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# Philosophical, Political and Economic Conflicts in Australian Federalism

## by Russell Mathews

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# PHILOSOPHICAL, POLITICAL AND ECONOMIC CONFLICTS IN AUSTRALIAN FEDERALISM

by

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# PHILOSOPHICAL, POLITICAL AND ECONOMIC CONFLICTS IN AUSTRALIAN FEDERALISM

Russell Mathews

The Australian federal Constitution which came into effect on the first day of the 20th century was very much a product of the political and economic philosophies of the 18th and 19th centuries. It reflected *laissez-faire* attitudes towards the role of government in economic and social policy, and the federation which it created had all the hall-marks of what we would now regard as a classical federal system, with the Commonwealth (that is, the Federal government) and the States (the former self-governing Colonies) co-ordinate and independent in their own fields of responsibility.

Nevertheless, the Constitution made express provision for the Commonwealth to make laws in a number of fields which would have the effect of increasing government regulation or extending expenditure functions; it gave the Commonwealth a parliamentary structure which established a new kind of relationship between the executive and legislative branches of government; and it included sections which gave effect to immediate innovations in fiscal federalism or which contained the seeds of future developments of an innovatory kind.

The three major issues in the Convention and popular debates which preceded federation were: the tariff question; the problem of achieving horizontal political and economic balance as between the more populous and economically advanced States of New South Wales and Victoria on the one hand and the remaining four States on the other; and the problem of achieving vertical fiscal balance between the Commonwealth and the States generally.

## *Economic and Social Opposition to Federation*

The tariff question had two dimensions, resulting from differences in attitudes to a common external tariff on the one hand and to interstate free trade on the other. The largest Colony - New South Wales - had been wholly converted to free trade (except for revenue duties) in the years preceding federation, while its main rival - Victoria - and the other Colonies were protectionist in varying degrees. There was therefore considerable opposition in New South Wales to the notion of a Federal external tariff.

Support for or opposition to federation on the basis of the internal free trade effects depended largely on the economic interests of individual industries in the several Colonies. In all Colonies, this issue was a major factor generating opposition to federation. It partly explains the strong opposition of the Labour parties which were then emerging as a major political force in most of the Colonies. There were other reasons for Labour opposition, such as a belief that voting arrangements for the new Commonwealth were undemocratic, or that the Constitution would impede social reform and industrial or political action to achieve improved working conditions.

In the event, it became clear that the Labour parties in the several Colonies had badly miscalculated the political, social and economic consequences of federation. From the beginning, Labour members held the balance of power between Protectionists and Free-traders in the Commonwealth parliament. During the first ten years of federation minority Labour governments twice governed briefly and in 1910 the Australian Labor Party[1] became the first party to achieve an absolute majority in the Commonwealth parliament. Although the Labor party had become nationalist rather than federalist in sentiment, it was more interested in extending the Commonwealth's role than the non-Labor parties and its influence was decisive in achieving this result. Among other things, the Constitution had made provision for Commonwealth powers with respect to invalid and old-age pensions, 'conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one State' and, subject to a restriction in relation to State banks, banking. These subjects were indicative of major fields of social welfare policy and economic activity for which the Commonwealth assumed responsibility, under Labor governments or non-Labor governments which depended on Labor support. Other activities in the fields of defence, transport and communications emphasised the growing importance of the Commonwealth, especially during World War I.

*Political Imbalance, Federalism and Responsible Government*

In most respects, the Australian Constitution had been modelled closely on the United States federal system, with one or two ideas such as the referendum being borrowed from the Swiss system. But Australia followed Canada in attempting to combine federalism on

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1 The present spelling of the name of the Australian Labor Party was adopted at a federal conference in 1908.

the American pattern with the Westminster system of responsible government. In order to strengthen the position of the smaller, less affluent, States, the Constitution established the Senate as a States' house with equal representation from each State and legislative powers which were virtually identical with those of the House of Representatives. This was the major federal innovation in the Australian Constitution, and like the Constitution generally it was a pragmatic response to a political problem rather than a conscious attempt to extend the range of application of the federal principle.

The founding fathers were well aware that the powers they gave to the Senate might impose severe constraints on the operation of a system in which the executive government was to form part of and be responsible to parliament. They therefore included provisions whereby the two houses could be dissolved simultaneously in the event of failure to agree on legislation, and for a joint sitting of the two houses to determine the fate of the disputed legislation if, after the resulting general election, the two houses still failed to agree.

The Senate soon came to reflect party political groupings rather than State interests and, although opposition parties often controlled the Senate to the discomfiture of the government, until 1974 there had been only two double dissolutions of parliament and no joint sittings. This was largely due to the emergence of a convention that, because governments were formed by the parties which controlled the House of Representatives, the Senate would not use its legislative powers to refuse supply. This convention was twice broken by the non-Labor opposition in 1974 and 1975. On the first occasion the Labor government itself sought a double dissolution and, although still without a majority in the Senate, on being re-elected it convened a joint sitting at which the disputed legislation was passed. In 1975, however, the Labor government's attempts to continue in office while the Senate refused to grant supply culminated in the government's dramatic dismissal by the Governor-General and its defeat at a subsequent general election.

In retrospect, it is surprising that the federal principle and the notion of responsible government managed to co-exist for so long before coming into head-on collision in this way, at a time when the Senate could no longer be regarded as a States' house, although bitter Commonwealth-State conflicts encouraged non-Labor State politicians and Senators to behave as though it were.

*Horizontal Economic Imbalance*

The less affluent Colonies had been especially concerned with the balance of economic power in the new federation, believing that the advantages of the common market would accrue mainly to the relatively industrialised economies of New South Wales and Victoria.

Nevertheless, horizontal economic imbalance has always been less marked in Australia than in most other federations; personal incomes per head in the smallest and poorest State, Tasmania, have never been more than about 20 per cent below those of the most populous and richest States of New South Wales and Victoria. Nevertheless, differences not only in taxable capacity but also in costs of providing services, resulting from such factors as differences in demographic structure, population size and density, have always resulted in financial inequalities among the States. The Constitution recognised the special problems of Western Australia by permitting that State to collect customs on interstate imports on a diminishing scale during the first five years of federation. After the transitional period, however, first Western Australia then Tasmania and later South Australia all ran into budgetary difficulties which they claimed were due to disabilites imposed upon them by Federal policies. The Commonwealth responded by making special grants of financial assistance to those three States from 1910-11, 1912-13 and 1929-30 respectively, usually on an *ad hoc* or arbitrary basis. By the early 1930s, however, dissatisfaction with Commonwealth economic policies had become so pronounced that secession movements developed in these States. A secession referendum was actually passed with a two-thirds majority in Western Australia in 1933 and submitted by the State government to the British parliament. The latter decided it had no power to intervene, but meanwhile the Commonwealth had established formal machinery to review the process of horizontal fiscal adjustment. This took the form of the Commonwealth Grants Commission, an independent quasi-judicial authority charged with responsibility for inquiring into and reporting on applications by so-called claimant States for special financial assistance from the Commonwealth. The Commission based its recommendations, which have always been accepted by Commonwealth governments, on the principle of financial need. Recommended grants were thus intended to make good deficiencies in revenue-raising capacity or compensate for higher costs of providing services relative to richer, more populous, so-called standard States. The fiscal equalisation principles and methodology developed by the Grants Commission have undoubtedly represented one of the major Australian contributions to the theory and practice of fiscal federalism.[2]

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[2] The development of the Commission's principles and procedures is traced in R.L. Mathews: 'Fiscal Equalisation in Australia: The Methodology of the Grants Commission', *Finanzarchiv*, Vol. 34, No.1, 1975.

*Vertical Fiscal Imbalance*

The other major issue in the debates which led to federation concerned the problem of achieving vertical fiscal balance between the Commonwealth on the one hand and the States collectively on the other. This problem arose because most of the costly expenditure functions - law and order, education, health, transport, power, economic development, commercial regulation, urban and community services - were to be retained by the States, whereas the main forms of Colonial taxation (customs and excise duties) were to be transferred to the Commonwealth. Several sections were inserted into the Constitution to deal with this problem, which it was thought would be a transitional one.

The fiscal adjustment that was most important immediately after federation represented another federal innovation; this was a constitutional tax-sharing provision whereby, during an initial period of at least ten years, at least three-quarters of net customs and excise revenues collected by the Commonwealth were to be paid to the States. Other sections of the Constitution made provision for the Commonwealth to take over State debts and required any surplus Commonwealth revenues to be paid to the States. The terms for the transfer of State debts were a source of continuing controversy in the early years of federation, and constitutional amendments were necessary before major adjustments in Commonwealth-State debt relationships were made in 1927 and 1970. In 1908, the Commonwealth escaped from its obligation to make surplus revenue payments to the States by the simple device of paying its surplus revenues into a trust fund and thereby ceasing to record surpluses.

Finally, the Constitution included a section which permitted the Commonwealth to grant financial assistance to any State on any terms and conditions. There had been considerable opposition, especially in New South Wales, to the constitutional provision for the compulsory sharing of customs and excise revenues, on the ground that this would encourage high levels of tariffs and taxes. Both the limitation of the compulsory tax sharing provision to ten years and the grant power were last-minute additions to the Constitution in a successful attempt to obtain the support of New South Wales for federation. The general grant power became the basis not only of the special equalisation grants to the financially weaker States which have been mentioned above, but also of different forms of general revenue grants and specific purpose (or conditional) grants from the Commonwealth to all States.

*Four Phases of Co-operative Federalism*

In the event, the need for vertical financial adjustments in the Australian federation proved to be a continuing one, the significance of which has waxed and waned in accordance with changes in State access to major revenue sources. Three or four phases of Australian federalism may be distinguished, reflecting shifts in financial balance between the Commonwealth and States. What may be loosely described as a system of co-ordinate federalism operated until the 1920s, with the Commonwealth and States acting independently in their own fields of responsibility. This was replaced by a system of co-operative federalism, in which the Commonwealth and the States tended to assume joint responsibility for major economic and fiscal decisions. Co-operative federalism gave way to coercive federalism when the Commonwealth achieved a monopoly of income tax revenues during World War II. Only during the last two or three years have there been indications that Commonwealth financial domination and coercive federalism are coming to an end, to be replaced by attempts at intergovernmental policy co-ordination which may be described as co-ordinative federalism.

*From Co-ordinate to Co-operative Federalism*

Even under the system of co-ordinate federalism which operated for the first quarter-century of federation, the division of powers and responsibilities between the Commonwealth and States was not complete. Taxing and borrowing powers were mainly concurrent, the principal exception being the Commonwealth's exclusive control over customs and excise duties. Later, however, successive High Court decisions invalidated most forms of State indirect taxation available to States or Provinces in other federations, including commodity sales taxes. Despite the constitutional attempt to prescribe a vertical division of powers with respect to spending and regulatory functions, there was a significant exercise of concurrent powers and in some cases a horizontal division of responsibility, with the Commonwealth being responsible for international and interstate aspects and the States for intrastate activities.

In the early years of federation, the existence of concurrent powers did not necessarily result in intergovernmental competition and conflict. Because of the prevailing view that the role of governments must be modest and unobtrusive, absolute levels of taxation and government spending were low. The Commonwealth did not raise any loans until 1912 and it did not impose land tax, death duties and income taxes, which by then were the main forms of State taxation, until 1910, 1914 and 1915 respectively.

Despite the growth in Commonwealth activity as a result of World War I, the States retained access to significant sources of revenue. The end of the constitutional provision for the sharing of customs and excise duties in 1910 had been followed by arrangements for Commonwealth general revenue grants to the States equal to $2.50 per head of population. After World War I, the Commonwealth government sought an end to these per capita payments, and a separation of taxing powers, as part of a return to co-ordinate federalism. The Commonwealth (non-Labor) government was strongly opposed, as a matter of political philosophy, to what it called 'the vicious principle of one authority raising taxation for another to spend'. In 1923, it even offered to withdraw from the field of personal income taxation altogether if the States would give up the $2.50 per capita grants and leave the company tax field to the Commonwealth. Only one State - New South Wales - failed to agree to this proposal.

Meanwhile, however, intergovernmental competition had developed in overseas and Australian loan markets. A voluntary Loan Council was established in 1923 to co-ordinate borrowing, and this was followed by a Financial Agreement between the Commonwealth and six States in 1927 which inaugurated a significant period of co-operative federalism.

The Financial Agreement and the constitutional amendment which followed it provided for: the substitution of Commonwealth fixed grants and sinking fund contributions, by way of debt charges assistance, for the per capita grants which had been paid to the States since 1910; the formal take-over of State debts by the Commonwealth, although the States continued to be responsible for interest and redemption charges to the extent that these were not met by the foregoing Commonwealth contributions; and the establishment of the Australian Loan Council, with power to control all borrowing by the Commonwealth and States (except temporary borrowing and Commonwealth loans for defence purposes), as well as to allocate the proceeds among the seven governments.

The Loan Council is a unique federal body in which both levels of government - embracing both the legislative and executive branches in each case - have yielded financial autonomy to a joint decision-making body on which the Commonwealth has two votes and a casting vote and each of the six States one vote. By a so-called Gentlemen's Agreement in 1936, the authority of the Loan Council was extended to local and semi-government authorities, so that it controls the level, distribution and conditions of all public sector borrowing in Australia.

Because Australian governments at that time lacked central banking powers and other forms of economic control, the Prime Minister and the State Premiers meeting in the Loan Council and the Premiers' Conference were forced to co-operate during the 1930s in formulating budgetary and economic policies to lead Australia out of the Great Depression.

Other aspects of co-operative federalism included the development by the Grants Commission of systematic methods of horizontal fiscal adjustment, as noted above; and the establishment of councils of Commonwealth and State ministers, supported by standing committees of senior officials, for the purpose of achieving uniform legislation or administrative co-operation in functional fields of mutual interest. The Australian Agricultural Council, which was established in 1934, was a prototype for ministerial councils of this kind. Although ostensibly a consultative and advisory body, the Australian Agricultural Council has played a major role in developing joint policies with respect to agricultural production, research and marketing of primary products.

*Coercive Federalism*

Intergovernmental co-operation did not long survive the tax competition which resulted from World War II, and when the States refused to agree to a voluntary scheme of uniform income taxation during war-time the Commonwealth in 1942 introduced legislation which effectively gave it a complete monopoly of income taxes. This legislation imposed uniform rates of tax at levels which exceeded existing Commonwealth and State taxes combined; it gave the Commonwealth priority in collection and enabled it to take over State administrative machinery; and it provided for the payment of a so-called tax reimbursement grant to each State, equal to the average amounts of income tax collected by that State in the two preceding years, on condition that it refrained from levying income tax itself.

The States challenged the legislation but the High Court validated it by reference to the Commonwealth's peace-time powers, so that when the Commonwealth maintained the uniform tax legislation after the war the States remained shut off from this important source of revenue. Because other High Court decisions had had the effect of excluding the States from commodity sales taxes, they became heavily dependent on the tax reimbursement grants, the name of which was changed to financial assistance grants in 1959 as part of a general adjustment in intergovernmental financial relations.

Uniform income taxation was thus the principal instrument of Commonwealth financial domination, or coercive federalism, in the post-war period, when intergovernmental relations came to be characterised by bitter disputes about the size and distribution of grants. The formula which was adopted to determine the general revenue grants was never adequate to meet State needs in a period of rising costs, high population growth and rapid development, and additional grants were made outside the formula while frequent changes were made to the formula on the basis of unilateral Commonwealth decisions.

The vertical financial imbalance was associated with an erosion of financial responsibility, resulting from the breaking of the link between taxing and spending decisions at both the Commonwealth and State levels. It was also associated with growing horizontal financial imbalance, as unilateral Commonwealth decisions or bilateral bargaining resulted in changes in the per capita distribution of the financial assistance grants to the advantage of the four financially weaker States.

At various times, these all found it unnecessary to have their needs systematically assessed by the Grants Commission and were thus able to forgo claimancy for long periods. By 1975-76, the last year of the financial assistance grants arrangements, Tasmania was receiving roughly twice the financial assistance grants per capita which were paid to New South Wales and Victoria, while the other States were receiving from one-third to two-thirds more. As a result, the less affluent States showed little interest in seeking a restoration of income tax powers.

The distribution of loan funds also left much to be desired, as Loan Council arrangements tended to result in a distribution which reflected past allocations and there was no attempt to assess the relative capital needs of the several States on any systematic basis.

Although uniform income taxation was the fountain-head of Commonwealth financial supremacy, it also had two indirect consequences which themselves became important elements of coercive federalism. These were, first, the domination of the Loan Council which the Commonwealth achieved through its revenue surpluses and its control over the Reserve Bank; and, second, the Commonwealth's intrusion into traditional fields of State responsibility (such as education, health and transport) by means of conditional grants or loans (known as specific purpose payments in Australia) to the States.

The Commonwealth's control over the Loan Council was achieved when State loan programs could not be financed from public subscriptions, and the Commonwealth used its revenue surpluses to make special loans to the States to the extent that it was prepared to underwrite the programs. As a result of these special loans, by the end of the 1960s the Commonwealth was in the unique position for a national government of being a net creditor to all other sectors of the economy, while the States' debt situation had steadily deteriorated as they were forced to borrow to finance schools, hospitals and other non-revenue-producing assets.

The growing use of specific purpose payments meant that the Commonwealth was able to influence the level and pattern of public sector spending in areas outside its own constitutional responsibility. The States objected to the conditions attached to specific purpose payments, especially the matching or other revenue conditions which were often imposed so as to prevent revenue or expenditure substitution, on the grounds that they were thereby forced to adopt the Commonwealth's spending priorities and were less able to act in accordance with their own assessments of changing community needs.

Frequent adjustments in intergovernmental financial arrangements, especially at the time of quinquennial reviews by the Premiers' Conference, alleviated the position of the States without correcting the fundamental fiscal disequilibrium which had existed since the introduction of uniform income taxation. In 1970, for example, provision was made for the progressive transfer of $1,000 million of State debt (and the associated debt charges) to the Commonwealth over a five-year period, while the Commonwealth agreed to make unconditional capital grants to finance approximately one-quarter (later one-third) of the States works programs from the same date. In 1971, the Commonwealth transferred pay-roll tax to the States. As a result of successive increases in rates, this has become easily the most important source of State taxation revenue.

During the period after World War II, the States also took action to increase the yields of other taxes under their own control, although in recent years they have begun to reduce the application of some taxes (such as land tax, probate and succession duties, and pay-roll tax) and to abolish others (such as entertainment tax, business franchise taxes on petroleum products and, in the case of Queensland, all succession duties).

Throughout the period of uniform income taxation, the States had never made a sustained and concerted attempt to have income tax powers restored to them. They were generally content to leave the Commonwealth to collect income taxes, but argued that the level of financial assistance grants should be related to income tax yields rather than to the formula, which had regard to changes in wage rates, State populations and a so-called betterment factor. The States' approach to fiscal federalism thus involved a pragmatic attempt to maximise the level of Commonwealth grants rather than an affirmation of the principle of State financial responsibility.

*The Shift to Centralism*

It is important to note that, except for the uniform taxation policy itself (which was implemented by the war-time Labor government), the centralising tendencies of the period of coercive federalism resulted from policies of non-Labor Commonwealth governments that held office continuously from 1949 to 1972. There was an obvious conflict between the decentralising philosophies of the conservative parties which formed those governments and the centralising forces which resulted from a growing recognition of the need for national economic and social policies, to say nothing of the human tendencies leading politicians (and bureaucrats) towards central power. This conflict became more pronounced towards the end of the period and was probably the main factor responsible for the rejection of the Liberal Prime Minister (Mr J.G. Gorton) by his own party in 1971.

The Australian Labor Party, on the other hand, had always been strongly centralist, and when it came to power in 1972 on a platform of social reform and urban improvement it sought to implement its policies partly through changes in the structure of government and partly through the extended use of specific purpose payments to the States.

*Local and Regional Government*

Paradoxically, major aspects of the Labor government's federalism policy were concerned with strengthening the role of local government - 'to make local government a genuine partner in the Federal system' - and with establishing a framework of decentralised regional administration. Local government, which is constitutionally a State responsibility, has historically been weak in Australia, its functions until recently being very largely restricted to the construction and maintenance of streets and footpaths, sanitation services, limited controls over land use, building regulation and other services to property. The provision of most forms of social, economic and community services has been undertaken directly by the States. Education and health services are thus provided through highly centralised bureaucracies, while State-wide (or metropolitan) special purpose authorities (so-called semi-government authorities) provide services such as electricity, housing, water supply, sewerage and public transport.

After 1972, the Labor government provided financial assistance for local government mainly by means of specific purpose payments which the States were required to pass on, although payments were made directly in cases where the Commonwealth had constitutional authority. The Commonwealth's attempts to obtain a general power to make direct grants to local governments, to borrow on behalf of local governments and to allow local government representation on the Loan Council were defeated in referendums.

The most important form of Commonwealth grants for local governments was provided through the Grants Commission, the role of which was extended to report on applications, made on behalf of local governments by 68 regional organisations established for the purpose, for special financial assistance for general revenue purposes. These were essentially equalisation grants, although 844 out of 885 local governments received grants in the first year of the new program.

There was statutory provision whereby grants could be made directly to regional organisations on the recommendation of the Grants Commission, but the regional organisations were largely co-ordinating bodies which lacked executive and financial powers; in fact equalisation grants were made only to individual local governments. However, grants were made to regional organisations to encourage local governments to co-operate in dealing with local problems, and so-called area improvement programs were operated on a regional basis in some of the largest cities. Separate Regional Councils for Social Development were established under the Australian Assistance Plan. This was a national welfare program initiated by the Labor government in which local governments as well as other community groups could participate.

The Labor government justified its regional policies by reference to the opportunities they provided for devolution of decision making, greater participation in government decisions, improved access to public services and alleviation of regional inequalities. The emphasis was on regionalisation of public administration rather than on the establishment of a new tier of responsible government, but the States regarded the Commonwealth's regional initiatives as a threat to their own position and equated regionalism with centralism. A statement which the Prime Minister (Mr Whitlam) had made in 1971, when he was in opposition, was thus used against him by non-Labor State politicians, who argued that it demonstrated that the Labor government wished to liquidate the States and put an end to federal government in Australia:

> 'The State boundaries arranged at Whitehall in the middle of the last century and the local government boundaries devised in the State capitals early this century have little relevance to today's needs. Ideally, our continent should have neither so few State governments nor so many local government units. We should not have a federal system of overlapping parliaments and a delegated but supervised system of local government. We should have a House of Representatives for international matters and nationwide national matters, an assembly for the affairs of each of our dozen largest cities and regional assemblies for the few score areas of rural production and resource development outside those cities. Vested interests and legal complexities should not discourage or deter us from attempts to modernize and rationalize our inherited structure.'

*Specific Purpose Payments*

The other major element of the Labor government's federalism policy was its use of specific purpose programs as a means of implementing Labor policies. Between 1972-73 and 1975-76, specific purpose payments to the States more than quadrupled, rising from $932 million to $4,153 million. The main increases were in education, health, social welfare, culture and recreation, urban and regional development, and transport. Even though general purpose payments also increased by nearly two-thirds during the same period, specific purpose payments as a proportion of total Commonwealth payments to the States rose from one-quarter to nearly one-half. By 1975-76, State recurrent revenues were derived in roughly equal proportions of one-third each from the States' own taxes, general purpose grants from the Commonwealth and specific purpose grants from the Commonwealth.

Some State functions began to be wholly financed by the Commonwealth through specific purpose grants or were taken over completely by the Commonwealth; tertiary education was in the first category and railways in two States (the whole railway system in Tasmania and non-metropolitan railways in South Australia) were in the second.

Although the States were usually able to apply the funds provided under the specific purpose programs in substitution for their own taxes or expenditure commitments, intergovernmental conflicts developed about program and policy objectives and about the procedures adopted for implementation of the programs. On the one hand, the Labor Prime Minister (Mr Whitlam) told the State Premiers:

> 'From now on, we will expect to be involved in the planning of the functions in which we are financially involved. We believe that it would be irresponsible for the national Government to content itself with simply providing funds without being involved in the process by which priorities are met, and by which expenditures are planned and by which standards are met.'

On the other hand, the States complained about what the New South Wales (Liberal Party) Premier (Mr T.L. Lewis) called 'naked centralism, based on expanding and duplicating functions to use centrally the vast income tax bounty'. The States said that the Commonwealth's use of specific purpose grants involved regulation of State activity, interference with State priorities and a waste of resources in setting up separate bureaucracies to administer the grants. Mr Lewis put the State view as follows:

> 'The processes require the preparation of State plans and submissions to the Federal Government, the determination in Canberra of programs and conditions, the State execution of those programs and the accounting by the States for the expenditure. This requires a duplication of effort at State and Federal levels at a cost which the community should not be required to meet.'

To some extent, this conflict reflected philosophical differences in attitudes to federalism, as between a Labor Commonwealth government and non-Labor State governments. But it was essentially a dispute about power, and occurred because preoccupation with political or bureaucratic power diverted attention from policy goals and decision processes. On the one hand, the States complained that programs and policies were formulated without adequate planning and consultation and without regard to legitimate State interests; and that the Commonwealth involved itself too closely in the detailed administration of programs which, if clear guide-lines had been established, the States could have implemented without the wasteful duplication of administrative machinery.

On the other hand, the States were often loath to accept the fact that national interests, more adequate information sources at the Commonwealth level and the effects on other States of decisions taken by individual States often made it necessary for programs and policies to be formulated by the Commonwealth government.

*Advisory Commissions*

Another important Australian innovation, which has been associated with the development of specific purpose grants programs, has been the use of independent statutory bodies to advise the Commonwealth government on financial needs in relation to the programs. The prototype for these bodies was of course the Commonwealth Grants Commission, but during the 1950s and 1960s non-Labor Commonwealth governments established the Australian Universities Commission, the Commonwealth Bureau of Roads, the Australian Commission on Advanced Education and the National Urban and Regional Development Authority. The Labor leader (Mr Whitlam) foreshadowed the extension of this device to other fields in the following statement, which he made before his party gained office in 1972:

> 'No member of parliament would denigrate the transformation which has taken place in Australian universities or deny that it has been achieved through processes of systematic, impartial, and objective inquiry followed by the establishment of national priorities and the provision of appropriate funds. Too little notice has so far been taken of this clear and fruitful lead.'

After 1972, the Labor government proceeded to establish new commissions whilst retaining and in some cases extending the role of existing ones (such as the Grants Commission). The National Urban and Regional Development Authority became the Cities Commission, legislation was passed to reconstitute the Inter-State Commission which under the Constitution had been intended to advise on transport matters, and action was taken to establish the following new commissions to advise on specific purpose grants: the Schools Commission; the Technical and Further Education Commission; the Children's Commission; the Social Welfare Commission; the Hospitals and Health Services Commission; and the Australian Heritage Commission.

The main reason for entrusting the advisory role to independent statutory commissions rather than to government departments was probably a desire on the part of governments to ensure that assessments of financial need were made, in a sensitive area of intergovernmental relations, on the basis of what Mr Whitlam called 'processes of systematic, impartial, and objective inquiry'. The undoubted success of the Grants Commission and the Universities Commission in evaluating the financial needs of a limited number of recipient units was no doubt an important reason for establishing similar agencies to report on financial needs in other fields where the Commonwealth was partially assuming responsibility for State functions.

The use of a formula approach by other countries for the assessment of financial needs has probably reflected the greater number of governments or other units eligible for assistance in those countries. But some advisory commissions in Australia have been required to report on the individual needs of a large number of recipient units. Thus the Grants Commission had responsibility for recommending equalisation grants for all local governments, while the Schools Commission assessed the needs of all Australian primary and secondary schools and the responsibilities of the Commonwealth Bureau of Roads extended to all Australian roads.

The extension of the use of advisory commissions created a number of problems of public administration and in some cases led to further tensions between the Commonwealth and State governments.

In the first place, the role of the commissions and their relationships with the executive government and parliament were not clearly defined. There was a resulting tendency for some commissions to act as administrative agencies on the one hand and for some of their advisory functions to be duplicated in the public service departments on the other.

Secondly, the recommendations of the commissions tended to be considered outside the normal budgetary processes of priority determination and financial appropriation. To some extent this was a legacy of the vertical fiscal imbalance which characterised the Australian federal system after World War II, when it became common for intergovernmental ministerial councils in functional fields such as roads and education to seek Commonwealth financial assistance on the basis of catalogues of needs which had no regard to budget constraints. Needs were expressed by these ministerial councils in terms of such criteria as miles of unsurfaced roads or shortages of teachers calculated by reference to arbitrary staff-student ratios. The advisory commissions used more sophisticated methods of evaluation, but their recommendations were not made by reference to budget guidelines within a framework of priority review. Each set of recommendations was therefore virtually open-ended in its budgetary implications, and when all the recommendations were added together and substantially adopted by the Commonwealth government they represented a massive increase in total budget outlays. The inflationary consequences of this expansion were so severe that cut-backs had to be made in 1975-76 and subsequent years, with resulting dislocations not only in new programs but also throughout the whole range of public sector activity.

Thirdly, the advisory commissions did not operate as intergovernmental agencies, despite the fact that they were concerned with making recommendations on financial assistance to State governments, for purposes which under the Constitution were the financial responsibility of the States.

It was thus necessary for the commissions to be more satisfactorily adapted to the decision-making processes within the Commonwealth government as well as to the task of co-ordinating policies with intergovernmental dimensions. It needs to be recognised that statutory commissions which have intergovernmental responsibilities are better equipped to assess relative needs than to advise on needs in some absolute sense; their recommendations should be capable of being fitted into the budgetary and political decision-making processes whereby priorities are determined by the different levels of government; they should be adjudicatory rather than administrative agencies; and they should be constituted in a manner which reflects their independence from governments.

The task of devising machinery to permit the work of the commissions to be integrated in the decision processes of government is obviously a difficult one, which has so far received little attention from Australian students of government. However, since 1975-76 there have been several developments affecting the advisory commissions. The Social Welfare Commission, the Children's Commission, the Cities Commission and the Commonwealth Bureau of Roads have been abolished as independent statutory bodies and their functions taken over by Commonwealth government departments. The Inter-State Commission legislation has not been implemented. The three post-secondary education commissions have been merged in a Tertiary Education Commission, while most of the local government functions of the Commonwealth Grants Commission have been transferred to new State Grants Commissions.

The commissions which have been retained to advise on specific purpose programs are now operating under physical and financial guidelines laid down by the Commonwealth government. The education commissions have pointed out that the effect of the guidelines is to give them a dual role, whereby they must offer independent advice about needs and then, when the government has determined its guidelines having regard to their recommendations, they must advise on allocation priorities to distribute the total amounts available. A two-way flow of information is needed under these arrangements, to ensure that the government's guidelines reflect the commissions' advice about emerging educational needs and that the commissions have regard to overall budget constraints in making their recommendations. Although the new arrangements provide a framework for more rational financial planning, by themselves they will not overcome the other weaknesses in the constitution and operation of advisory commissions which were noted above. In particular, the problem of reconciling the independence, the advisory character and the intergovernmental role of the commissions with the budget processes of Commonwealth and State governments has not yet been resolved.

### *The States' Response: Political Action*

By 1975, Commonwealth-State relations were at an all-time low as the States sought to break the Commonwealth's financial domination and resisted the centralising tendencies of the specific purpose programs and the growing Commonwealth involvement in local and regional affairs. The States resorted increasingly to political weapons, using battlecries of centralism and State rights. The Australian Labor Party suffered dramatic reversals in State elections fought mainly on these issues in 1974 and 1975, and the non-Labor parties were able to use their control of the Senate (achieved partly because two State governments broke long-standing conventions in filling casual Senate vacancies) to block government legislation and eventually, by refusing to grant supply, to make it impossible for the Whitlam government to continue in office.

### *Towards Co-ordinative Federalism*

Before this, however, the need for intergovernmental policy co-ordination was at last beginning to be recognised by all Australian governments and political parties. At the Premiers' Conference in May 1975, the Prime Minister (Mr Whitlam) had sought a basis for co-ordination in the following terms:

> 'The Australian Government will be seeking in the longer term a more rational and co-ordinated system of assessing needs, setting priorities and allocating resources in the public sector - one based on co-operation between Governments. It may take years to develop a new approach of the kind we have in mind, of the kind discussed among our officials. But we believe a start should be made now.
>
> The view of the Australian Government is that in seeking better co-operative planning arrangements it would be best to begin with particular important functions where there is a clear need for co-ordination and where early progress seems possible. Three such functions have been suggested in the discussions among our officers - transport, health and urban development ...'

The Commonwealth suggested and the States agreed that ten forms of co-operative planning should be investigated, including 'the scope for some relaxation of conditions attached to specific purpose assistance to the States as more satisfactory co-operative planning arrangements are developed'. However, the impact of the proposals was lost in the general atmosphere of hostility and suspicion and little progress had been made by the time the Whitlam government was dismissed.

Meanwhile, the Liberal-National Country Party opposition had announced that, if elected to office, it would implement a new federalism policy. This also emphasised the need for policy co-ordination between the Commonwealth and State governments, but the opposition parties said that they viewed federalism as a philosophical rather than a structural concept, which would prevent undue concentration of power in the hands of any government and thus help to guarantee political and individual freedom.

Following the defeat of the Labor government in December 1975, the new Prime Minister (Mr J.M. Fraser) convened a series of Premiers' Conferences for the purpose of putting the Liberal-National Country Party federalism policy into effect. The outcome of these Conferences was an agreement on what were called 35 points of understanding. The main elements of the agreed policy are summarised in the next section.

*The Fraser Government's New Federalism Policy*

The new federalism policy provided for the introduction in two stages of a system of personal income tax sharing, in place of the financial assistance grants which had been paid under the uniform income tax arrangements. Under Stage 1 of the tax sharing arrangements, the States were to receive annually 33.6 per cent of personal income tax collected by the Commonwealth. This was the estimated proportion of financial assistance grants to income tax collections in 1975-76. Provision was made for the exclusion of special Commonwealth surcharges or rebates from the base figure used to calculate State entitlements. There were also guarantee provisions designed to prevent State entitlements falling below the amounts they would have received as financial assistance grants during the first four years, or below the absolute amounts received in a preceding year thereafter.

The initial distribution of the Stage 1 tax sharing entitlements among the six States was to be in accordance with the per capita relativities of the financial assistance grants in 1975-76, but there was to be a review of the relativities by an augmented Grants Commission before the end of 1980-81. The four less populous

States could continue to apply for special grants through the Grants Commission; such grants would be additional to tax sharing entitlements.

Under Stage 2 of the tax sharing arrangements, which would no operate before 1977-78, individual States would be able to impose percentage surcharges or allow percentage rebates of personal income tax, and thus vary the taxes paid by their citizens to the benefit or cost of their own revenues. But there would continue to be a uniform basis of assessment and collection on the basis of Commonwealth laws; only percentage rates of tax would vary among States. In recognition of the differences among the States in taxable capacity, provision was made for equalisation of surcharges by means of supplementary grants to be assessed by the Grants Commission.

Specific purpose payments to the States were to be reduced and, where appropriate, absorbed into tax sharing entitlements or other general revenue funds.

Local governments were also to receive a fixed proportion (1.52 per cent) of personal income tax collections. This represented the proportion of local government equalisation grants to personal income tax collections in 1975-76. But the role of the Commonwealth Grants Commission was now to be restricted to that of advising on the distribution of the total amount among the six States, and State Grants Commissions were to be established in 1976 to advise on allocations to individual local authorities. From 1976-77, at least 30 per cent of the total amount within each State was to be distributed on a population basis (possibly adjusted for area, population density or other factors agreed with the Commonwealth), while the remaining assistance was to be distributed on an equalisation or needs basis.

An Advisory Council for Inter-government Relations was to be established, comprising members of Commonwealth and State parliaments, local government representatives and private citizens, to facilitate intergovernmental co-operation and consider matters referred for investigation and advice by the Premiers' Conference. Machinery for intergovernmental co-operation was to be strengthened in other ways, for example by making the Premiers' Conference a forum for debate on broad economic issues.

Despite subsequent disagreement on the part of some States about the details of the new policy, especially the introduction of State surcharges and the future of specific purpose grants, action has now been taken to put the policy into effect.

*Evaluation of the New Federalism Policy*

The tax sharing arrangements in the new federalism policy represent a significant retreat from the Commonwealth's income tax monopoly and a step towards State financial responsibility. They retain many of the advantages of uniform taxation, including effective Commonwealth control over policies for economic management and income distribution, the convenience to taxpayers of a single system of assessment and collection, and the minimisation of wasteful intergovernmental tax competition.

However, it is not yet clear whether the States will take advantage of the opportunities for greater financial autonomy which the new scheme will provide, and there are already indications that they will be more inclined to argue about percentage shares and the revenue base than to impose their own surcharges. State surcharges will involve additions to a form of taxation which many people already regard as unduly burdensome. If the Commonwealth and the States had both genuinely sought a restoration of State fiscal autonomy, they should have agreed on a reduction in Commonwealth rates to make tax room for the States, accompanied by an equivalent reduction in tax sharing entitlements. The States would then have been forced to impose their own surcharges to the extent that they wished to maintain revenues.

The equalisation provisions of the tax sharing arrangements have the potential for achieving better horizontal financial balance than exists under the present system, because the per capita relativities of the six States will now be subject to periodic review on a systematic basis by an enlarged Grants Commission, instead of being left to political bargaining and arbitrary allocations. However, different equalisation criteria and methods are being used for the equalisation of surcharges from those used for equalisation grants generally. As a result, there will be financial advantages for all States in substituting income tax surcharges for existing forms of State taxation, although it is not yet clear how State governments will balance these financial advantages against the political disadvantages of increasing the effective level of income taxation.[3]

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[3] This point is explained by the author as part of a general evaluation of the new federalism policy in the *1975* and *1976 Reports of the Centre for Research on Federal Financial Relations*, The Australian National University, Canberra, 1976 and 1977.

The absorption of specific purpose grants in general purpose funds will be difficult, because the former are distributed on a basis which differs from either existing per capita relativities for tax sharing entitlements or the relativities which are likely to be assessed by the Grants Commission. But the Commonwealth has already abolished all regional programs and begun to phase out most programs in the field of urban development, and it seems likely to convert grants for particular health and welfare purposes into block grants which will increase the spending discretion of the States. Although most specific purpose payments for education will be retained, the Commonwealth is seeking some form of cost sharing with the States in this field.

Ironically, the quadrupling of specific purpose payments between 1972-73 and 1975-76, which the States resisted as a threat to their own fiscal autonomy, has locked the Commonwealth into a difficult budgetary situation, changed the relative debt position of the two levels of government and shifted the balance of financial advantage towards the States. But just as most States now seem to have lost any enthusiasm for a restoration of income tax powers, so they seem unwilling to accept greater responsibility for the functions covered by specific purpose grants programs.

The new federalism policy has done nothing to restore horizontal financial balance in relation to loan programs. Because capital outlays represent one of the few areas in the Commonwealth budget where there is still some spending flexibility, loan programs and capital grants have fallen in real terms and relative to recurrent outlays during the last two years, thereby introducing another kind of distortion into the resource allocation process in the public sector.

The new local government tax sharing arrangements will result in some overlapping and duplication of effort as between the Commonwealth and State Grants Commissions. There has also been a significant shift in emphasis, from horizontal adjustments for equalisation purposes to vertical adjustments intended to augment the revenues of all local governing bodies. Although at least 30 per cent of a State's entitlement must be distributed among local authorities on an equal per capita basis, this is a minimum proportion and it will be possible for a State Grants Commission to recommend that the whole amount be allocated proportionately to population. This would largely nullify the equalisation purpose of the Commonwealth assistance.

*Conclusion*

It is too soon to say whether the tax sharing aspects of the Fraser government's new federalism policy will restore vertical and horizontal financial balance in the Australian federal system, reduce the centralising tendencies of recent years and devolve significant decision-making responsibilities on the States. The States themselves, after making much political capital out of the questions of State access to income taxes and the Commonwealth's use of specific purpose payments, now seem to be resisting the very developments which they had claimed to be seeking. It is difficult to avoid the conclusion that the States are continuing to place expedience before principle and are more concerned with maximising the amounts of financial assistance they receive from the Commonwealth than with the restoration of financial responsibility for their own taxing and spending decisions.

Most of the problems which have been noted are capable of being remedied relatively easily. The new federalism policy provides a credible framework for improving financial responsibility at all levels of government and for achieving more effective policy co-ordination. The potential scope for achieving intergovernmental financial balance has therefore been extended, although the opportunities for continuing intergovernmental conflict also remain.

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