

FEDERATION ISSUES

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THIS SERIES OF PAPERS WAS COMMISSIONED TO ASSIST WESTERN AUSTRALIANS
TO ENGAGE IN INFORMED DISCUSSION ON A RANGE OF CONSTITUTIONAL ISSUES
OF IMPORTANCE TO THE STATE

FEDERATION ISSUES

FEDERATION : THE PEOPLE'S CHOICE

The process by which the Commonwealth of Australia was formed on 1 January 1901 was unusual then, and still is. As the Clerk of the Senate, Harry Evans, said recently :

Popular election of convention delegates to draw up a Constitution was accompanied by a very open public debate with opportunity for all citizens (at least all male citizens) to participate. The formation of the nation and the establishment of its system of government were then achieved by direct vote of the electors, a remarkable occurrence at that time.

It seems logical that people who are mostly of the same ethnic background, almost all speaking the same language and with a shared experience of legal systems and political institutions, should want to join in some kind of union. But in the 1890s only the United States of America, Switzerland and Canada provided any precedents for such a move. Furthermore, the form of government which emerged in Australia was itself an amalgam: it combined an American-style division of powers between Commonwealth and States, a system of responsible cabinet government derived from Britain, and some features peculiar to Australia (including votes for women in Commonwealth elections as early as 1902).

DIVISION OF POWERS

When we talk of a federal system of government, we are referring to a system in which the powers of government are distributed between a central government and parliament and governments and parliaments in the regions or provinces. An important effect of distributing power between levels of government is to limit the power of governments or of any particular majority. If the central government becomes either too strong or too weak, the federal balance is said to be upset and either the regions lose most of their effective powers or the federation falls apart (as has happened in a number of Federations in Africa, Asia and Europe).

Given that the Canadian Federation came into being in the immediate aftermath of the American Civil War, it is hardly surprising that the Canadian Constitution was intended to create a relatively centralised system. The Constitution gave certain specified powers to the provinces, leaving the rest (known as residual powers) to the central government. By contrast, the Australians followed the American model, ceding certain specific powers to the Commonwealth and leaving all the residual powers with the States, an approach explicitly intended to curtail the scope of national power. According to one constitutional convention delegate in the 1890s :

We should most strictly define and limit the powers of the central government, and leave all other powers not so defined to the local legislatures.

Among the powers given to the Commonwealth were authority to legislate on coinage and currency, corporations, interstate and overseas trade, commerce and taxation, aged and invalid pensions and some aspects of industrial arbitration. A few of these powers – defence, coinage, customs and excise – were exclusive to the Commonwealth, but the others could be exercised by the States as well. Matters such as education, hospitals, issues of land tenure and crime prevention were assumed to remain with the States.

Two important qualifications on the division of powers should be noted. The first is that under section 109 of the Commonwealth Constitution, where there is conflict between Commonwealth and State law in areas on which both can legislate, the Commonwealth law will prevail (but only to the extent of the inconsistency). Secondly, section 96 gave the Commonwealth power to make grants to the States 'on such terms and conditions as it thinks fit'. This was to leave an opening for substantial involvement by the Commonwealth in areas (such as tertiary education) that were regarded as definitely matters for the States.

THE FEDERAL INTENTION

The federal nature of the Commonwealth Constitution was also implicit in the decision to follow the United States of America and have two Houses of Parliament, with one providing special representation for the regions. While the Lower House, the House of Representatives, represents the electors of each State (and later Territory) in proportion to its numbers (though with each Original State guaranteed five members), the Commonwealth Constitution specifies that there must be equal representation from each of the six Original States in the Senate.

To preserve the federal intention further, a High Court, modelled on the United States Supreme Court, was established to settle legal disputes concerning interpretation of the meaning of the Commonwealth Constitution. Unlike the American system, however, the judges were to be appointed, in effect, by the Commonwealth Government, without any requirement for confirmation by the Senate (on behalf of the States). Over the years there have been numerous proposals put forward to give State Governments at least some say in the appointment of High Court judges.

In one important respect the Commonwealth Constitution makers went beyond the American approach, where proposed constitutional amendments have to be initiated by two-thirds majorities in the national Parliament or a people's convention and ratified, according to the most usual procedure, by three-fourths of the State Parliaments. With the decision to give voters a direct say in the process of constitutional amendment, the Australians adopted a model closer to the Swiss system. Section 128 of the Commonwealth Constitution specifies that any change to the wording of the Constitution requires the approval of the Commonwealth Parliament followed by the approval at a referendum of a majority of voters in a majority of States, as well as a national majority.

It should be noted that although Australia has followed Switzerland in requiring a referendum to make constitutional amendments, there is no

provision for a popularly initiated constitutional referendum, that is, one where the people by petition can require a referendum to be held. Nor is there any provision for the States to initiate a referendum as is found in the United States Constitution. Thus in Australia, the electors can only vote for or against those proposals which the Commonwealth legislators choose to place before them.

WESTERN AUSTRALIA'S ENTRY INTO THE COMMONWEALTH

Some confusion remains about Western Australia's status at the time of Federation. By the end of 1899 the other five Australian colonies had all voted to accept the draft Constitution, which then required only enactment by the United Kingdom Parliament to become law. Western Australia was still holding back from submitting the proposal to its electors, arguing that further changes were required, including permitting colonies to retain control over their tariffs for a further five years and the guaranteed construction of a federal intercolonial railway. Despite some reservations within the British Government, the Commonwealth of Australia Constitution Act went through the British Parliament and received the Royal Assent on 9 July 1900. This explains why there is no mention of Western Australian in the preamble to the Act establishing the Constitution.

Section 30 of the Act, however, provided that Western Australia would be included in the Commonwealth of Australia once 'Her Majesty is satisfied that the people of Western Australia have agreed thereto'.

Section 95 of the Constitution was included as an inducement to Western Australia, allowing the Colony to retain its tariffs for five years, though on a reducing sliding scale. With federation all but a fait accompli, the Western Australian Government gave way and agreed to submit the draft Constitution to referendum. On 31 July 1900 the Western Australian electors voted by more than two to one to join the Federation, in time to be classified as an Original State with guaranteed five seats in the House of Representatives and equal membership with the other States in the Senate. The intercontinental railway was also achieved, though not until the latter part of World War One.

THE FEDERATION OVER THE YEARS

In the 96 years since the Commonwealth Constitution came into force, there have been 42 separate constitutional amendment proposals put to the people by referendum under the terms of section 128. Of these, only eight (seven with majorities in every State) have been carried and only three have significantly affected the powers of the Commonwealth vis-à-vis the States. Five other proposals received national majorities but failed to carry a majority of the States, while four of the six proposals which failed to be approved in even one State were all submitted to the people in 1988.

Among powers which the electors have refused to grant to the Commonwealth by constitutional amendment are control of prices and wages, marketing, industrial employment and essential services, and provision for the nationalisation of monopolies. Proposals to bring local government within the ambit of Commonwealth power have also been rejected.

Despite this record of failed referendums, and against the expectations of most of those who drew up the original Constitution, the powers of the Commonwealth have increased steadily over the years.

The reasons for the accretion of power to the Commonwealth include :

- the two World Wars, which enabled the Commonwealth to exercise substantial powers as part of its defence role, thereby gaining greater political influence and financial powers which did not disappear with the return of peace;
- the internationalisation of the global economy, which made increasingly important Commonwealth control over such issues as interest and foreign exchange rates, and other broad areas of economic policy;
- the failure of the Senate to fulfil the intention that it be a 'State's House' (although the Senate has, at various stages in its history, acted as a substantial check on majority power);
- the formation of trade unions with branches in several States, which enabled the Commonwealth to get around the restriction that it could only legislate for 'conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of one State';
- the preparedness of the High Court at various stages to interpret the Constitution in a manner favourable to the accession of additional power to the Commonwealth.

The importance of the role of the High Court is not unique to the Australian Federation. In Canada, for example, the scope of provincial power even in the 19th century tended to develop beyond the apparent original intention, with the courts interpreting certain provincial powers more broadly, and the centre's residual powers more narrowly, than had been expected.

In Australia, while it is true that the High Court has frustrated Commonwealth Governments frequently over the years – for example, by denying it the power to ban the Communist Party, to nationalise banks and to ban political advertising – at other times it has handed down landmark judgements in terms of expanding the power and influence of the Commonwealth vis-à-vis the States. These include the following :

- In the 1920 Engineers Case, the High Court allowed Commonwealth industrial law to apply to State instrumentalities. Until then the High Court had tended to interpret the Constitution so as to preserve the States' undefined residual powers and the consequential immunity of their own instrumentalities, but this decision reversed that approach.
- In the 1982 Koowarta Case, the High Court overruled the Queensland Government's refusal to allow an Aboriginal community to lease a pastoral property on the ground that it violated the terms of an international convention on human rights signed by the Commonwealth under its external affairs powers. Similarly, in 1983 the Tasmanian

Government was prevented from constructing the Franklin below Gordon dam because the Commonwealth had signed an international covenant on heritage.

Despite the importance of these decisions, perhaps the most important of all have been High Court decisions affecting Commonwealth-State financial relations. These include :

- In 1942 the High Court upheld the validity of Commonwealth legislation by which it took over control of all income tax and then undertook to 'reimburse' the States under the terms of its section 96 granting powers. While subsequent decisions confirmed that the States had not lost the right to impose income tax, this could only be done in addition to existing Commonwealth tax rates.
- In August 1997 the High Court ruled (by a majority of four judges to three) that State business franchise fees on tobacco were unconstitutional. This decision also threw into doubt the validity of similar franchise fees on fuel and liquor. It was based on the view that franchise fees were excise fees in terms of section 90 of the Commonwealth Constitution, and as such could be imposed only by the Commonwealth.

Taken together, these two cases have clearly limited the capacity of State Governments in Australia to raise more than a limited portion of the revenue needed to finance their own expenditures, giving rise to the situation known as **vertical fiscal imbalance**. This is, in many respects, the major issue facing the future of the Australian Federation, along with **horizontal fiscal imbalance** and the resultant need for **fiscal equalisation**.

VERTICAL FISCAL IMBALANCE

Vertical fiscal imbalance refers to the difference between the amount of revenue collected by each level of government and the amount it spends. In Australia :

- the Commonwealth Government raises far more money than it requires for its own direct expenditure needs;
- the State Governments are only able to raise a proportion of the money they require for their expenditure needs; and therefore
- significant sums of money have to be transferred from the Commonwealth to the States to rectify the imbalance.

This situation was to some extent inevitable given the original division of powers in the Commonwealth Constitution, a division of powers which led Alfred Deakin in 1902 to exclaim :

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. The Commonwealth will have acquired a general control over the States.

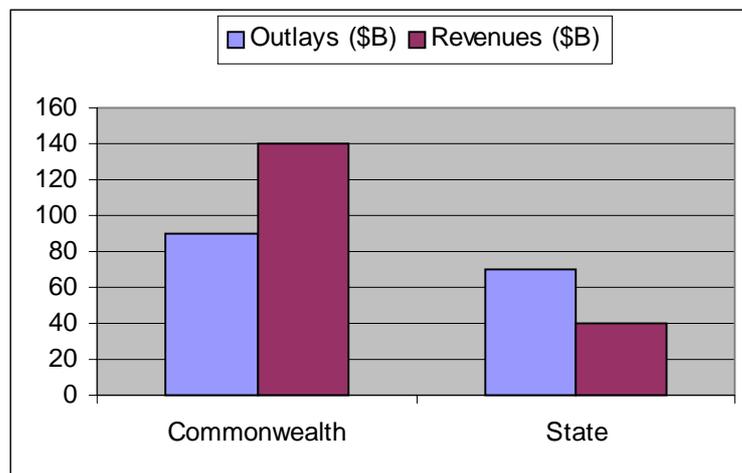
While it is true that vertical fiscal imbalance occurs to some extent in most federations, in Australia it is much greater than in any comparable country.

In 1993-94, the Commonwealth collected 70% of all public sector revenue but was responsible for only 53% of all public spending. The States raised only 27% of public sector revenue, but were responsible for 43% of public spending. By 1997 the Commonwealth's share of tax revenue raised had risen to 77%; after the High Court excise decision it is estimated to reach 80%, leaving the States in a situation where they are raising only about half of their total expenditure needs from their own sources.

VERTICAL FISCAL IMBALANCE

Australia 1997-98 (Estimate)

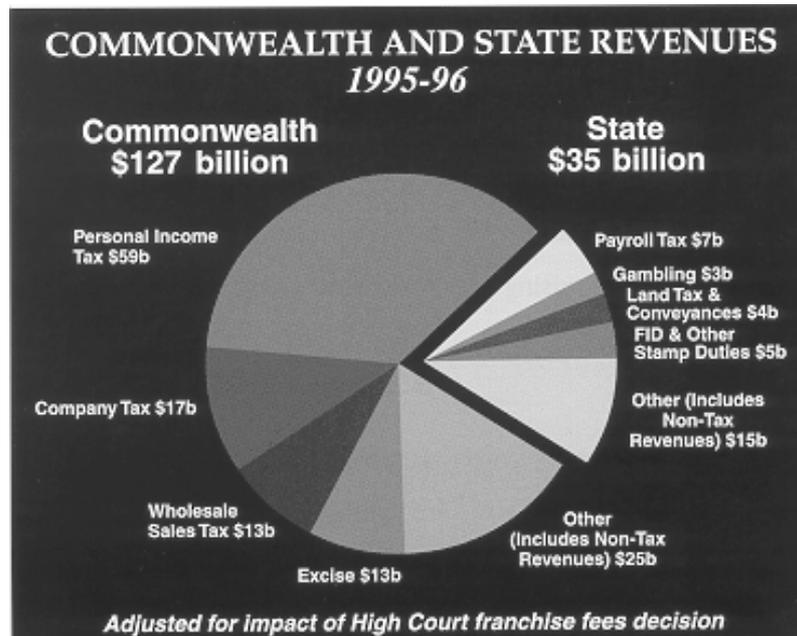
Adjusted for impact of High Court franchise fees decision



By contrast, in the United States of America the States actually raise more revenue than required to meet their responsibilities and in Canada and Germany the balance is much more even than in Australia.

The Australian States have lost all access to income tax collection. In most comparable federations the regional provincial governments raise half or more of their revenue from income tax (in the United States of America the proportion is just under 40%). Since the recent High Court decision on business franchise fees, the main sources of revenue for the Australian States are payroll tax, property tax and stamp duty.

COMMONWEALTH AND STATE REVENUES 1995-96



Before World War Two, the situation was very different, with both the States and the Commonwealth collecting income tax. Immediately before World War Two the States were collecting two-and-a-half times the revenue that came to the Commonwealth from income tax. With only 16% of its revenue coming from this source, the Commonwealth had to rely on customs and excise duties, the earnings of its business undertakings and wholesale taxes (first introduced during the Great Depression).

In the Uniform Tax Case of 1942 the High Court upheld the Commonwealth Government's decision to make itself solely responsible for the collection of income tax, some of which was to be returned to the States on condition that they did not themselves impose income tax. One reason for the Commonwealth takeover was to ensure that the taxpayers in each State took an equal share of the financial burden of World War Two. In Canada a similar arrangement lasted only until one year after the war, while in the United States of America and States had adequate indirect taxes to meet their needs.

In Australia the High Court decision enabled the Commonwealth monopoly to continue into peacetime.

One important feature of the Commonwealth Constitution is that under section 51(ii), 99 and 117 the Commonwealth cannot discriminate between the States in terms of taxation or give preference in matters of trade, commerce or revenue. As a consequence, once the Commonwealth became the major player in the field it was not possible for any one State to raise its own income tax in return for a reduction in Commonwealth tax on its citizens. Instead, any State income tax would have to be imposed on top of that collected by the Commonwealth from taxpayers in all States. No State Government has seen its way clear to make such a move.

A problem related to vertical fiscal imbalance is that of **tied grants** made under section 96 of the Commonwealth Constitution. From the point of view of the States, there is a significant loss in autonomy and flexibility when funds are delivered with conditions attached rather than as a block grant to be spent as the State sees fit. The proportion of total State revenue received in the form of 'tied' or 'specific purpose' grants has increased from about 25% in the early 1970s to 55% now. At the same time, the proportion of Commonwealth revenue being returned to the States has been dropping; in 1997-98 the Commonwealth is expected to return just over 20% of its taxation revenue to the States, compared with 35% in 1977-78.

Commonwealth intervention through tied grants has also produced an unnecessary degree of duplication, with the Commonwealth establishing bureaucracies and formulating policy initiatives to deal with areas of State responsibility such as school education and health.

The main objections to excessive vertical fiscal imbalance are that it :

- promotes duplication and overlap of expenditure responsibilities by allowing the Commonwealth to become involved in areas of State responsibility;
- reduces the accountability of both Commonwealth and State Governments by breaking the nexus between revenue raising and expenditure;
- encourages growth of inefficient and narrowly based State taxes and charges; and
- has the tendency to encourage the Commonwealth to cut grants to the States rather than its own expenditure.

Not surprisingly, since 1942 the States have made various efforts to make themselves less fiscally dependent on the Commonwealth. As indicated previously, section 90 of the Commonwealth Constitution has emerged as a major stumbling block to these efforts. Section 90 provides that the Commonwealth has exclusive power over customs and excise duties. Interpretation of what is meant by excise duties has become a major legal battleground.

Excise duties include taxes on goods produced within Australia, while customs duties are a tax on goods entering Australia. Having lost the power to impose customs and excise duties on goods such as tobacco and liquor, which had been important sources of revenue before Federation, the States imposed so-called 'business franchise fees' on the sale of fuel, liquor and tobacco. The franchises were for specified periods of time and the fees were based on the level of turnover, with the rates varying from State to State. The States argued that business franchise fees did not constitute excise duties, partly because they fell equally on Australian and imported goods. However, a majority of the High Court judges ruled in August 1997 that business franchise fees were an infringement of section 90, and therefore unconstitutional.

As a result, the State Governments lost access to significant own source revenues. In Western Australia, the loss is more than \$600 million per year, more than 13% of the State's own source recurrent revenues. The rescue solution adopted involves the Commonwealth collecting the taxes foregone and paying revenue replacement grants to the States, a solution generally regarded as highly unsatisfactory. As already indicated, the Commonwealth is prevented from levying different rates in different States. The effect has been to remove the States' capacity to determine tax rates and tax bases. (It should be noted that the High Court decision on business franchise fees still leaves open the possibility of State taxes on services; for example, hairdressing, entertainment or, as currently in New South Wales, the provision of hotel accommodation.)

The Commonwealth now has a monopoly over income tax and all taxes on goods produced within Australia. This has produced a very high level of vertical fiscal imbalance. One of the major questions for decision, ultimately by the Australian electors if constitutional change is deemed necessary, is how to return sources of revenue to the States so they can raise a significantly higher proportion of the revenue they need to meet their obligations.

HORIZONTAL FISCAL IMBALANCE

Horizontal fiscal imbalance occurs because the States and Territories vary both in their capacity to raise revenue and in their expenditure needs. The less well-off States have difficulty in maintaining government services comparable with those in other States. The process used to correct this situation is referred to as **fiscal equalisation**. This is one reason for some degree of vertical fiscal imbalance in the Federation; that is, the Commonwealth needs to have more revenue than is required for its own purposes if it is to provide specific assistance to the less well-off States and Territories.

In Australia, however :

- the degree of vertical fiscal imbalance is manifestly excessive for the purpose of fiscal equalisation; and
- fiscal equalisation can have the effect of penalising States with stronger economies by not giving sufficient attention to the correspondingly larger expenditure needs they may face.

According to the Western Australian State Treasury, Western Australia provides a net subsidy to the other States, estimated in the 1994-95 financial year to amount to nearly \$900 per person (more than any State or Territory except the Australian Capital Territory). In that year the Northern Territory, Queensland, South Australia and Tasmania were all substantial beneficiaries.

Obviously these situations vary over time. In Western Australia, concerns over the impact on the State of the way the federal compact was developing reached a peak during the period of the Great Depression. The State Government and many of its supporters believed that the State's problems were exacerbated by the high tariff policies of the Commonwealth, which were designed to protect manufacturing industries in eastern Australia and the

Queensland sugar market. Indeed, in April 1933 the State's electors voted by more than two to one to secede from the Commonwealth, and a petition to this effect was taken to London. However, the United Kingdom Parliament refused to act on the grounds that the Imperial Parliament could only 'dissolve' the Commonwealth constitutionally 'with the consent of a Commonwealth Parliament'. (The strong weight of legal opinion would still be that unilateral secession is not available to Western Australia as a remedy for any perceived ills of the federal system.)

As one consequence, for the next 35 years Western Australia, as one of three 'claimant' States, received special financial assistance grants from the newly created Commonwealth Grants Commission. These grants were important in enabling the three States concerned (the others were South Australia and Tasmania) to provide services to the level of the other States, but they also involved a degree of Commonwealth interference. Western Australia was only too glad to forfeit its status as a needy recipient when its economy took off in the 1960s.

There is little argument that some degree of transfer should take place between the more and less prosperous members of the Federation. But the strength of Western Australia's economy must be balanced against the cost of providing services and infrastructure across a vast geographical area. It is hardly in the national interest to kill the goose that lays the golden egg. The situation warrants a major review of the principles to be applied in implementing fiscal equalisation.

OPTIONS FOR REFORM

Locking the States out of collecting taxes on goods has exacerbated what was already an excessive degree of vertical fiscal imbalance in the Australian federal system. The High Court decision on business franchise fees may, however, prove to have been a watershed in Commonwealth/State financial relations. Prime Minister John Howard has acknowledged the need to tackle the issue in his announcement on the national tax reform agenda.

A lively national tax debate on whether to reduce Australia's dependence on income tax through some form of goods and services tax is in progress. From the States' point of view, the debate needs to be broadened to include consideration of :

- giving States access to growth revenues in lieu of their current tax sources, which are essentially low growth and often inefficient;
- reducing the reliance of States on Commonwealth grants, particularly tied grants, which must be spent according to guidelines laid down by the Commonwealth.

There is widespread agreement that any tax reform needs to be achieved in a manner that does not increase the total tax take from the community.

The options for reform outlined below span the range from constitutional amendment to inter-governmental agreements at the executive level, and can be considered separately or in combination.

Option One

The Commonwealth could seek to amend the Constitution to allow States to levy taxes on goods. This option would, at the very least, return to the States the capacity to impose business franchise fees.

Option Two

The Commonwealth could impose and collect taxes on goods on behalf of the States. Each State would have the capacity to vary tax rates independently, possibly as part of a broad-based consumption tax levied by the Commonwealth. Constitutional amendments would be required to make this possible.

Option Three

The Commonwealth could make room for the imposition of State income taxes. There would be no overall increase in the tax burden, because Commonwealth grants to the States would be cut correspondingly.

Option Four

The Commonwealth could legislate to return to the States a guaranteed share of income tax revenue, thus giving the States access to a growth tax, but no control over rates.

Option Five

The States could be given a guaranteed share of a broad-based consumption tax levied by the Commonwealth, as with the income tax in Option Four.

Whichever option or combination of options may be chosen, there is a clear need for a major overhaul of the Australian tax system, both to improve the balance between Commonwealth and the States and to achieve a better mix of taxation.