Fiscal Federalism in Australia

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1. Goals of the Existing System

Identifying what might be called the 'goals' of the Australian federal fiscal system is a vexed task, essentially because the system has evolved over many years and is the result of many factors. Here we focus on what the intentions of the framers seem to have been.

1.1 Background

In the lead up to Federation in 1901, the six constituent colonies enjoyed substantial powers of local self-government and constitutional self-determination within the broad constraints of British imperial oversight and control. Each colony had an independent power to raise taxes, borrow funds and spend money. These powers were exercised in accordance with each colony's constitution and the conventions of parliamentary responsible government as adapted to the conditions prevailing in the Australian colonies.

When the colonial delegates deliberated about the particular form that a federation might take, it was assumed that the colonies would continue to operate as self-governing constituent units of the federation, independently exercising the vast bulk of their existing executive, legislative, judicial and financial powers in a manner that they had prior to federation, subject only to those changes considered necessary in order to establish an effectively operating federal system of government.

1.2 Federation

At the time of federation, political actors from the six constituent Australian colonies harboured varying aspirations. The constitutional settings upon which they settled had to be resolved by majority votes among delegates to the federal conventions of 1891 and 1897–98, and agreed to by majority votes in the referendums that were held in each of the colonies between 1898 and 1900. At the beginning of each of the two federal conventions the delegates debated and approved a set of resolutions that set out the basic features of the system they wished to see established.[1] The resolutions from the second convention of 1897–98 included the following:

> That the powers, privileges, and territories of the several existing colonies shall remain intact, except in respect of such surrenders as may be agreed upon to secure uniformity of law and administration in matters of common concern. …
>
> That the exclusive power to impose and collect duties of Customs and Excise, and to give bounties, shall be vested in the Federal Parliament. …

[1] Nicholas Aroney, *The Constitution of a Federal Commonwealth: the making and meaning of the Australian Constitution*. Cambridge: Cambridge University Press, 2009, ch. 6.

> That trade and intercourse between the Federated Colonies, whether by land or sea, shall become and remain absolutely free.[2]

The resolutions also called for the framing of a federal constitution that would establish a Federal Parliament consisting of a directly-elected Senate with equal representation of each State, and a House of Representatives elected by districts formed on a population basis that would possess the sole power of originating bills appropriating revenue or imposing taxation.[3]

1.3 Co-ordinate design within a common market

In very broad terms, these resolutions were consistent with the proposition that the federated colony-states would continue to possess the taxing, borrowing and spending powers they had prior to federation, subject to the surrender to the federal government of the exclusive power "to impose duties of customs and of excise". This latter measure was intrinsic to the goal of establishing free trade among the colonies because one of the main restrictions on inter-colonial trade had been the imposition of customs or excise duties on goods traded between the colonies. In addition, the intention was that the federal parliament would have full power to authorise the imposition of taxation and appropriation of revenue, thus enabling the Commonwealth (federal) government impose and collect taxes of essentially any kind and spend those revenues on matters falling within the responsibility of the federation. The result would be two sets of parallel governments, Commonwealth and State, each possessing largely independent powers of taxation and spending.[4]

As the debate in the federal convention progressed, however, these underlying goals were elaborated and extended in several important ways. These included provision for the Commonwealth to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit"; requirements that the federal government must not discriminate between the States when levying taxation; and that the federal government may not tax the property of a state, and vice versa. These elaborations and extensions are explained in more detail in the next section.

2. Evolution and Issues

The federal system operating in Australia today has travelled a long way from its origins. While envisaged as a non-centralised system, it has undergone steady process of centralisation—particularly since 1920. Supported by expansive interpretation of its enumerated powers by the High Court, the Commonwealth has steadily and sometimes dramatically increased its power in the federation. The two main means by which it has done

[2] *Official Report of the National Australasian Convention Debates*, Adelaide. Adelaide: Government Printer, 1897, 395.

[3] Ibid.

[4] For more background, see Cheryl Saunders, 'The Hardest Nut to Crack, in Greg Craven, ed., *The Convention Debates 1891–1898: commentaries, indices and guide*. Sydney: Legal Books, 1987, 149.

so are through expansive exercise of its legislative powers and through mechanisms of fiscal centralisation.[5]

2.1 Overview

At the time of federation, the most important sources of government revenue were taxes on goods imported into each colony. One of the primary objectives of the federation was to establish freedom of trade, commerce and intercourse between the states. In order to achieve this, it was considered necessary to prohibit the states from imposing customs and excise duties on goods imported into or circulating within each state. The power to impose duties of customs and excise was made an exclusive power of the Commonwealth. This prevented the States from adopting protectionist policies against other states, leaving it to the Commonwealth Parliament to determine whether or not it would adopt protectionist or free trade policies with respect to other countries. However, because taxes on goods had been the major source of revenue for the colonies prior to federation, this opened up serious questions about their fiscal capacities after federation. A temporary system, whereby the excess revenues received by the federation would be distributed proportionately to the states was implemented by the constitution, but after this initial period, it was left to the discretion of the federation to determine whether and, if so, how much excess revenue or other financial assistance would be distributed to the states. A provision was accordingly inserted into the constitution expressly stated that the federation could grant financial assistance to the states on such terms and conditions that it thinks fit.[6]

Given the fiscal advantages enjoyed by the Commonwealth, provisions were also included in the constitution to prevent it from (a) discriminating between states or parts of states in any law imposing taxation, (b) giving preference to one state or any part of a state through any regulation of trade, commerce or revenue, and (c) imposing tax on the property of a state. The states were likewise prohibited from imposing taxes on the property of the Commonwealth, and they were also prohibited from coining money and from making anything other than gold and silver coin legal tender in the payment of debts. The Commonwealth was thus placed into a position of being able to exercise substantial fiscal power through its powers to legislate with respect to taxation, borrowing, currency, coinage and legal tender. Although the states could continue to legislate with respect to their own taxation and borrowing, in the event of any inconsistency between a law of the Commonwealth and a law of a state, the constitution provided that the former would prevail and the latter would, to the extent of the inconsistency, be invalid.

With the later emergence of personal and corporate income taxes as important sources of government revenue, the significance of the states' loss of customs revenue had the potential to be less significant. Under their respective constitutions, they continued to have the authority to impose taxes generally (other than customs and excise duties) and they continued to have

[5] James Allan and Nicholas Aroney, 'An Uncommon Court: how the High Court of Australia has undermined Australian federalism', *Sydney Law Review* 30:2 (2008), 245–94; Alan Fenna, '*The Centralization of Australian Federalism 1901–2010: measurement and interpretation*', *Publius* 49:1 (2019), 30–56.

[6] Saunders, 'Hardest Nut'.

authority to make determinations about the expenditure of government revenue for public purposes. Recognising that the capacity of the Commonwealth to borrow money could not be separated from the financial condition of the states, and vice versa, the constitution provided that the Commonwealth could take over the debts of the states with consequential adjustments to the distribution of surplus federal revenue to the states in accordance with federal government policy. However, subject to the potential for the Commonwealth to take over state debts (a possibility expanded and clarified by a constitutional amendment in 1928) at the time of federation it remained for each of the states, as well as the federation, to determine their respective fiscal policies in relation to taxation, borrowing and expenditure.

2.2 Driving Forces

Since the early days of the federation, Australia's federal system has undergone considerable centralisation. Several features of the system as originally constructed laid the foundation or provided grounds for centralisation even though many of the original founders necessarily anticipated or wanted this to occur.

As with other federations, a combination of modernisation, the emergence of the modern welfare state, and crises have been the primary drivers of this centralisation, especially from the 1920s onwards.[7]

2.3 Key Moments

Since the time of federation, the fiscal powers of the Commonwealth have waxed, while the corresponding powers of the State have generally waned. This occurred through a series of developments outlined below.[8]

Federal income tax (1915). Up until the First World War, the Commonwealth had access to ample (and indeed substantially excess) revenues thanks to the fiscal primacy of customs tariffs, where it exercised a constitutional monopoly. Restricted tariff revenues and escalating costs led the Commonwealth to exploit its plenary power to tax by entering the field already occupied by the States and levying its own income tax. While this was not significant in terms of fiscal federalism in the short to medium term, it was a harbinger of great changes to come.

High Court Decision Repudiating 'Federal' Reading of the Constitution (1920). Until 1920, the High Court of Australia adopted an approach to the interpretation of the Constitution that restricted the scope of Commonwealth legislative powers and prohibited either the

[7] Paolo Dardanelli, John Kincaid, Alan Fenna, André Kaiser, André Lecours, Ajay Kumar Singh, Sean Mueller and Stefan Vogel, 'Dynamic De/Centralization in Federations: comparative conclusions', *Publius* 49:1 (2019), 194–219.

[8] For more detail, see Alan Fenna, 'Commonwealth Fiscal Power and Australian Federalism', *University of New South Wales Law Journal* 31:2 (2008); and Neil Warren, 'National fiscal consolidation and the challenge to Australian Federalism', *Economic and Labour Relation Review* 24:2 (2003).

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Commonwealth or the States from enacting laws interfering with each other's operations. It was held that this meant that the States were unable to impose taxes on the incomes of Commonwealth government employees; although the point was never tested, it also probably precluded the Commonwealth from imposing taxes on the incomes of State government employees. However, in a landmark decision in 1920, the High Court rejected this approach to constitutional interpretation, potentially opening up the capacity of the Commonwealth and the States to impose taxes on each other's employees. This development was especially advantageous to the Commonwealth because its laws prevail over inconsistent State laws, enabling the Commonwealth to protect its employees from State taxes, a capacity that is not enjoyed by the States.

High Court Decision Giving Emphatic Endorsement to the 'Spending Power' (1926). In 1926, the High Court affirmed that the Commonwealth is authorised to make financial grants to any State 'on such terms and conditions as the Parliament thinks fit', as the words of section 96 of the Constitution literally read. They did this notwithstanding that section 96 was intended to be a transitional provision, confined to supplementing State finances in the special circumstances of the States' loss of customs and excise duties, and imposing terms and conditions relevant to those circumstances. The High Court held that since a State cannot be legally compelled to accept a grant, the Commonwealth can determine the purposes for which a grant will be made and the manner in which those purposes are effectuated, going so far as to make the grant conditional on a State refraining from imposing income tax (see below). This interpretation of the grants power has enabled the Commonwealth to regulate fields lying far beyond its constitutionally limited legislative powers.

Australian Loan Council (1928). State indebtedness and the costs of competitive individual borrowing led to an intergovernmental agreement in 1927 to centralise Australian government fund raising, with the Commonwealth assuming responsibility for State debts. The Loan Council, which dated back to 1923, would be responsible for managing that borrowing. Each State was given one vote on the Council and the Commonwealth was given two and a casting vote. A constitutional amendment in 1928 inserted section 105A providing constitutional authority for these arrangements — though without in any way mandating them.

Wholesale Sales Tax. As noted above, central to the establishment of a single market across the federation was section 90, giving the Commonwealth exclusive authority "to levy duties of customs and of excise". The High Court interpreted the latter as encompassing indirect taxes, thereby denying the States any access to sales tax. In 1930, the Commonwealth introduced a national Wholesale Sales Tax, which remained the exclusive general sales tax in Australia until it was superseded in 2000 by the Goods and Services Tax or 'GST' (a national value-added tax at 10 percent). The background to the introduction of the GST in 2000 is explained below.

Commonwealth Grants Commission (1933). Following Western Australia's unequivocal referendum vote in favour of secession, a vote expressing discontent with economic conditions and fiscal arrangements, the Commonwealth established the Commonwealth Grants Commission (CGC) to regularise equalisation payments across the federation.

Federal Monopolisation of Income Tax (1942). Up until the Second World War, the bulk of personal and corporate income tax in Australia was raised by the States. This changed

fundamentally when, after the States rejected a request to lend their tax systems to the Commonwealth for the duration of the war, the Commonwealth passed legislation commandeering their tax systems and excluding them from the field.

In 1942, the Commonwealth passed four separate laws the combined effect of which was: (a) to impose a very high graduated tax on personal income; (b) to provide a grant to each State on condition that it ceased levying income tax, the quantum of the grant being roughly equivalent to the amount that it would have collected under its existing income tax laws; (c) to make it an offence for a person to pay any State income tax before paying the Commonwealth tax; and (d) to transfer State taxation officials temporarily to the Commonwealth public service in order to administer the scheme.

The Court upheld these laws, insisting that each Act had to be considered separately, and that it was not appropriate to question the constitutionality of the four Acts as an entire scheme directed to some unconstitutional objective. The Court rejected the argument that the Commonwealth Grants Act were unconstitutionally directed to 'destroying or weakening the constitutional functions or capacities of a State'. In 1957, the High Court again upheld the uniform tax scheme, except that a majority of the Court struck down the provision requiring taxpayers to pay the Commonwealth tax in priority to any State tax. This qualification has had little practical effect on the constitutional capacity of Commonwealth to monopolise the imposition of income tax.

Agreement on Introduction and Distribution of the GST (1999). Following High Court interpretations of section 90 prohibiting the States from imposing taxes on goods, the States found ways to avoid the prohibition by requiring wholesalers and retailers to pay licence fees to sell particular kinds of goods (e.g., tobacco, liquor, petroleum) with the licence fees calculated on the quantity or value of the goods traded in a previous period. The States used these 'backdating' devices to secure increasingly large sources of revenue until in 1997 the High Court struck down one of these devices on the basis that it was essentially a revenue-raising scheme rather than a means of regulating the supply of particular kinds of goods.

This removal of a very significant source of revenue gave the States incentive to lend political support to the Commonwealth in a scheme by which the Commonwealth would impose a general tax on the sale of goods and services on the condition that the revenues would be distributed to the States on a basis determined by the Commonwealth Grants Commission (CGC). The GST replaced the Commonwealth's Wholesales Sales Tax that had been operating for the preceding 70 years, as well as several economically inefficient State taxes. Under the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*, the entire net proceeds of the GST would be transferred to the States as a general-purpose grant, replacing the existing process of annual budgetary measures. The States welcomed this arrangement because (a) it would make them less vulnerable to the whims of Commonwealth budgeting; and (b) because the proceeds of the GST should rise in line with economic growth and thus maintain their value. It remains in place to this day and makes up roughly half of the intergovernmental transfers received by the States and a fifth to a quarter of their total revenues.

Reform of Conditional Grant System 2009. Under the *Intergovernmental Agreement on Federal Financial Relations*, the Commonwealth agreed to condense a swag of conditional

grants into a handful of block grants, in exchange for the States agreeing to a new regime of outcomes assessment. That outcomes assessment process in turn involved the creation of a new jointly-managed body, the COAG Reform Council to undertake the process of assessment. It functioned until 2014 when it was terminated by the Commonwealth government.[9]

Henry review 2010. In 2008, Commonwealth Treasury was commissioned to undertake a strategic review of the tax system. One of the report's recommendations (no. 45) was that the Commonwealth introduce a 'uniform resource rent tax' that would replace or displace existing Commonwealth and State taxes on non-renewable resources. This was one of the very few recommendations followed by the government of the day, resulting first in the policy débâcle of the Resources Super Profit Tax and its revised version, the Mineral Resources Rent Tax, opposed by the mining states and the mining industry.

2.4 Australian Democracy and the System of Fiscal Federalism

The process of fiscal centralisation described above proceeded as it did in large part because it accorded with the character of Australian society and democracy. With no federal society, and a strong Left–Right party system operating across the country, the introduction of national programs, often by the Labor Party, had ideological but not identity-based opposition.

3. Distribution Mechanisms

Because there are no shared tax bases in Australia, revenue autonomy is high. And because the main taxes bases are controlled by the Commonwealth, it is the Commonwealth that enjoys the lion's share of that autonomy. It has complete control over the personal income tax, the corporate income and the sales tax (the Goods and Services Tax or 'GST', a nationwide value-added tax). The only deviation from that is that, under Commonwealth legislation pursuant to the Intergovernmental Agreement of 1999 described above, any changes to the GST must be approved by the States. However, Parliament has the ability to amend that legislation at any time of its choosing. The States, meanwhile, rely for their own-source revenue on such taxes as natural resource royalties, payroll tax, and property conveyancing fees. In these and other own-source revenues they are fully autonomous.

The non-contributory old-age pension scheme, the contributory system of occupational superannuation, and unemployment benefits scheme are all run exclusively by the Commonwealth. Similarly, while the public hospital systems are State responsibilities, Australia's system of public health insurance, Medicare', is entirely Commonwealth-run.

[9] Alan Fenna, 'Performance Comparison in Australian Federalism', in CEDA, ed., *A Federation for the 21st Century*. Melbourne: The Committee for Economic Development of Australia, 2014.

4. Fiscal Relations and the Division of Powers

The constitutional division of powers at Federation left the States with prime or exclusive responsibility for almost all domestic governance and service delivery, including health care, education and infrastructure provision, civil and criminal law; policing; land management; environmental protection; and local government. These have only increased in expense over time. Other than in a time of war, the Commonwealth's main responsibilities were not financially burdensome. There has thus emerged a great disconnect between the highly centralised fiscal arrangements and the generally non-centralised expenditure responsibilities.

This situation of great Vertical Fiscal Imbalance (VFI) makes the States heavily reliant on transfers and thus gives the Commonwealth great opportunity to exercise its 'spending power' and shape policy in areas of State jurisdiction such as health, education and infrastructure. Since the mid-1970s, the Commonwealth has made extensive use of the spending power to shape policy across a wide range of State-government domains. Specific Purpose Payments generally make up around half of all federal transfers and carry a range of conditions.

5. Ensuring Financial Stability

The issue of fiscal consolidation, or policies designed to reduce government deficits and debt accumulation, have been the focus of little attention in the Australian federation. Typically, any agreement on fiscal consolidation would need to involve agreement on five key issues:

1. Tax and expenditure assignment (to ensure fiscal transparency and therefore accountability of policymakers);
2. Intergovernmental transfers and associated fiscal equalisation;
3. Fiscal rules by level of government;
4. Independent review of performance against agreement;
5. How to regularly review the arrangements in (1), (2), (3) and (4).

A fiscal consolidation agreement in the Australian federation is simply not possible under current arrangements. This is because the Australian COAG processes (in place from 1993-2019, but subject to change in 2020 in response to the COVID-19 crisis) are based around intergovernmental agreements that are neither enforceable nor necessarily inclusive of all States and Territories. Additionally, while it is generally accepted that transparency about roles and responsibilities is critical, in the Australian federation clear agreement on assignment has been difficult to achieve. Without legal enforcement, there is an inability to impose sanctions for non-compliance with agreed fiscal outcomes. Given high VFI in Australia, a possible Commonwealth response might be to impose sanctions for non-compliance when assessed by some agency independent of all governments – but the Commonwealth has shown little interest in this option.

The lack of agreed fiscal rules in the Australian Federation is therefore hardly surprising given the lack of enforceability with intergovernmental agreements.[10] Instead, governments have adopted a self-regulatory approach as with the Commonwealth *Charter of Budget Honesty Act 1998* and States and Territories who have focused on self-imposed borrowing constraints enacted through legislation on 'fiscal responsibility' (New South Wales, Victoria and Queensland), 'fiscal integrity and transparency' (Northern Territory), 'budget honesty' (South Australia) and 'budget responsibility' (Tasmania). The effect is to make explicit the criteria States and Territories impose on themselves 'with a view to maintaining financial results that are fiscally sustainable in the medium and long term'.[11] Such self-regulatory approaches while sound in principle, are undertaken without fear of sanction (except from the public) for non-compliance or under-performance.

An option also applied is undertaking *ad hoc* independent government reviews. These are common and initiated by both the Commonwealth and State and Territory governments. However, these too result in non-binding outcomes and are initiated for very political reasons (as with an incoming government) or responded to with a political bent. It is also common for such inquiries to point accusingly at other jurisdictions as contributing to their policy problems. It is common for Commonwealth fiscal reviews to suggest State and Territory reforms or for State reviews to attribute their policy problems to their exclusion from access to the income and consumption tax bases.

Where there is greater consistency across the federation is with independent statutory authority reporting to Parliament which focus on *ex post* reviews of government expenditure and tax programs. At the Commonwealth level, this occurs through the auditor-general function and the Australian National Audit Office (ANAO) whose 'purpose is to provide the Parliament with an independent assessment of selected areas of public administration, and assurance about public sector financial reporting, administration, and accountability' (ANAO, 2013).

States and Territories also have similar agencies with comparable functions such as undertaking performance audits, financial statement audits and assurance reviews. These functions are also often complemented by an ombudsman's responsibility to address issues arising from the community's dealings with government agencies. Again, the focus is on undertaking investigations and audits with the objective of encouraging good public administration.

The Commonwealth also established a Parliamentary Budget Office (PBO) in February 2012. States and Territories have examined the benefits of a PBO, with the Australian Capital Territory concluding that it was too small a jurisdiction for such an office; the Victorian

[10] Compliance with agreed fiscal rules (and the imposition of sanctions) requires monitoring of outcomes to be undertaken by a credible institution with an unfettered ability to actively disseminate its findings. Robert Hagemann, 'How Can Fiscal Councils Strengthen Fiscal Performance?', *Economic Studies* 36 (2011), 75–98.

[11] See purpose, objects, and application of Act in the *Fiscal Responsibility Act* (New South Wales) (2005).

Parliamentary Public Accounts and Estimates Committee supporting such an office in 2011; and New South Wales introducing a PBO in 2010.[12]

On the issue of State debt and borrowing, the Loan Council is now mainly concerned with enhancing the transparency and accountability of public sector finances rather than, as in the past, securing adherence to strict borrowing limits. The present arrangements, introduced in 1993-94, are designed to enhance the role of financial market scrutiny as a discipline on borrowings by the public sector, rather than to force such scrutiny through government oversight. Consequently, it usually meets once a year,[13] with each jurisdiction nominating its forthcoming borrowing allocation known as its Loan Council Allocation (LCA) and since 1993-94, it has approved all jurisdictions' LCA nominations without change.

6. Federal Solidarity

Australia's comprehensive system of Horizontal Fiscal Equalisation makes it one of the most, if not *the* most solidaristic of all federations. OECD calculations indicate that the ratio of highest to lowest tax-raising capacity across the Australian federation in 2012 was 7.5 before equalisation and 1.0 afterwards.[14] The only other federation to come close was Germany, where the respective figures were 1.7 and 1.1.

Overseen by a dedicated statutory body established in 1933, the Commonwealth Grants Commission (CGC), this system has until very recently worked to ensure a full levelling of fiscal capacity across the federation. Distribution of a dedicated pool of funds transferred to the States follows a complex formula factoring in both fiscal capacity and fiscal need to calculate each jurisdiction's "relativities", or deviation from equal *per capita* share. Not only is the system highly solidaristic, but it was long supported by solidaristic assumptions that made it uncontroversial until disrupted by the impact of the mining boom from 2005 on Western Australia's place in the system.

Prior to the mining boom, the system was paid for by the two demographically and economically dominant jurisdictions, New South Wales and Victoria. Their large population meant that the *per capita* cost to them of subsidising the smaller, weaker, jurisdictions was reasonable. Only when skyrocketing iron ore royalties made WA the leading benefactor was the equilibrium disturbed. With its much smaller population, WA's relativity dropped to 30 percent it began campaigning for a change to the system. After two rounds of inquiries, the Commonwealth altered the system by inserting a floor guaranteeing a minimum 70 percent per capita share.

[12] https://www.parliament.nsw.gov.au/pbo/Pages/Parliamentary-Budget-Office.aspx

[13] The Loan Council technically consists of the Prime Minister and the Premier/Chief Minister of each State and Territory but in practice each member is represented by a nominee, usually the Treasurer of that jurisdiction, with the Australian Treasurer as Chairman.

[14] Hansjörg Blöchliger, *Fiscal Federalism 2014: making decentralisation work*. Paris: Organisation for Economic Co-operation and Development, 2014.

7. ‘One size fits all’ monetary policy

Consistent with the effectively exclusive powers of the Commonwealth over matters such as currency, coinage and legal tender, Australia has a unified monetary policy determined at a federal level. The Reserve Bank of Australia (RBA) sets interest rates independently but within a framework laid down by the Commonwealth government. Exchange rates are now set by the open market.

In 1983 the Commonwealth government decided to float the Australian dollar, allowing its value to fluctuate on international money markets. This decision to discontinue the fixed exchange rate policy that had existed since federation has led the Australian dollar to be one of the most highly traded currencies in world foreign exchange markets. Commodity prices are among the most significant factors that determine the value of the dollar, causing Australian exchange rates to vary in a manner that is different from many other national currencies. Noting that Australia’s balance of trade depends very heavily on the exportation of minerals and agriculture, shifts in the value of the dollar have significant consequences for many of the most important sectors of the Australian economy, often with differential impact on particular States and regions. Since these differential effects are a matter of concern to State, Territory and local governments, they are often of significance in intergovernmental negotiations concerning fiscal relations between the Commonwealth and the other levels of government and the HFE settings determined by the CGC.

8. Merits and Deficiencies of Australian Fiscal Federalism

8.1 Impact on equalisation in the federation

While significantly reducing the ability of the States to exercise their policy-making powers, Australia’s high level of vertical fiscal imbalance is part of a system which enables the Commonwealth to oversee a complex system of horizontal fiscal equalisation regulated by the Commonwealth Grants Commission.

8.2 Macro-economic effects on the federation and its entities

The Commonwealth’s monetary and fiscal dominance gives it abundant capacity to engage in macro-economic management through its monetary, taxing and spending powers. Monetary policy is set through the Reserve Bank of Australia, an independent statutory body established by Commonwealth law and required to maintain the stability of Australian currency in accordance with inflation rate targets, the maintenance of full employment and the economic prosperity and welfare of the people of Australia.[15] Since federation, the Commonwealth has had power to shape terms and conditions of employment through the establishment of a system for the settlement of inter-state industrial disputes, and power which the High Court has

[15] *Reserve Bank Act 1959*, s 10(2).

interpreted widely. The Commonwealth is also able to shape employment law through the High Court's wide reading of the Commonwealth's power to legislate with respect to trading and financial corporations, enabling the Commonwealth to regulate the terms and conditions of employment in situations where the employer is a trading and financial corporation.

8.3 The system's democratic legitimacy

There are concerns that the executively-focused nature of intergovernmental relations in Australia gives rise to weaknesses in democratic accountability, and lack of clarity about the distribution of responsibilities among the levels of government gives rise to 'buck-passing' between them.[16]

8.4 Control

Although the Australian constitution establishes a relatively clear demarcation between Commonwealth and State spheres of responsibility, the extension of the Commonwealth into fields previously under largely State control, especially through State dependence on tied grants under section 96 of the Constitution, has given rise to a situation where the Commonwealth exercises considerable control or at least influence over many fields, contributing in some ways to improved coordination between the levels of government, but contributing in other ways to the lack of clarity about the distribution of responsibilities among the levels of government and the resulting lack of clear lines of democratic accountability for policy decisions and their implementation.

8.5 Legitimacy and efficiency of conflict resolution

Conflicts within the Australian fiscal system can arise at constitutional, legislative and administrative levels and are potentially addressed at these levels in different ways. Some disputes concern constitutional questions of power and its limitation which can be resolved by the High Court if at least one of the parties to the dispute is willing and able to commence legal proceedings and the matter falls within the Court's jurisdiction. The Court is also able to resolve disputes in which it is alleged that there is a consistency between Commonwealth and State laws. In these cases, the Court will determine whether an inconsistency exists and, if this is found to be the case, the Commonwealth law will prevail to the extent of the inconsistency pursuant to section 109 of the Constitution. While judicial decisions resolving such disputes are sometimes the subject of political debate and contestation, the High Court's role is generally respected and its decisions are generally complied with.

Other disputes arise as a matter of competing fiscal goals or policies adopted legislatively or as a matter of administrative regulation or practice. These disputes can persist for long periods of time and can only be resolved through negotiations between governments or changes

[16] Nicholas Aroney, 'Reinvigorating Australian Federalism' in Michael White and Aladin Rahemtula (eds), *Supreme Court History Program Yearbook 2009* (Supreme Court Library Queensland, 2010) 75; Cheryl Saunders and Michael Crommelin, 'Reforming Australian Federal Democracy' (2015) 74(3) *Meanjin* .

in government following general elections at a Commonwealth, State, Territory or local level. These processes are generally regarded as legitimate, although there is always considerable public criticism and political contestation concerning the varying policy positions adopted by particular governments.

9. Dos and Don'ts: What Can the EU Possibly Learn from Fiscal Federalism in Australia?

9.1 Deficiencies

While the expansion of Commonwealth control and influence through VFI and other underlying causes of centralisation can enable the Commonwealth to implement and drive coordinated responses to emergent problems or to secure particular economic or social goals, it has serious detrimental effects. Most notably, it undermines the federal nature of the system by reducing the policy making autonomy of the States, potentially limits their capacity to engage in 'competitive federalism' (as a potential driver of efficiency gains) and reduces democratic accountability and responsiveness of the system, partly by removing decisions from local and State-level influence and control, and partly by confusing lines of responsibility and enabling governments to engage in 'blame shifting'.

9.2 Achievements

Australia's system of horizontal fiscal equalisation, regulated as it is by an arm's-length expert body and using sophisticated calculations of relative capacity and need, contributes to the maintenance of a degree of fiscal and economic solidarity between the Commonwealth, the States and the Territories.[17] It also ensures that all jurisdictions can exercise their responsibilities equally, and in that way reduces the need for central government provision.

The basis on which that system of equalisation rests, viz., the distribution of the pool of GST funds to the States, also represents an achievement of the Australian system. The fact that Australia's most important tax reform in decades rested on a formal Intergovernmental Agreement that was then enshrined in legislation makes it a model exercise in fiscal federalism.

10. Conclusion

The fiscal system operating within the Australian federation has maintained certain important features of its original design, but has also departed from the expectations of its framers in other significant respects. The Commonwealth and the States (as well as the Territories and local

[17] It should be noted that some States express long-standing concerns about the fairness or effectiveness of the calculations and redistributions. See GST Distribution Review, *Final Report.* Canberra: Commonwealth of Australia, 2012.

governments to a lesser extent) continue to function as politically independent, democratically accountable governments, each setting its own policy goals and priorities and shaping its taxation and spending settings accordingly. However, over time the Commonwealth has enjoyed a considerable expansion of its fiscal powers vis-à-vis the States, particularly through its monopolisation of individual and corporate income tax and the dependence of the States on fiscal transfers from the Commonwealth to make up deficiencies in their own sources of revenue. As Alfred Deakin adroitly observed two years after the establishment of the federation:

> 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.[18]

Within this context, the federation has seen the development of high levels of VFI and a comprehensive system of HRE, each with their attendant strengths and weaknesses.

[18] Alfred Deakin, Letter to the *Morning Post*, 1 April 1902.