in question was making a reasonable effort to raise revenues from the sources available to it.

Under this approach, any State requesting special financial assistance (a so-called 'claimant State') had its revenue raising capacities and expenditure disabilities compared with other States in the federation (the so-called 'standard States').[69] Where a claimant State was assessed by the Commission as suffering a significant financial disadvantage, a special grant for that State was recommended. It should be noted that, up until 1974, special grants recommended by the Commission were basically concerned with assessing a claimant State's minimum financial needs and not with bringing its fiscal capacity up to the level of the most prosperous States. Moreover, claimant States were generally required to make an above-average effort to raise revenue from their own sources before qualifying for special assistance.

In 1974, the Commission adopted a more sophisticated approach to the assessment of special assistance to the States. This reflected the Commission's philosophy of attempting to balance equality with diversity. Equality requires that any State should be able, if it so wishes, to provide services to its citizens at the same standard as other States yet without having to impose a higher burden of taxes and charges. On the other hand, diversity requires that each State should be free to choose the standard and range of services to be provided to its citizens, and the level and pattern of its charges, independently of what is done in the other States of the federation.

Putting this philosophy into practice, the Commission developed a methodology whereby special grants to claimant States were calculated so as to provide that level of assistance necessary to give a State the *capacity* to provide services at a standard comparable with those of the standard States but without requiring that State to impose a greater burden of taxation. In essence, the Commission decided that it would make its recommendations on the basis of equalising *potential* fiscal capacity, while ignoring as far as possible any policy differences between the States.

In simple terms, once a claimant State applied to the Commission for the assessment of a special grant, the Commission would attempt to ascertain the potential revenue raising capacity of that State compared with that of the standard States, that is, by comparing their relative revenue bases. Furthermore, the Commission also attempted to assess the extent to which a claimant State experienced particular expenditure disabilities, relative to the standard States, in the provision of public goods and services.[70] It is the Commission's consideration of both the revenue and expenditure disabilities of the States that is one factor which makes the Australian approach to fiscal equalisation unique. Canada, for example, bases its horizontal equalisation grants solely on an assessment of the relative revenue positions of its provinces.

Since 1982, the Commission has adopted a full fiscal equalisation approach to the assessment of the distribution of general revenue assistance. Up until 1982, the Commission was required to assess special grants for those States which requested an assessment. This approach had two main flaws.

Firstly, a special grant was only assessed when requested. No mechanism existed for periodic review of the appropriateness of the distribution of Federal general revenue grants amongst *all* States. Any State which considered that it was getting more than adequate funding would obviously not request the Commission to undertake an assessment. Throughout most of Australia's federal history, the distribution of the bulk of Federal general revenue assistance had always been somewhat ad hoc, and, by the 1970s, it was widely felt that a number of smaller States were now receiving quite generous funding. In fact, by the late 1970s, only Queensland and the Northern Territory were regular claimants. It was argued that, if anything, it was the two populous States of New South Wales and Victoria which were being excessively called upon to financially support the rest of Australia, yet these two States, due to their 'standard State' status, were effectively excluded from the Commission's examination. Full fiscal equalisation was not being achieved.

Secondly, the special grants system was open-ended, in that such grants were paid by the Commonwealth as additional assistance to the States concerned. Such assistance was thus purely at Commonwealth expense. With growing Commonwealth concern with its own budgetary position, such a situation was seen as untenable.

In order to achieve more equity in the provision of general revenue grants and to 'close' the system to ensure that fiscal equalisation would be paid from the existing general revenue grants pool, the Fraser Government requested the Commission, in 1979, to undertake regular reviews of the appropriate general revenue sharing relativities which should apply to the allocation of such assistance amongst all the States. This is the approach which continues to apply to this day.

To achieve fiscal equalisation, the Commission continues to compares the fiscal capacity of each State in turn with a 'standard' which now comprises the State concerned plus all of the other States and Territories. In this way, the relative fiscal capacity of all States can be determined. These assessments are ultimately expressed as a set of per capita funding relativities which are used to weight the distribution of Commonwealth general revenue assistance to the States.

The Commission currently undertakes major reviews of its methodology at five-yearly intervals but makes annual recommendations as to the funding relativities which should apply. In making comparisons of the States' revenue and expenditure needs for any year, the Commission utilises State financial information over the preceding five year period. While such an approach has the effect of smoothing annual adjustments by the States to new funding relativities, it does mean that the Commission's recommendations are being made on the basis of quite outdated financial information. This has led to certain anomalies whereby the recommended distribution has reflected past financial circumstances rather than the current financial needs of the States.

The issue of fiscal equalisation amongst the States and Territories will no doubt remain a vexed question. The distribution of Commonwealth financial assistance to the States has preoccupied policy makers and legislators from as far back as the pre-Federation Constitutional Conventions. Over the years, it has been quite common, during Parliamentary debate on the numerous Bills appropriating general revenue assistance to the States, to find speakers objecting to the 'unfairness' of the allocation to their particular State or Territory. Despite the inherent difficulties facing the Grants Commission in applying its philosophy and methodology, it has nevertheless fulfilled the function of providing a transparent set of principles upon which the distribution of Commonweath financial assistance can be assessed.

The Commission now faces a major methodological challenge as a result of the Howard Government's Tax Reform proposals. The Commission will be tasked with recommending the allocation of the proceeds of the GST amongst the States. Not only will this revenue replace the financial assistance grants currently provided to the States, it will also replace the invalidated business franchise fees and a range of other abolished State financial fees and taxes. The States will now have a much more limited range of tax bases upon which the Commission can base its assessments. More importantly, however, the Commission may have to seek guidance on how to treat those States which had not been fully exploiting the tax bases replaced by the GST proceeds. This problem arises particularly in the case of Queensland which has never imposed a business franchise fee on the sale of petroleum products.

Government Borrowing

Prior to 1901, the States had pursued significant public infrastructure programs and thus entered the Federation with considerable debts. The loss of their customs and excise revenues therefore imposed significant pressures upon them to service this debt, a fact alluded to by Alfred Deakin in his 1902 letter from London. This pressure could be alleviated either by the payment of assistance from the Commonwealth to the States (as was indeed specified under sections 87 and 94 of the Constitution) or through the assumption by the Commonwealth of State debt. The framers of the Constitution provided this latter possibility by inserting section 105, which authorised the Commonwealth to take over all or part of the State debt outstanding at the time of Federation. In 1910, this section was amended to enable the Commonwealth to assume State debt incurred at any time.

In the first two decades of Federation, the Commonwealth and the States often found themselves competing for loan funds, both on the London financial market and the relatively thin domestic market. The Commonwealth had often argued that there should be greater coordination of Federal and State borrowing and made any suggestion of a takeover of State debt conditional upon this. However, although several States permitted the Commonwealth to issue securities on their behalf during the First World War, in general the States were opposed to greater cooperation in the debt raising field, fearing that they could lose autonomy in pursuing their own capital programs.

However, during the 1920s, the question of co-ordinating Commonwealth and State borrowings became more pressing. The Commonwealth had a large amount of War debt to refinance and the States were undertaking substantial infrastructure programs. The two tiers of government often found themselves competing in both foreign and domestic capital markets. Not only did they try to outbid each other in terms of interest rates and various concessions and incentives, there were also frequent conflicts in the timing of debt issues.

To resolve this problem, the Premiers' Conference of May 1923 agreed to the formation of a voluntary Loan Council. This Council was concerned only with coordinating the timing of debt issues, the rate of interest and other terms and conditions attached to loans. Initially, there was no attempt to centralise borrowing powers—each government was responsible for the issuance of its own debt. On the whole, the voluntary Loan Council operated smoothly for the next few years.[71] During this time, however, it became practice for the Commonwealth to issue all securities on behalf of itself and the States on both the domestic and the New York capital markets.

Ultimately, in June 1927, the Commonwealth submitted to the voluntary Loan Council the draft of a Financial Agreement which would formalise the borrowing arrangements currently applying. The Agreement provided for the establishment of the Australian Loan Council to regulate borrowing by the Commonwealth and the States; for contributions by the States and the Commonwealth to the National Debt Sinking Fund; and for grants by the Commonwealth to assist the States to meet their interest and Sinking Fund obligations.

By December 1927, the Financial Agreement had been accepted by the Commonwealth and the States. It was ratified by all consenting parties during 1928. The Commonwealth legislation which gave effect to the Agreement was the *Financial Agreement Act 1928*. In order to overcome possible Constitutional objections to the Agreement, a referendum was held in November 1928 to insert an enabling section (section 105A) into the Constitution which authorises the Commonwealth to enter into agreements with the States with respect to their public debts and to undertake the management of such debts. In an environment of general public concern about the size of the public debt, the referendum was overwhelmingly carried.

The Australian Loan Council comprises the Heads of all jurisdictions—the Prime Minister and the Premiers of the States (and, more recently, the two Territories) or their nominees. Each member has one vote except for the Commonwealth which has two votes plus a casting vote. It is therefore possible for a majority of States to outvote the Commonwealth but the financial strength of the Commonwealth has effectively allowed it to dominate Loan Council for much of its life.

Loan Council approves the aggregate borrowing program of the Commonwealth and the State governments; allocates the aggregate approved program amongst its members; and, until recently, set the terms and conditions for the raising of loans. Until 1994, all borrowing by the States was to be undertaken by the Commonwealth and secured by the issuance of Commonwealth securities, although State governments could undertake short-term 'temporary' borrowings and arrange their own borrowing from financial bodies constituted within their jurisdictions. This latter provision is quite significant, since from the early 1980s, State governments began to undertaken most of their borrowings through the central borrowing authorities (CBAs), such as the NSW Treasury Corp, which they established.

In offering to borrow on behalf of the States, the Commonwealth made various commitments. In particular, the Commonwealth undertook to subscribe from its own resources any funds included in the approved Loan Council borrowing program for the States which were not forthcoming from the issuance of securities. In effect, the Commonwealth agreed to underwrite the loan programs of the State governments.

In discussing the operation of the Financial Agreement, a very important distinction must be made. The Financial Agreement applied only to the borrowing of the general government sector. It did not formally encompass borrowing by semi-governmental and local authorities established by the Commonwealth and the States. It became apparent within a few years of the ratification of the Agreement that governments could circumvent the provisions of the Agreement by assigning functions to such authorities, which were able to borrow in their own right and issue their own securities. As a result, in 1936, it was resolved to bring such authority borrowing under Loan Council supervision. This was done by the negotiation of a 'Gentlemen's Agreement'. This Agreement, although not given any force of law, persisted until 1984–85, when it was superseded by the so-called Global Borrowing Limits, under which Loan Council asserted its control over authority borrowings (and all other financial arrangements, e.g. financial leases, involving the incurring of a liability).

The Loan Council arrangements worked reasonably well until after the Second World War. For the first few years after the War, the infrastructure programs of the States were constrained more by the lack of physical resources rather than financial resources, while the Commonwealth with its greater taxation revenues flowing from the imposition of Uniform Income Tax had few financial worries. Public loans could be raised without too much difficulty and at quite low rates of interest.

With the economic boom of the 1950s, however, the role of Loan Council began to change. Initially Loan Council might have been regarded essentially as a mechanism for ensuring a more efficient method of loan raising in a thin and fragile domestic capital market, although the Commonwealth was also aware that it was a useful instrument for the control of interest and exchange rates. From the 1950s, however, it began to be regarded by the Commonwealth more than ever as an instrument of macroeconomic policy—a role which it has continued to play to the present day. In the early 1950s, faced with significant inflationary problems, the Federal Treasurer advocated significant reductions in the proposed Loan Council borrowing programs. With Commonwealth control over monetary policy, the loan programs proposed by the States had no hope of success and capital funding to the States was only maintained by the Commonwealth subscribing its own financial resources by contributing to what is commonly referred to as 'special loans'.

It was this ability of the Commonwealth to underwrite the borrowing programs of the States which gave the Commonwealth substantial power over the magnitude of the Loan Council programs. It should be noted, however, that the States probably acquiesced to some extent in this situation, as they were able to gain access to guaranteed levels of funding at reasonable interest rates. Nevertheless, through this process, the Commonwealth was able to assert a considerable amount of influence not only over the economy but also over the fiscal independence of the States. The States were made even more beholden to the Commonwealth after 1970, when a portion (around one-third) of the States' agreed Loan Council programs began to be provided in the form of non-repayable grants (although this move was also designed to ease financial pressures upon the States which, in 1970, had had their request for restored access to the income taxing field refused).

Beginning in 1978, the States were gradually allowed more freedom in arranging their borrowings. In 1982–83, for example, electricity authorities were exempted from Loan Council control, albeit on a trial basis. The States were also permitted to nominate all or part of the borrowings raised on their behalf by the Commonwealth to be used for public housing, on very concessional terms.

Even though the Global Borrowing Limits imposed by the Hawke Government in 1984 imposed stricter regulation of the volume of overall State borrowing, more freedom was given to the States to determine the terms, conditions and origins of these borrowings.

Moreover, throughout the 1980s the States increasingly met their own borrowing needs through the issuance of CBA securities rather than through Commonwealth securities issued on their behalf. By 1988–89, the Commonwealth was no longer borrowing on behalf of State governments.

At the June 1990 Loan Council meeting, this de facto situation began to be formalised. The Commonwealth and States agreed that not only would the Commonwealth cease borrowing on behalf of the States but also that the States would make accelerated Sinking Fund contributions such that all Federal debt outstanding for the States would be fully redeemed by 2005–06. The States were thus made responsible for the refinancing of such debt and the raising of new debt.[72] Nevertheless, Loan Council was still empowered to determine the level and distribution of overall State and Commonwealth borrowing programs.

A wide ranging reform of Loan Council arrangements was precipitated in 1992 by the so-called Victorian Loans Affair, when Victoria was alleged to have significantly exceeded its annual borrowing entitlement under the Global Limits. Moreover, the Treasurer, Mr Dawkins (ALP, Fremantle, WA), was accused of having failed to adequately provide details of the Victorian financing arrangements in the annual Budget papers. A Senate Committee[73] was constituted to examine the Victorian Loans Affair and to review the operation of the Financial Agreement in general. Before the Committee reported, however, the Commonwealth, represented by Mr Dawkins, called a special meeting of the Loan Council in December 1992 at which the Commonwealth and the States agreed to significant changes to the Loan Council borrowing arrangements.

The Financial Agreement Bill 1994 and the National Debt Sinking Fund Repeal Bill 1994 were introduced by Mr Robert Elliott (ALP, Parramatta, NSW), Parliamentary Secretary to the Treasurer, to give effect to these arrangements.[74] This legislation provides for the continued existence of the Australian Loan Council and formally incorporates the ACT and the Northern Territory into the Council. It removes the requirement for the Commonwealth to borrow on behalf of the States and permits the States to borrow by the issuance of securities in their own name. As a result, borrowing by the individual States is now much more subject to financial market scrutiny, which is designed to impose the financial discipline upon them which previously had been the province of Loan Council.

Technically, Loan Council is now tasked merely with monitoring and approving the loan programs of the Commonwealth and the States. Nevertheless, the current Loan Council arrangements are still used as a tool of macroeconomic policy. The overall level of conventional borrowings and other financing arrangements proposed by the Commonwealth and the States is still assessed for consistency with Commonwealth macroeconomic objectives. A rather arbitrary mechanism, introduced in 1991, which would have seen overall Loan Council program allocated amongst the States on an equal per capita basis, was replaced in December 1992 by a system of Loan Council Allocations which reflect the actual financing needs of the individual jurisdictions. Should the proposed Loan Council program exceed the Commonwealth's preferred level, more onus is placed upon those States with more fragile debt positions to reassess their borrowing needs. As part of the 1992 reforms, jurisdictions are also required to improve the frequency and openness of their financial reporting, not only as a means of permitting the monitoring of their financial activities by Loan Council but also to provide more reliable information to financial markets.

The legislation effecting these changes was strongly endorsed by all major parties. In fact, Opposition speakers objected only that the measures should have been implemented sooner, as an extension of the liberalisation process begun by the Fraser administration, rather than having been frustrated by the restrictive controls imposed by the Global Borrowing Limits.[75] Only one of the minor parties expressed doubts as to whether the Commonwealth is really prepared to allow the States more freedom in their borrowing. Senator Dee Margetts (WA Greens, WA) warned that 'by moving to a position where the power is held by fact rather than in law, the Bill appears to be loosening Commonwealth control when actually it is not'.[76]

While the amount of government borrowing and the size of the public debt have been favourite topics of debate within the Parliament ever since Federation, Loan Council arrangements per se have not attracted a great deal of attention within the Parliament. One very significant exception to this was, of course, the Overseas Loans Affair[77] of 1975. It was alleged that the Government, mainly through the actions of the Treasurer, Mr James Cairns (ALP, Lalor, Vic.) and the Minister for Minerals and Energy, Mr Francis Connor (ALP, Cunningham, Qld), was seeking to raise up to $4 billion through unorthodox avenues and was attempting to circumvent Loan Council guidelines by portraying such borrowing as being for temporary purposes only. Debate on the Overseas Loans Affair occupied much of the Parliamentary agenda throughout the latter half of 1975. As a consequence, the Treasurer was dismissed on 2 July 1975 and Mr Connor resigned on 14 October 1975. The allegation of financial mismanagement deriving from this issue was the keystone of the Opposition's refusal to pass supply, which ultimately led to the dismissal of the Whitlam Government by the Governor-General on 11 November 1975.

Conclusion

Over the past 100 years, Parliament has approved a significant amount of legislation which has inexorably concentrated financial power in the hands of the Commonwealth. The Commonwealth currently has not only garnered sole access to all of the major sources of taxation revenue in the federation but has used its strong financial position to regulate borrowings by the States. Through the use of section 96 grants, the Commonwealth has also increasingly imposed its priorities upon many of the programs which are implemented by the States.

It might be tempting to simply conclude that Alfred Deakin was correct in asserting that, once having tasted the 'sweets of supremacy', the Federal Parliament would inevitably legislate to extend the financial and policy role of the Commonwealth at the expense of the States. However, this is probably too simplistic an explanation. In the matter of Federal–State financial relations, perhaps more than in any other area of legislation, Parliament has frequently been placed in a situation where it has been constrained in its ability to modify the will of the Executive.

There is little doubt that successive Executives have come to embrace the perceived advantages arising from the structure of Federal–State financial relations which has evolved through the decades. These advantages include the administrative simplicity and equity of a nationally uniform tax and social security system, stronger Commonwealth control over macroeconomic policy, more scope for ensuring that national standards and objectives are met and the ability to achieve significant fiscal equalisation amongst the States.

No serious attempt has been made by Parliament to reverse this trend. Even those parties which have claimed to be the guardians of States' rights have not introduced legislation which would have significantly altered the pattern of Federal–State financial relations. It is true that a number of governments have attempted to ensure that the States are more adequately resourced to meet their expenditure responsibilities. Examples of this are the provision of the Whitlam guarantee in 1975, the Keating real per capita terms guarantee in 1994 and the current proposals of the Howard Government to provide the entire proceeds of a GST to the States. However, Parliament has rarely been prepared to legislate to provide the States with substantially more autonomy in their fiscal affairs.

There may be quite a number of reasons for such apparent acquiescence, albeit grudgingly in many instances, on the part of Parliament. Certainly, many of the most significant changes to Federal–State financial arrangements have been made in periods of great unrest, especially during the wars and the depression. Despite the bitter debates in 1915 and 1942 over proposed Commonwealth income tax policies, Parliament would have found it very difficult to have denied the Executive the wherewithal to conduct a war. Even the first foray by the Commonwealth into the use of tied grants (for roads) in 1923 was tolerated as a measure to reduce unemployment.

Moreover, many of the measures placed before Parliament by the Executive had already been discussed and agreed with the States beforehand at Premiers' Conferences. Parliament would have had difficulty justifying its opposition to arrangements which were countenanced by the States, even if the latter may have done so grudgingly.

But most importantly Parliament, along with the States themselves, often found that opposition to Executive policies was untenable given the alternatives. Were Parliament to have opposed proposed legislation, having only limited power to propose alternative policies,[78] the States may well have found themselves in parlous financial circumstances. To requote Mr Bowden during the 1946 tax reimbursement grant debates: 'if this measure be not passed the States will receive no money, and if it be passed they will receive what is tantamount to a dole'. A similar complaint was heard almost 50 years later from Senator Dee Margetts who stated, during debate on the Financial Agreement Bill 1994: '[this legislation] belongs to that strange category of Bills that come through the Parliament from time to time—Bills we do not want to support but, given the alternatives, do not want to oppose'.[79]

Endnotes

1. To say such powers are concurrent means that they may be exercised by both the Commonwealth and the States. Section 109 of the Constitution, however, ensures that where Commonwealth and State laws are in conflict, Commonwealth law will prevail to the extent of any inconsistency. Apart from the explicit heads of power provided in the Constitution, the High Court has also acknowledged the existence of an 'implied national power'. The High Court has held that the Commonwealth may legislate in respect of matters, not enumerated in the Constitution, that are inferred from the 'peculiar province of the Commonwealth in its capacity as the national and federal government' (see, for example, *Davis v Commonwealth* [(1988) 166 CLR 79] and *Victoria v Commonwealth (Australian Assistance Plan Case: AAP Case)* [(1975) 134 CLR 338].
2. The transfer of power over duties of customs and excise was effected by section 86 of the Constitution. Federal exclusivity over this form of taxation was guaranteed by section 90.
3. J. Quick and R. Garran, The Annotated Constitution of the Australian Commonwealth, Angus and Robertson, Sydney, 1901, p. 219.
4. The requirement for the return of Commonwealth surplus revenue to the States, which ultimately found force in section 94 of the Constitution, was one of the earliest issues agreed during the Constitutional debates. This principle was endorsed by the Colonies during the Constitutional Convention held in Sydney in March 1891.
5. Alfred Deakin. 'From our Special Correspondent, Sydney', *Morning Post*, London, 12 May 1902.
6. It should be noted that the exercise of Commonwealth powers has not been extended merely by virtue of its dominant financial position. High Court decisions have also validated the expansion of Commonwealth activities (for example, greater Commonwealth involvement in environmental issues by virtue of being a signatory of international environmental conventions, relying upon its external affairs power under the Constitution). Certain Constitutional amendments have also provided the Commonwealth with wider powers, such as the inclusion, in 1946, of placitum 51(xxiiiA) which authorises the Commonwealth to provide a range of social security and health benefits and services.
7. Hansard, House of Representatives, 31 March 1908, p. 9847.
8. Hansard. House of Representatives, 31 March 1908, p. 9856.
9. The distribution of customs and excise revenue amongst the States was extremely complex as it relied upon the so-called 'book-keeping' system to determine the flow of excisable goods between the States in order to return the proceeds of the duties proportional to the excise paid by the inhabitants of each jurisdiction. This process was required by sections 89 and 93 of the Constitution and was to apply for the first five years after the imposition of uniform customs and excise duties or thereafter until Parliament determined otherwise. The book-keeping system also adjusted the States' grants for the cost of departments transferred from the States to the Commonwealth and for new Commonwealth expenditures in the States.
10. Hansard, House of Representatives, 14 July 1910, p. 414.

11. The Land Tax Assessment Bill 1910 was introduced by Mr Andrew Fisher, Hansard, House of Representatives, 16 August 1910, p. 1535.
12. Hansard, House of Representatives, 15 December 1910, pp. 1932 and 1948 respectively.
13. Hansard, Senate, 16 December 1914, p. 1976.
14. Hansard, House of Representatives, 18 August 1915, pp. 5844, 5851.
15. Sections 99 and 51(ii) of the Constitution require that Commonwealth taxation shall not discriminate between the States or parts of States.
16. Commonwealth distaste with bearing the odium for raising such taxation was summed up by Dr Earle Page (Country Party, Cowper, NSW). In introducing the States Grants Bill 1926, he condemned 'the vicious principle of one authority raising taxation for another to spend'. Hansard, House of Representatives, 4 June 1926, p. 2682.
17. At the 1926 Premiers' Conference, for example, the Commonwealth offered to vacate the fields of land taxation, entertainments tax and probate duties and to reduce its income tax by 40 per cent.
18. Hansard, House of Representatives, 14 December 1927, p. 3178.
19. *Commonwealth and Commonwealth Oil Refineries Ltd v South Australia* [(1926) 38 CLR 263] and *John Fairfax and Sons Ltd and Smith's Newspapers Ltd v NSW* [(1927)39 CLR 139].
20. Sales Tax Assessment Bills, introduced by Hon. James Scullin (ALP, Yarra, Vic.), imposed a two and a half per cent wholesale sales tax on a wide range of commodities. (Hansard. House of Representatives. 30 July, 1930, p. 4930.
21. All States except Western Australia had, in any case, been the collectors of income taxes levied by the Commonwealth.
22. Hansard, House of Representatives, 15 May 1942, p. 1285.
23. Hansard, House of Representatives, 27 May 1942, p. 1601.
24. Victoria, Queensland, South Australia and Western Australia.
25. *South Australia v Commonwealth (First Uniform Tax Case)* [(1942) 65 CLR 373].
26. *Victoria v Commonwealth (Second Uniform Tax Case)* [(1957) 99 CLR 575].
27. Hansard, House of Representatives, 27 March 1946, p. 657.
28. Hansard, House of Representatives, 27 March 1946, p. 653.
29. Hansard, House of Representatives, 27 March 1946, p. 656.
30. A classic example of such competition was the abolition by Queensland, in 1977, of estate and gift duties. By 1984, all States and the Commonwealth had abolished these taxes, which were both lucrative and one of the very few taxes imposed on wealth in this country.
31. For example, where State hospitals provide drugs to outpatients only upon prescription, thus passing the cost from the hospital system to the Commonwealth's Pharmaceutical Benefits Scheme.

32. *Victoria v Commonwealth (Second Uniform Tax Case)*, loc. cit.

33. The Commonwealth instituted payroll tax in 1941, initially to cover the cost of the Commonwealth's child endowment scheme.

34. See, for example, *Dennis Hotels Pty Ltd v Victoria* [(1959–60), 104 CLR 529], *Dickenson's Arcade v Tasmania* [(1974), 130 CLR 177] and *HC Sleigh Ltd v South Australia* [(1977), 136 CLR 475].

35. Queensland, however, never introduced such a tax on petroleum products.

36. On 5 August 1997, the High Court brought down a combined decision in the cases of *Walter Hammond and Asociates v the State of NSW and others* and *Ha and anor v the State of NSW and others* [(1997) 189 CLR 465].

37. Hansard, House of Representatives, 17 May 1973, p. 2302.

38. Hansard, Senate, 5 June 1923, p. 2349.

39. Commonwealth general revenue assistance to local government has continued to the present day. It is interesting to note that, as part of the tax and Federal-State relations reforms proposed by the Howard Government in 1998, the States would have assumed the responsibility of funding local government from the revenue they received from a Federally imposed goods and services tax. However, as a result of negotiations with the Australian Democrats in May 1999, the Commonwealth has agreed to continue providing funding for local government.

40. Hansard, House of Representatives, 14 October 1976, pp. 1895, 1898.

41. Such indexation would have prevented so-called 'bracket creep'. However, indexation was never fully applied by the Fraser Government and was ultimately abandoned.

42. Hansard, House of Representatives, 31 May 1978, p. 2817.

43. Hansard, House of Representatives, 1 June 1978, p. 2973.

44. At the time, the Hawke Government seized upon comments by the Leader of the Opposition, Dr John Hewson (Lib., Berowra, NSW) that he might favourably consider some resumption of income tax by the States. The 1978 Act was repealed to require any future government to explicitly put legislation to this effect before the Parliament.

45. During the campaign prior to the December 1984 election, Mr Hawke committed his Government to a trilogy of pledges. These were:
    - there will be no increase in tax revenue as a proportion of GDP in 1985–86 and over the life of the Parliament
    - government expenditure will not increase as a proportion of GDP in 1985–86 and over the life of the Parliament, and
    - the budget deficit will be reduced in money terms in 1985–86 and reduced as a proportion of GDP over the life of the Parliament.

46. Hansard, House of Representatives, 20 October 1987, p. 1147.

47. Hansard, House of Representatives, 13 October 1988, p. 1655.

48. Hansard, House of Representatives, 25 October 1989, p. 1874.
49. The National Competition Agreement, signed by all States and the Commonwealth in 1993, requires each jurisdiction to undertake regulatory review, removing those regulations which do not have a proven public interest basis. The Agreement also requires the jurisdictions to promote competition within those areas traditionally supplied by monopoly public authorities, such as electricity and water. As an incentive to meet these objectives the States, in addition to the real per capita grants guarantee, will also receive national competition payments from the Commonwealth amounting to an estimated $16 billion to the year 2005–06.
50. Hon. Robert Hawke, Speech to the National Press Club, 19 July 1990.
51. *Taxation and the Fiscal Imbalance Between Levels of Australian Government: Responsibility, Accountability and Efficiency.* Report of the Working Party on Tax Powers to the November 1991 Special Premiers' Conference.
52. Hon. P. J. Keating, *The Commonwealth and the States and the November Special Premiers' Conference,* Address to the National Press Club, 22 October 1991.
53. Commonwealth-State Financial Arrangements, A Position Paper by Premiers and Chief Ministers, May 1992.
54. The *Hammond and Ha* cases, loc.cit.
55. Prime Ministerial Press Release. *Taxation Reform*. 13 August 1997.
56. See letter and attachments from Prime Minister John Howard to Senator Meg Lees, Leader of the Australian Democrats, dated 28 May 1999.
57. Hansard, House of Representatives, 22 June 1923, p. 311.
58. Hansard, House of Representatives, 22 June 1923, p. 314.
59 Hansard, Senate, 28 June 1923, p. 431.
60. Hansard, Senate, 28 June 1923, p. 432.
61. Section 99 provides that the Commonwealth shall not, by any law or regulation of trade, commerce or revenue, give preference to one State or any part thereof over another State or part thereof.
62. *Victoria v Commonwealth (Federal Aid Roads Act)* [(1926) 38 CLR 399].
63. Local government assistance to the six States increased rapidly throughout the Fraser years, rising from $79.9 million in 1975–76 to $424.5 million in 1982–83.
64. Hansard, House of Representatives, 28 May 1981, p. 2820.
65. In order to achieve more flexibility, for example, the Commonwealth is beginning to adopt an 'agreed outcome' approach to funding. Instead of specifying how funds should be used, the Commonwealth specifies certain outcomes and leaves it up to the States as to how they might achieve these. Grants designed to reduce hospital waiting lists are a case in point.
66. This provision has been formalised in clause 5(v) of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, signed by the Commonwealth and the States on 9 April 1999.

67. Not only have Parliamentary Committees examined the details of individual programs, they have also investigated the operation of specific purpose grants as a whole. See, for example, Joint Committee of Public Accounts and Audit, *General and Specific Purpose Payments to the States,* Report No. 362, June 1998.

68. Hansard, House of Representatives, 19 May 1933, p. 1570.

69. The Commission, over time, used a number of definitions of what constituted the 'standard States'. At times, the claimant State may have been compared with all the other States, while at other times (especially in the 1970s), only New South Wales and Victoria together were regarded as the 'standard States'. Furthermore, over time, various States relinquished or regained their right of claimancy, usually as the result of some financial arrangement with the Commonwealth.

70. It should be noted that, in assessing relative expenditure needs, the Commission only examines a range of recurrent expenditure items. It does not take capital expenditures into consideration.

71. Even though the incoming Lang Government in NSW withdrew from the voluntary Loan Council in 1925 NSW continued to substantially undertake its borrowing along Loan Council guidelines.

72. At the same time, the Commonwealth agreed to provide debt assistance payments to the States to compensate them for the higher interest rate premiums they would be likely to face when undertaking their own borrowings.

73. Senate Select Committee on the Functions, Powers and Operation of the Australian Loan Council. Report tabled in December 1993. Hansard, Senate, 14 December 1993, p. 4527.

74. Hansard, House of Representatives, 10 May 1994, p. 538.

75. See, for example, the speech of Mr Alan Cadman (Lib. Mitchell, NSW), Hansard, House of Representatives, 11 May 1994, p. 611.

76. Hansard, Senate, 30 June 1994, p. 2510.

77. Also referred to as the 'Khemlani Affair' after the financier Tirath Khemlani, who had been commissioned to seek sources of loan funds for the Commonwealth.

78. It must be remembered that the Senate, by virtue of section 53 of the Constitution, cannot introduce Bills appropriating monies, nor can it amend Bills so as to increase the amount of any appropriation. It can return legislation to the House with its recommendations and a stalemate can be resolved through a double dissolution of both Chambers. However, such action could seriously affect the flow of Commonwealth funding to the States.

79. Hansard, Senate, 30 June 1994, p. 2509.

Appendix 1: Constitutional Provisions

There are a number of sections of the Constitution which have had an important bearing on the moulding of current Federal-State relations, especially financial relations. These include:

Section 51. The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to:

(i) trade and commerce with other countries and among the States.

(ii) taxation; but so as not to discriminate between States or parts of States.

(iii) bounties on the production or export of goods, but so that such bounties shall be uniform throughout the Commonwealth.

(iv) borrowing money on the public credit of the Commonwealth.

(xx) foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth.

(xxiiiA) the provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services (but not so as to authorise any form of civil conscription), benefits to students and family allowances.

(xxix) external affairs.

(xxxi) the acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws.

(xxxvii) matters referred to the Parliament of the Commonwealth by the Parliament or Parliaments of any State or States, but so that the law shall extend only to States by whose Parliaments the matter is referred, or which afterwards adopt the law.

Section 52. The Parliament shall, subject to this Constitution, have exclusive power to make laws for the peace, order and good government of the Commonwealth with respect to:

(i) the seat of government of the Commonwealth, and all places acquired by the Commonwealth for public purposes.

Section 53. Proposed laws appropriating revenue or moneys, or imposing taxation, shall not originate in the Senate…

The Senate may not amend proposed laws imposing taxation, or proposed laws appropriating revenue or moneys for the ordinary annual services of the Government.

The Senate may not amend any proposed law so as to increase any proposed charge or burden on the people…

Section 81. All revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities imposed by this Constitution.

Section 83. No money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law.

Section 86. On the establishment of the Commonwealth, the collection and control of duties of customs and of excise, and the control of the payment of bounties, shall pass to the Executive government of the Commonwealth.

Section 87. During a period of ten years after the establishment of the Commonwealth and thereafter until the Commonwealth otherwise provides, of the net revenue of the Commonwealth from duties of customs and excise not more than one-fourth shall be applied annually by the Commonwealth towards its expenditure.

The balance shall, in accordance with this Constitution, be paid to the several States, or applied towards the payment of interest on debts of the several States taken over by the Commonwealth.

Section 88. Uniform duties of customs shall be imposed within two years after the establishment of the Commonwealth.

Section 89. Until the imposition of uniform duties of customs:

(i) The Commonwealth shall credit to each State the revenues collected therein by the Commonwealth.

(ii) The Commonwealth shall debit to each State—

(a) the expenditure therein of the Commonwealth incurred solely for the maintenance or continuance, as at the time of transfer, of any department transferred from the State to the Commonwealth.

(b) the proportion of the State, according to the number of its people, in the other expenditure of the Commonwealth.

(iii) The Commonwealth shall pay to each State month by month the balance (if any) in favour of the State.

Section 90. On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and excise, and to grant bounties on the production or export of goods, shall become exclusive.

On the imposition of uniform duties of customs all laws of the several States imposing duties of customs or excise, or offering bounties on the production or export of goods, shall cease to have effect, but any grant of or agreement for any such bounty lawfully made by or under the authority of the Government of any State shall be taken to be good if made before the thirtieth day of June, one thousand eight hundred and ninety eight, and not otherwise.

Section 91. Nothing in this Constitution prohibits a State from granting any aid to or bounty on mining for gold, silver, or other metals, nor from granting, with the consent of both Houses of the Parliament of the Commonwealth expressed by resolution, any aid to or bounty on the production or export of goods.

Section 92. On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free.

But notwithstanding anything in this Constitution, goods imported before the imposition of uniform duties of customs into any State, or into any colony which, whilst the goods remain therein, becomes a State, shall, on thence passing into another State within two years after the imposition of such duties, be liable to any duty chargeable on the importation of such goods into the Commonwealth, less any duty paid in respect of the goods on their importation.

Section 93. During the first five years after the imposition of uniform duties of customs, and thereafter until the Parliament otherwise provides:

(i) the duties of customs chargeable on goods imported into a State and afterwards passing into another State for consumption, and the duties of excise paid on goods produced or manufactured in a State and afterwards passing into another State for consumption, shall be taken to have been collected not in the former but in the latter State.

(ii) subject to the last subsection, the Commonwealth shall credit revenue, debit expenditure, and pay balances to the several States as prescribed for the period preceding the imposition of uniform duties of customs.

Section 94. After five years from the imposition of uniform duties of customs, the Parliament may provide, on such basis as it deems fair, for the monthly payment to the several States of all the surplus revenue of the Commonwealth.

Section 96. During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

Section 99. The Commonwealth shall not, by any law or regulation of trade, commerce, or revenue, give preference to one State or any part thereof over another State or any part thereof.

Section 105. The Parliament may take over from the States their public debts ~~as existing at the establishment of the Commonwealth~~*, or a proportion thereof according to the respective numbers of their people as shown by the latest statistics of the Commonwealth, and may convert, renew, or consolidate such debts, or any part thereof; and the States shall indemnify the Commonwealth in respect of the debts taken over, and thereafter the interest payable in respect of the debts shall be deducted and retained from the portions of the surplus revenue of the Commonwealth payable to the several States, or if such surplus is insufficient, or if there is no surplus, then the deficiency or the whole amount shall be paid by the several States.

[* deleted by referendum in 1910].

Section 105A. (1) The Commonwealth may make agreements with the States with respect to the public debts of the States, including:

(a) the taking over of such debts by the Commonwealth.

(b) the management of such debts.

(c) the payment of interest and the provision and management of sinking funds in respect of such debts.

(d) the consolidation, renewal, conversion, and redemption of such debts.

(e) the indemnification of the Commonwealth by the States in respect of debts taken over by the Commonwealth.

(f) the borrowing of money by the States or by the Commonwealth, or by the Commonwealth for the States.

(2) The Parliament may make laws for validating any such agreement made before the commencement of this section.

(3) The Parliament may make laws for the carrying out by the parties thereto of any such agreement.

(4) Any such agreement may be varied or rescinded by the parties thereto.

(5) Every such agreement and any such variation thereof shall be binding upon the Commonwealth and the States parties thereto notwithstanding anything contained in this Constitution or the Constitution of the several States or in any law of the Parliament of the Commonwealth or of any State.

(6) The powers conferred by this section shall not be construed as being limited in any way by the provisions of section one hundred and five of this Constitution.

Section 109. When a law of a State is inconsistent with a law of the Commonwealth, the latter shall prevail, and the former shall, to the extent of inconsistency, be invalid.

Section 114. A State shall not, without the consent of the Parliament of the Commonwealth, raise or maintain any naval or military force, or impose any tax on property of any kind belonging to the Commonwealth, nor shall the Commonwealth impose any tax on property of any kind belonging to a State.

Section 117. A subject of the Queen, resident in any State, shall not be subject in any other State to any disability or discrimination which would not be equally applicable to him if he were a subject of the Queen resident in such other State.