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The Character of Australian Federalism

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Abstract
Current issues of taxing power, revenue distribution, policy jurisdiction and intergovernmental relations in Australia today must be seen in the context of the 'character' of Australia's federal system. That character is given by the interaction between constitutional design, judicial interpretation, economic and social change, and political processes over the past century. Designed for an earlier epoch, Australian federalism has undergone substantial adaptation to meet the needs of modern social and economic conditions. As has been widely recognised, that adaptation has been highly centralising in its effect. While Australia is not alone in this respect — indeed, such tendencies have been endemic in the established federations — the syndrome is particularly evident in the Australian case. Aspects of this particular character raise continuing issues for resolution as well as imposing severe constraints on what solutions might realistically be considered.

1. INTRODUCTION

Australia is a notably centralised federation where the Commonwealth exploits a position of fiscal dominance to intervene extensively in areas of State jurisdiction. The consequence of this is not only to reduce the policy autonomy of the States but also to foster a complex overlap and entanglement of the two levels of government sometimes called 'cooperative' or 'administrative' federalism. Australia is also a highly-egalitarian federation that implements a comprehensive degree of horizontal fiscal equalisation (HFE) to ensure that the States and Territories are able to offer public services of the same standard regardless of their particular circumstances. These vertical and horizontal realities may, in their effect, be good, bad or indifferent — and there are certainly arguments in all three regards. The question here is how these realities are to be explained and how amenable they might be to alteration. The answer is that they are embedded in the design and history of Australian federalism and in the underlying realities of Australian society and are reinforced by external and global forces.[2]

2. CONSTITUTIONAL DESIGN

The constitutional framework is far from everything one needs to know to understand a particular federation, but it is, as K.C. Wheare (1963: 20) put it, a 'convenient' way to begin — and indeed perhaps the most logical place to begin. Australian federalism takes its character from a combination of its constitutional framework and the way it has diverged from that framework.

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[2] This paper draws on arguments I have made in more detail elsewhere, chiefly in Hueglin and Fenna 2006; Fenna 2007a, 2007b, 2008.

2.1 Original intentions

At the very first meeting the colonial delegates held to discuss the possibility of union, the Federation Conference of 1890 in Melbourne, Alfred Deakin declared that 'the model of the United States, preserving state rights with the most jealous caution, is that most likely to commend itself to the people of these colonies'.[3] When delegates met in Sydney the following year to get down to brass tacks, the very first of only four governing propositions launching those deliberations was:

> That the powers and privileges and territorial rights of the several existing colonies shall remain intact, except in such surrenders as may be agreed upon as necessary and incidental to the power and authority of the National Federal Government.[4]

From these declarations flowed two key features of the Commonwealth Constitution: the States were to retain primacy in almost all matters of domestic affairs not fundamentally concerning the integrity of the union; and, the way to ensure this was to follow the drafting example provided by the US Constitution.

2.2 The single list approach

Following that American example, the Commonwealth was assigned a specific set of enumerated powers — the 39 headings of section 51. A small number of these were made exclusive and the rest were to be held concurrently with the States. Most importantly, this was, first of all, a *limited* list. Section 51 comprised, on the whole, two broad matters: those powers necessary to provide a common market and those concerning the country's external relations and borders. Secondly, it was a *limiting* list: the purpose of listing the areas in which the Commonwealth Parliament was entitled to legislate was simultaneously to empower *and to constrain* the new government. The Commonwealth was intended to be a government of certain specified powers and no more.

The States, meanwhile, were assigned not a single specified power. Instead they were assigned, under s.107, an infinite range of powers, excepting only those explicitly denied them. Thus, the vast majority of domestic responsibilities were to stay the exclusive responsibility of the States. These powers were anything and everything not mentioned in s.51 — such as: infrastructure; resources; the environment; education; health; policing; criminal and civil law.

2.3 Taking full responsibility

Powers were divided by assigning discrete policy domains wholesale to one level of government or the other. Each level would have full responsibility for policy making, implementation and administration for a set range of policy fields; each would be accountable to its own citizens for those domains. Similarly, each would have responsibility for raising revenue from whatever tax bases it had authority to exploit. This was by contrast with the approach that had taken shape in 19th century Germany and prevails in the German system today, which was to assign complementary functional roles rather than specific policy domains. The central government was

[3] *Debates and Proceedings of the Australasian Federation Conference*, Melbourne, 13 February 1890.
[4] *Debates of the National Australasian Convention*, Sydney, 2 March – 9 April, 1891.

given extensive responsibility for general policy frameworks but the States were left with responsibility for implementation and administration. A correlate of that approach has been constitutionally-defined revenue sharing of the main tax bases.

2.4 Tending to their own affairs

An implication of being assigned distinct policy domains was that the Commonwealth and the States would operate autonomously in their respective spheres. The reservoir of exclusive State powers was large and thus the expectation was that the States could carry on governing their populations without let or hindrance from the Commonwealth and the federation could function with a minimal degree of intergovernmental coordination being required. This, again, contrasts with the German approach, which required a more integrated approach, the main conduit for which was a truly federal upper house in the national parliament — the *Bundesrat*, made up of emissaries from the constituent units (*Länder*). Collectively, the *Länder* governments have a say in the design of any federal law that affects them and a veto over the passage of any such laws.

2.5. The safeguards of federalism

Federal constitutions are meant to be self-enforcing in some way. That is to say, they characteristically build 'safeguards' into the system of government they are establishing that are expected to preserve the agreed-upon balance between larger and smaller States and between the States and the central government. Four main safeguards were built into the Australian Constitution to protect against serious encroachment by the Commonwealth on the powers of the States. First, the formal division of powers prescribed for the Commonwealth a defined sphere of action. Secondly, a bicameral legislature with equal State representation in the Senate was to provide an internal check on any untoward actions by the Commonwealth. Thirdly, an independent supreme court, the High Court of Australia, with power of judicial review, would provide an external check on Commonwealth expansionism. Fourthly, an amending procedure that requires the approval of a majority of voters in a majority of States before any alteration can be made would prevent unilateral changes to the rules. As it turned out, only the fourth of those, the double majority amendment procedure, lived up to expectations — and even it fell well short of being an adequate safeguard.

2.6 The financial gap

There was one small matter the founders were unable to resolve: the money problem. With federation, the States would, almost unavoidably, lose the authority to levy and collect customs tariffs — the single most important source of government revenue in that period. Since federation was driven in no small part by the desire to eliminate barriers between the colonies, it is not surprising that the Constitution lays down in sections 90 and 92, strict prohibitions on such devices. At the same time as they were losing much of their revenue capacity, the States were losing almost none of their service delivery responsibilities. Australian federalism thus came into this world with a pronounced case of 'vertical fiscal imbalance' (VFI) or 'vertical fiscal gap' as Boadway (2007) prefers to call it. The founders assumed that subsequent generations would somehow find mechanisms through which the Commonwealth's 'surplus' revenue would be transferred directly back to the States.

To compound matters, the founders made four decisions that stacked the deck against the States. They allocated the Commonwealth a plenary power to tax even though it had very limited spending needs. They included, as per the US Constitution, a supremacy clause stipulating that in cases of conflict Commonwealth laws prevail over State laws (s.109). They prohibited the States not just from imposing customs tariffs, but also from imposing 'excise' duties — however those might be defined (s.90). And they gave the Commonwealth authority to 'grant financial assistance to any State on such terms and conditions as the parliament thinks fit' (s.96) — a clause without parallel in comparable federations.

3. HOW HAS THIS WORKED IN PRACTICE?

Constitutions may be virtually immutable — and, indeed, governments have enjoyed astonishingly little success in changing Australia's Constitution — but the systems over which those constitutions preside have proven anything but (Fenna 2012). Australia is no exception in this regard. While on paper we have almost exactly the same federal system as the framers bequeathed us 110 years ago, in practice we have something very different. As is well known, Australian voters have been asked to approve 44 different amendments to the Constitution but have rejected all except eight. Of those eight, only three concerned the federal system and of those three, the one major change was the social services amendment of 1946. Australians have pretty consistently rejected proposals to centralise power.

A Constitution has its primary effect on the evolution of a federal system through application to concrete disputes — and application of a Constitution unavoidably and by definition means *interpretation*. The key to Australia's federal Constitution was not whether it would be amended, but what meaning it would be interpreted as having in those concrete situations.

3.1. Best laid plans…

Initially things looked quite good for the States: the early High Court was determined to protect the federal character of the Constitution and the States developed new and promising revenue sources. Most important of the latter was the income tax, a new source that might genuinely compensate for the customs revenues they had lost.

Not all went well, though: Commonwealth governments quickly figured out that they didn't really have surplus revenues, they only had revenues that were surplus to currently existing requirements. And the High Court began its long process of turning s.90 into a prohibition against State sales taxes. Then, in relatively rapid succession, three developments altered the situation fundamentally:

1. In 1920 the High Court decided that the Constitution should be read just like any statute and did not need to be given any special respect as a document of federal union when it came to interpreting and applying specific clauses.[5] The effect of this was to undermine the single list approach to dividing powers between the Commonwealth and the States, with s.51 becoming much less of a limiting list and more of an empowering one.

[5] *The Amalgamated Society of Engineers v Adelaide Steamship Co Ltd.* (1920) 28 CLR 129.

2. In 1926 the High Court agreed that s.96 meant exactly what it said and the Commonwealth could use its spending power to extend its control into areas of State jurisdiction howsoever it wished.[6] This authorised both the *directive* and the *prohibitive* use of 'tied grants'.

3. In 1942 the High Court agreed that Parliament's right to set terms and conditions extended as far as being able to force the States to abandon their most important revenue source, the personal and corporate income tax altogether.[7] This gave the Commonwealth a monopoly over the country's two most important tax bases.

4. NO ACCIDENT

Possibly the transformation of Australian federalism has been the result of design errors. The American single-list approach, though logical, was clearly ill-conceived; s.96 was a uniquely Australian innovation that could only be described, from a federalist point of view, as perverse; the drafting of s.90 was likewise culpable; being popularly elected, the Senate was never going to act as a States' house; the amending procedure, while it protected the States, inexplicably sidelined them when it came to suggesting changes (as did the High Court appointment procedure); and the Constitution laid down no meta-rules protecting its federal character.

But there is much more to it than that. The enormous changes that have occurred in Australian federalism, changes that have in many ways reversed the intended relationship between the Commonwealth and the States, reflect two particular realities to do with the underlying society on which the system was to operate.

4.1. Old ideas, new realities

First of all, the American model on which Australian federalism was based presupposed several essential facts that were soon rendered anachronistic by the great economic and social changes of the 20th century. It presupposed that tasks could be neatly allocated to one level or the other. It presupposed that the vast bulk of domestic governance responsibilities were local in their nature and had little or no spillover effects beyond State borders. It presupposed that social and cultural norms were in the first instance a matter for local communities, not the national community, to decide. It presupposed a world where business firms rarely spanned jurisdictions and trade and intercourse between the States was modest. And it presupposed a world without the redistributive welfare state or macroeconomic management.

In all these respects, the basis on which the American model was established was turned on its head by the rapid shift to modern industrial society. Those changes entailed a general migration of tasks from the subnational to the national level.

4.2. Federal systems and federal societies

This explains a powerful tendency common to federal systems, but it does not explain variations between them. The particular design choices made by the framers of the Australian Constitution may go some way to explaining that variation, but there is yet more to the story. The fact is that federal systems cannot help but be fundamentally

[6] *The State of Victoria and Others v The Commonwealth* (1926) 38 CLR 399.
[7] *The State of South Australia v The Commonwealth* (1942) 65 CLR 373.

shaped by the kind of society over which they preside and Australian society lacks any of the powerful regional differences that provide such an effective countervailing force to those centralising pressures in Switzerland or Canada. Western Australia may have its own sense of regional difference and grievance, but it does not have any of the kind of identity characteristics — language, religion, ethnicity — that would make it a distinct society within the Commonwealth.

It is also not surprising that the two most regionally homogeneous federations, Germany and Australia, are the two where horizontal fiscal equalisation is the most comprehensive. An absence of significant regional difference means that the logic of a single citizenship prevails. This does not mean that equalisation will be uncontested, but it does help explain why equalisation is implemented to the degree that it is. Equalisation presents real dilemmas for federal systems since it is simultaneously inherent and alien to federalism: inherent because federalism is about providing for collective security and welfare and a common destiny, alien because federalism is about respecting regional diversity and maintaining regional autonomy (Fenna 2011).

5. HOW DO THINGS LOOK TODAY?

The result of the way the Constitution was drafted, the profound changes that have occurred in economy and society, and the disconnect between a federal Constitution and an effectively unitary society is a high degree of centralisation and extensive practical overlap and entanglement of the two levels of government in Australia that is widely criticised (e.g., Warren 2006).

5.1 State revenue

Centralisation is evident in, and facilitated by, vertical fiscal imbalance. As early as 1942, Australian federalism had reached a high degree of fiscal centralisation. Despite the Constitution allocating a shared or concurrent jurisdiction over all tax bases except 'duties of customs and of excise', the Commonwealth had come to monopolise the most important ones. The *coup de grâce* was finally delivered in 1997, when the High Court ruled that various efforts by the States to levy some sort of sales taxes, in the form of franchise fees on tobacco and other substances, violated s.90's prohibition on excise duties.[8] Canada and the United States, the two federations most similar to Australia, also went through a process of centralisation in the 20th century, but these developments made Australia stand out as the only one of the three where the national government had achieved exclusive control over *either* the general sales tax *or* the personal and corporate income tax, let alone *both*. Under the Fraser government, the States were invited to re-enter the income tax field, but the Commonwealth made no move to create tax room and the offer was an empty one (Saunders and Wiltshire 1980: 358). Being so thoroughly excluded from the main tax bases has left the States scrounging for 'own source' revenue in a variety of places where they are regularly accused of imposing economically 'inefficient' taxes or encouraging socially harmful activities such as gambling.

Of course, scrounge as they might, the States simply do not have access to sufficient own-source revenue to cover more than a certain part of the substantial service

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

delivery expenditures. The States must rely on transfers from the Commonwealth for close to half of their funding needs. Being so dependent on the Commonwealth has carried two disabilities: whether the quantum will be sufficient and what the terms and conditions will be. Since the explosion in conditional grants under the Whitlam government, 1972–75, transfers have been split roughly equally between general and specific purpose (i.e., 'tied' or conditional).

The heavy reliance of the States on general purpose transfers has given the Commonwealth the opportunity to 'down shift' deficit-cutting policies. Fiscal virtue at the national level can be bought at the expense of fiscal pain at the State level. The derisive remark — attributed to Paul Keating — about not wanting to get caught between a State premier and a bucket of money, added insult to that injury. In this regard, the position of the States has improved significantly in recent times. The 1997 High Court decision invalidating franchise fees dovetailed nicely with the Howard government's desire to replace the old Wholesale Sales Tax with the Goods and Services Tax (GST), a comprehensive value-added tax applied to most goods and services. Support from the States lowered the political risk of this controversial – and in the past fatal – initiative. For that support, the States were endowed with the new tax's net revenue as a replacement for the general purpose Financial Assistance Grants.

This was a win for the States and removed one major source of fiscal vulnerability. However, it was not without its limitations and compromises. One of those is that although the deal is enshrined in legislation, any Commonwealth government with sufficient support in the Senate can readily alter it — as both the Howard government's Treasurer, Peter Costello, and Labor Prime Minister Kevin Rudd, threatened to do at different times. Rudd, in particular, announced that he would withdraw a third of the GST revenues to finance his health and hospital program (Fenna and Anderson 2012). The other is that while the GST is indeed a 'growth tax', generally increasing with economic activity, it could not help but perform poorly by comparison with the Commonwealth's surge in income tax revenues from the mining boom that took off only a few years later. It also gave the States no control individually, and very limited influence collectively, over the rate and nature of the tax. Ideally for the States, perhaps, they would be in a position to raise the GST rate with the Commonwealth being obliged to compensate by a proportionate decrease in the personal income tax; but that is not within their power.

5.2. Commonwealth grants

More significantly, perhaps, the GST superseded the general purpose payments previously received by the States and did nothing to curtail the Commonwealth's use of tied grants. There are two federations today, Australia and the United States, where extensive use is made of conditional grants to circumvent the constitutional division of powers. As some of the foregoing suggests, this has been one of the main ways a pre-industrial constitution has adapted to modern conditions. At the same time, though, it has created a number of pathologies: decreasing efficiency, accountability and legitimate local autonomy while allowing opportunistic intervention to flourish. The Howard government's Mersey hospital rescue during the 2007 federal election was the most flagrant example of such opportunistic intervention, but by no means the only example.

Enthusiasm for the Rudd reforms of 2008–09 reflected widespread desire to address that problem and some of the pathologies of Australian federalism more broadly (Fenna and Anderson 2012). Conversion of a large number of individual Specific Purpose Payments (SPP) into a handful of omnibus block grants provided sought after relief from a number of intrusive Commonwealth requirements. However, this came at a cost for the States in the form of new outcomes assessment carried out by the COAG Reform Council. While the Council of Australian Governments (COAG) has functioned as the peak forum for intergovernmental relations in Australia since the early 1990s, this represented a significant increase in COAG's monitoring and coordinating function (Anderson 2008). Even then, the SPP reform did not close the door on the individual tied grants. They have been rebadged as National Partnership Payments, of which there have already been at least sixty to date. Some of those are truly trivial, others seriously substantial; many apply the kind of intrusive conditionality that was so deplored in the old-fashioned SPPs.

6. CONCLUSION

Australian federalism has undergone extensive change to adapt what was fundamentally a pre-industrial Constitution to modern conditions. Many functions whose boundaries were then unambiguously local have assumed a much larger footprint or an entirely national dimension; increasing economic integration is driving a push for a single market as distinct from merely a common market; the national economy requires a degree of 'management' unknown at Federation; greater integration and mobility continually weaken local taxing power; the national community is far less tolerant of diversity in policy and practices across the country than citizens might have been a century ago; and there is little by way of countervailing pressures from distinct subnational communities.

Responding to these radically changed realities, national governments have exploited loopholes in the Constitution to create national policies where once Australians relied on their State governments. The Commonwealth now plays an extensive role in areas of State jurisdiction. The primary mechanism for this has been conditional grants, a mechanism built on the vastly superior financial resources the Commonwealth has been able to consolidate for itself and facilitated by the explicit grant of a directive spending power. In doing so it is responding both to citizen expectations and to the various pressures for national action coming from the international economy and the international community. Though not designed as one, Australia has become much more of an 'integrated' federation, where the central government plays an overarching policy-making role in many areas and the States wrestle with their service delivery responsibilities.

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