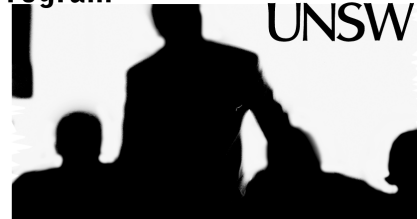


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**THE LONG AND WINDING ROAD: A CENTURY OF
CENTRALISATION IN AUSTRALIAN TAX**

**Rodney Fisher
Jacqueline McManus
Senior Lecturers
ATAFX
Faculty of Law
The University of New South Wales**

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Dr Binh Tran-Nam & Colin Fong
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INTRODUCTION

From the time of Federation of the Australian colonies, there has been tension surrounding the relationship between the governments at the State and Federal levels in balancing revenue and responsibility. While the *Constitution*¹ granted the Commonwealth a non-exclusive income taxing power,² the power to impose customs and excise was exclusive.³ This inability of the States to levy excise duties greatly restricted the taxes they could impose, and yet the responsibilities allocated to the States were not similarly restricted.

Despite the non-exclusive income tax power, the Commonwealth government has been able to effectively centralise the imposition of income tax in Australia, with the sanction of the *Constitution* and the courts, and this paper charts the path by which that has been achieved. The path to centralisation commenced with the move to Federation, and while the Commonwealth may have been slow in exercising its income taxing power, once driven by the exigencies of war to use the power for revenue purposes there is arguably an almost inexorable path leading to the effective centralisation of the levying of income tax in the hands of the central government.

With States being effectively, if not legally, excluded from levying income tax, the equally vexed question arose of State funding. Initially the Commonwealth made grants to the States in the form of unconditional payments, although over time conditions as to how the money should be spent were attached. As a result, the Commonwealth was able to set the agenda for legislation even in areas outside its constitutional jurisdiction. Recent changes to Commonwealth-State financial relations attempt to address these issues by unconditionally allocating GST revenue raised by the Commonwealth to the States.

COLONIAL TAXES

The imposition of income tax for the purpose of raising revenue was not an early priority in the colonies, with funding available from the levying of customs and excise duties, and from the sale of public land. The first colony to adopt a comprehensive income tax was South Australia, where a growing public debt could not be met by the excise on alcohol and tobacco, as "... the abstemious South Australians used too little of these commodities to make a tax worthwhile."⁴

While budget deficits in the colonies forced governments to attempt to introduce direct taxes, generally in the form of land and income taxes, the bicameral legislatures acted for some time to thwart these efforts. The taxation of income and land were often readily accepted in the lower houses which were elected under universal adult suffrage, while the upper houses, elected on a more restrictive property franchise, resisted such attempts until forced by economic necessity to accede to such measures.

¹ *Commonwealth of Australia Constitution Act* (63&64 Victoria, Chapter 12), herein referred to as the *Constitution*.

² Section 51(ii)

³ *Constitution*, s 90.

⁴ Fayle R, (1984) "An historical review of the development of income tax in Australia", *Taxation in Australia*, February Vol 18, p 666 at 673

Over a period all colonies followed the lead established by South Australia in imposing income taxes, and by the early 1900s the levying of income taxation by the States had become firmly entrenched, and would not be lightly surrendered.

FEDERAL CONSTITUTIONAL POWER

Given that by the time of Federation the colonies were moving towards a greater reliance on revenue raised from income taxation, it may seem anomalous that they would be prepared to allow such a power to be concurrently held by the proposed Commonwealth government. The path towards this granting of power to the Commonwealth is one of political brinkmanship, with compromise based on expediency and practicality. Some of the developments towards granting the new Commonwealth the taxation powers with which it was bestowed are outlined below.

Constitutional Conventions

The path to Federation was marked by a series of Constitutional Conventions, the final outcome from which was the *Commonwealth of Australia Constitution Act* (63&64 Victoria, Chapter 12) presented to the British Parliament.

It would appear that in delineating the powers to be conceded to the new Commonwealth Government, the Conventions accepted that the power to impose taxation was among the first to be included, with the draft bill presented by Sir Samuel Griffith to the 1891 Sydney Convention conferring on the Federal legislature the power for “Raising money by any mode or system of taxation; but so that all such taxation shall be uniform throughout the commonwealth.”⁵

Limitation of taxation power

Rather than the contentious issue being the granting of the power to impose taxation to the Commonwealth, the matter attracting debate at the conventions centred on whether such power should be limited or at large.

Concern was expressed by some delegates that granting an unlimited taxing power, in conjunction with the power to levy customs and excise duties, was premature, with the suggestion being that the power be withheld until allocation to the Commonwealth of the duties to be discharged in connection with the power.⁶

However the prevailing view considered that the Commonwealth power of taxation should be an unlimited power, largely on the basis that the objects of the Federal government were unlimited, requiring a coexistent unlimited power of taxation. Indeed the argument was submitted that “... to limit the greatest and necessary power of any state, the power of taxation, which lies at the bottom to a certain extent of all government, would be to at once stultify the whole constitution you bring into existence.”⁷

⁵ Draft bill s 52(3)

⁶ *Official record of the debates of the Australian Federal Convention, Vol I Sydney 1891*; see for example Sir John Bray at 671

⁷ Above note 6, per Mr McMillan at 671

The recognition of the critical importance of defence was also raised in support of unlimited taxing power, the requirement being that "... unlimited power of taxation must accompany the unlimited responsibilities of the commonwealth. One of the foremost of its duties ... was to provide for the common defence of Australasia, and it may be necessary to devote not only the last ship, but the last shilling to that object. It is impossible to cast the duty of defence on the commonwealth without giving them unlimited taxing power."⁸

Residual power for States

A second issue concerning some delegates related to whether the Commonwealth taxation power would be exclusive⁹ or coexistent with State power. Reassurance was given that "With regard to direct taxation ... the colonies will possess in future every power which they now possess."¹⁰ Further, "There is no doubt that all the parliaments of the states will have precisely the same powers of (direct) taxation as they have at present ... It is possible that both parliaments might impose taxes on the same thing. That cannot be helped."¹¹

In what may be seen as an expression of confidence in future Commonwealth governments, or as exhibiting a degree of political naivety, Sir Samuel Griffith also expressed surety that "... the federal parliament would never impose direct taxation excepting in a case of great national urgency."¹²

Interpretation of the power

In relation to the scope of the taxation power,¹³ the view following from the Conventions saw "The power which is the sinews of all government ... granted in the most unqualified terms, separately and not as a mere incident to other powers of the Commonwealth."¹⁴ Reinforcing his views expressed at the Convention, the now Chief Justice Griffith highlighted the Federal and not unitary purpose of the *Constitution* in *Municipal Council of Sydney v The Commonwealth*,¹⁵ with Federal and State taxation powers not competing but being "... concurrent and independent powers."¹⁶

DEVELOPMENTS PRE WORLD WAR 1

For the first ten years after Federation the finances of the Commonwealth were almost wholly based on revenue from customs and excise duty. At least three quarters of the collections were assigned to the States in compensation for lost revenue from customs

⁸ Above note 6, per Deakin at 675

⁹ As was the commonwealth power to levy customs and excise duty

¹⁰ Above note 6, per Deakin at 674

¹¹ Above note 6, per Griffith at 907

¹² Above note 6, per Griffith at 907

¹³ Section 51(ii) of the *Constitution*, provides the power for "Taxation; but not so as to discriminate between States or parts of States "

¹⁴ Harrison Moore W, *The Constitution of the Commonwealth of Australia* 2nd ed, Sweet & Maxwell, Melbourne 1910, p 505

¹⁵ (1904) 1 CLR 208

¹⁶ Above note 15, per Griffith CJ at 232

and excise duties previously levied by them.¹⁷ The Australian governments seemed to hold the view that Commonwealth payments to States should directly relate to the financial sacrifice brought by Federation to a State. This arrangement however left the States largely at the mercy of the Commonwealth. As the scheme was considered less than optimal, it was therefore implemented as an interim arrangement and subject to change. The scheme was to span 10 years only.

During this period the Commonwealth made no attempt to introduce an income tax, largely since the revenue requirements did not dictate the need for such a tax.

State grants

Given the rather temporary nature of the grant arrangements at this stage, several substitute systems were discussed at length at Premiers' Conferences, but to no avail. However one common theme did emerge from the discussions. It was agreed that the distribution of Commonwealth payments should be on a per capita basis, rather than a percentage of customs and excise receipts. Accordingly legislation in 1910 provided for a flat amount of 25 shillings per capita. The amount was again granted for ten years 'and thereafter until the Parliament provides.'¹⁸ The introduction of the per capita grants resulted in a reduction in payment to the States. This shift was responsible for the invention of special grants.

Special grants were provided on the basis that some States made larger per capita contributions to the customs revenue and should be compensated accordingly. Western Australia received special grants in 1910-11 on this basis, Tasmania in 1912 and later South Australia in 1929. Although the Commonwealth paid these special grants, it was of the opinion that they were of a temporary nature.

WARTIME BEGINNINGS

In 1915 the first *Income Tax Assessment Bill* was introduced, passing into law in only three weeks.

While the taxation measures were undoubtedly designed for their fiscal effect of financing a shortfall in funds in the expenditure required for the war effort, despite UK loans, the Second Reading Speech of Labour Attorney-General Hughes does provide a hint of potentially deeper motives. In outlining the circumstances which required the new taxation measures, he noted:

"That additional revenue is necessary to meet the great and growing liabilities of the War is amply apparent. ... I have always regarded this form of direct taxation as peculiarly appropriate to a modern community, and if the incidence of tax be based upon sound principles, not only an effective means of raising money for the conduct of the government, but serving as an instrument of social reform."¹⁹

¹⁷ *Constitution*, s 87 (often referred to as the Braddon clause).

¹⁸ It was proposed that this arrangement be made permanent through an amendment to the Constitution however the referendum was defeated. The provisions therefore were made through legislation, namely the *Surplus Revenue Act 1910*.

¹⁹ Mills S, *Taxation in Australia* at p 237

While assuring that “The Bill, of course, is frankly a War measure designed to meet the present circumstances,”²⁰ the *Income Tax Assessment Act* was amended before the end of the session of Parliament in which it was introduced, thus establishing a great Australian tradition of regular and frequent amendment to income tax laws. Additionally, the rates of income tax²¹ increased in 1916, 1918, and 1920, and the war measure has survived into the next century.

With the introduction of this Commonwealth income tax, both the Commonwealth and States now imposed separate and distinct income taxes. While this may have created practical difficulties, there was no legal impediment as the power for the Commonwealth to levy tax was not an exclusive power except in limited areas such as customs and excise.²²

POST-WORLD WAR I PROGRESS

Taxation

Following the Commonwealth imposition of income tax in 1915, taxpayers were faced with filing two separate income tax returns for their State and Federal income taxes. Despite attempts to harmonise these taxes little progress was made, although in respect of administration of the dual taxes the Commonwealth administered and collected State income taxes for Western Australia.²³

The final report of the Kerr Royal Commission into income taxation in 1923 rather prophetically recommended an allocation of direct taxing powers between the Commonwealth and States, with the Commonwealth taking an exclusive income taxing power, and the States an exclusive power for other direct taxes. While such a radical proposal would not be accepted (by the States), a further Conference of Commonwealth and State Ministers in 1923 did reach a basis of agreement in that the States, with the exception of Western Australia, became agents for the collection of Commonwealth income tax. As part of this agreement, the States took over Commonwealth taxation staff and resources, with the benefit for taxpayers being that only one income tax return (per State) needed to be prepared.

In a further attempt to harmonise the various income taxes, 1932 saw the appointment of another Royal Commission (the Ferguson Commission), which recommended the adoption of uniform legislation and administration by the Commonwealth and States. The outcome from this was the *Income Tax Assessment Act* 1936, and while uniformity reigned for a short time, a diversity of amendments reintroduced differences between the Commonwealth and States.

New Framework for fiscal federalism

In 1926 the Commonwealth announced the termination of per capita subsidies. A new framework for fiscal federalism was developed, the main focus of the scheme being

²⁰ Above note 19, at p 238

²¹ Rates were prescribed by the *Income Tax Act* 1915

²² *Constitution* s 90

²³ vanden Driesen I& Fayle R, “History of income tax in Australia” in Krever R (ed) *Australian Taxation: Principles and Practice*

government debt. The State debts were taken over by the Commonwealth, and State borrowings were placed under a newly formed Loan Council.²⁴ An annual grant was established for the servicing of State debt. This annual grant was set at the existing level of per capita grants and was to grow with population. Consequently what was previously an unconditional grant had been converted to a conditional specific grant. This framework was set out in a Financial Agreement in 1927. It provided for 58 years. A sinking fund was also established to compensate States for any loss as a result of the new scheme.

The Agreement was ratified by constitutional amendment which in turn gave States constitutional claims to Commonwealth revenue for the first time.²⁵ State borrowing (except temporary borrowing) from this time forward was dependent on the approval of the Loan Council. The Council was given full legislative and Constitutional status. There is no ability to appeal against its decisions, as it is not directly responsible to any one Parliament or electorate.

Commonwealth Grants Commission

Additionally, around this time it was argued that all special grants should be applied for and considered by the same person or persons rather than operate through ad hoc bodies as had been occurring until this time. This view was accepted in 1933 when the Commonwealth Grants Commission was established.

The purpose in establishing the Commonwealth Grants Commission was to achieve uniformity and to clarify and develop the principles for determining State special grants. The method developed involved comparing the budgetary circumstances of the States claiming special grants with those of the other, so called 'standard States'.

While the method was modified over time, the underlying principle remained that of ensuring a claimant State had the financial capacity to provide the same range and quality of services as the standard States, provided it imposed the same range of taxes and charges at the same rates. The Commission's calculations were based on the principle of fiscal equalisation which states that:

“each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.

Equalisation is designed to equalise States' capacity, not their results. This is because the Commission's recommendations relate to untied general revenue grants and each State is free to decide its own priorities.”²⁶

The Commonwealth Government accepted the Commission's recommendation although it was not entirely satisfied with the principle of financial need adopted by the Commission.

²⁴ The Loan Council was established in 1928-29 to handle all borrowing by Commonwealth and State governments except temporary borrowing or Commonwealth borrowing for defence.

²⁵ Refer *Constitution*, s 105A, inserted by *Constitution Alteration (State Debts) 1928*.

²⁶ www.cgc.gov.au

WAR TIME MEASURES (THE PENULTIMATE ENGAGEMENT)

The success of the 1927 Financial Agreement was thwarted by unrelated world events. The depression of the 1930s, followed by the Second World War, caused the Commonwealth Government to take drastic measures in relation to finances.

In 1941 the Commonwealth unsuccessfully offered the States a grant in compensation for withdrawing from income taxation. A further unsuccessful attempt to get the States to relinquish their income taxes was made at the 1942 Premier's Conference, despite the added guarantee that the States would have the right to again impose income tax after the war.

To meet the exigencies created by the funding requirement for the war effort, the Commonwealth finally took matters into its own hands in 1942 and introduced four Bills which were enacted as:

- the *Income Tax Act* 1942; which set an income tax rate higher than the combined existing State and Commonwealth rates;
- the *Income Tax Assessment Act* 1942; which gave priority to payment of the Commonwealth income tax over State income tax;
- the *States Grants (Income Tax Reimbursement) Act* 1942; which provided for Commonwealth financial assistance to those States which did not impose their own State income tax; and
- the *Income Tax (War Time Arrangements) Act* 1942; which allowed for the Commonwealth to take over State income tax officers, premises, equipment, and records.

The latter of these measures may appear rather ironic, given that there had been a transfer of Commonwealth taxation resources to the States as a result of the 1923 agreement, and now these State resources would be transferred to the Commonwealth.

The practical result of these measures was to effectively reserve to the Commonwealth the exclusive power to raise income taxes, thus achieving for the Commonwealth, albeit by a rather circuitous path, a power which had been recommended by the Kerr Royal Commission some twenty years earlier.

The inevitable consequence of such Commonwealth legislation was the High Court challenge in *South Australia v Commonwealth*,²⁷ the basis of the challenge being that the Commonwealth lacked the constitutional power for the legislative provisions that had been introduced.

In separate judgements, their Honours²⁸ considered each of the legislative measures, and the discussion follows the same format.

While the challenge to the legislation was argued on a myriad of fronts, the essence of the States' argument contended that the provisions were in breach of the *Constitution* since they were "... in fact a single legislative scheme, and that the substance, purpose

²⁷ *The State of South Australia & Another v The Commonwealth & Another; The State of Victoria & Another v The Commonwealth & Another; The State of Queensland & Another v The Commonwealth & Another; The State of Western Australia & Another v The Commonwealth & Another* 65 CLR 373

²⁸ Latham CJ, Rich, Starke, McTiernan and Williams JJ

and effect of it is to make the Commonwealth Parliament the exclusive taxing authority in the Commonwealth in respect of income tax, and to prevent the States from exercising their constitutional powers in relation to income tax,”²⁹ the effect being to weaken or destroy the constitutional functions or capacities of the States. Further, such a scheme demonstrated “... an interference with and a discrimination against the States,”³⁰ for which the Commonwealth had no constitutional power.

In arguing for the validity of the legislative measures it was suggested that:

“The Court is not concerned with the wisdom or fairness of the legislation. The only question is one of power. It is enough if the legislation can possibly operate for the peace, order and good government of the Commonwealth, whether with respect to defence, or taxation, or borrowing, or grants, or matters incidental thereto. If the legislation can possibly operate in respect of any one of these things, then the Commonwealth has power, and it does not matter whether it has used the power wisely or unwisely.”³¹

Income Tax Act 1942

The Full Court found this Act to be a valid exercise of Commonwealth power, although there was not unanimity of reasoning.

Addressing the question of the purpose of the legislation, Latham CJ considered that neither the indirect effect nor the ultimate purpose could determine the validity of a statute, and the Act in question was “... merely and simply an Act imposing taxation upon incomes”³² for which the Commonwealth had power subject to certain limitations, none of which had been infringed.

McTiernan J found this Act and the *Income Tax Assessment Act 1942* justified not only by the taxing power in the *Constitution*, but also by the defence power, to which a wide interpretation should be applied. His Honour noted that while all powers in s 51 of the *Constitution* are at the same level, the defence power may justify temporary suspension of State powers in the interests of the preservation of the State. The power to legislate for defence, “... although it shows itself on the same level as the other powers, has a deeper tap-root, far greater height of growth, wider branches, and overshadows all the other powers.”³³

Because the Act imposed the same rate of tax on all incomes, Williams J was able to find that the Act was valid under the taxing power in that it did not discriminate between States or parts of States “... considered as geographical entities.”³⁴

States Grants (Income Tax Reimbursement) Act 1942

The High Court by a 4:1 majority found this legislation to be a valid exercise of Commonwealth power.

²⁹ Above note 27, per Ligertwood KC for South Australia

³⁰ Above note 27, per Ligertwood KC at 389

³¹ Above note 27, per Ham KC for the Commonwealth at 398

³² Above note 27, at 412

³³ *Farey v Burvett* (1916) 21 CLR 433 per Higgins J at 455; quoted in *South Australia v Commonwealth* at 451

³⁴ Above note 27, at 462

Latham CJ found that the provision of grants to States did not purport to repeal State income tax legislation or require States to abdicate their power to impose income taxes. Rather, it offered an inducement to States not to exercise their (still existing) power to impose an income tax.

In relation to the argued discrimination between States, his Honour found that while the States may receive varying amounts of grant, the "... indirect effect of varying grants upon the fortunes of taxpayers of different States is an irrelevant circumstance,"³⁵ and the Act operated without discriminating.

Williams J also found no illegal interference with the sovereignty of States, as the matter of whether they levied an income tax was left entirely to the discretion of the States.³⁶

In a dissenting judgement, Starke J was not persuaded that the Act merely granted financial assistance to the States, but concluded that there was "... linked up in it an object and an end that is inconsistent with the limited grant of power given by s 96 to the Commonwealth, namely, making the Commonwealth the sole effective taxing authority if respect of incomes."³⁷ Further, His Honour was of the view that the "... argument that the *State Grants Act* leaves a free choice to the States, offers them an inducement but deprives them of and interferes with no constitutional power, is specious but unreal."³⁸

Income Tax (War Time Arrangements) Act 1942

This Act would appear to have been the most contentious of the legislative enactments, being held valid by a 3:2 majority decision, both Latham CJ and Starke J dissenting.

Rich J looked to a wide application of the defence powers as supporting the validity of the Act, finding that "If the Commonwealth is to wage war effectively, it must command the sinews of war."³⁹ A broad application was found for the defence powers, such that "... if the measure questioned may conceivably in such circumstances even incidentally aid the effectuation of the power of defence, the Court must hold its hand and leave the rest to the judgement and wisdom and discretion of the Parliament and Executive it controls."⁴⁰

While noting that the defence power did not become paramount in time of war,⁴¹ Williams J had regard to the changing scope of the power, in that "its application depends upon facts, and as those facts change so may its actual operation as a power enabling the legislature to make a particular law."⁴²

³⁵ Above note 27, at 427

³⁶ Above note 27, at 463

³⁷ Above note 27, at 443

³⁸ Above note 27, at 443

³⁹ Above note 27, at 437

⁴⁰ *Farey v Burvett* (1916) 21 CLR 433 at 455, 456 in *South Australian v Cth* at 437

⁴¹ *Andrews v Howell* (1941) 65 CLR per Starke J at 268 in *South Australia v Cth* at 467

⁴² *Andrews v Howell* per Dixon J at 278 in *South Australia v Cth* at 467

In his dissenting judgement, Latham CJ considered that the Act could only be supported by reliance on the defence head of power,⁴³ and while this power had been widely interpreted and applied, His Honour was unable to establish a sufficient connection with the legislation, since "... even this power has a limit – it is not sufficient to wave the flag as if that were a conclusive argument."⁴⁴

Also in dissent, Starke J was unconvinced that the defence power should be given broad operation. His Honour saw this Act as being "... wholly inconsistent with the exercise by the States of their powers, and of their functions as self-governing bodies,"⁴⁵ and the defence power, no more than any other power, allowed the Commonwealth to exercise power "... for ends inconsistent with the existence of the States or the exercise of their powers or their functions as self-governing bodies."⁴⁶

Income Tax Assessment Act 1942

This final Act was held to be a valid exercise of Commonwealth power, but not all judges were in agreement as to the reasoning to reach such a conclusion.

Latham CJ referred to the Canadian case of *In re Silver Brothers Ltd*⁴⁷ as being conclusive in regard to priority between taxes at different levels of government, finding as a consequence that the "... Commonwealth has power, by a properly framed law, to make Commonwealth taxation effective by giving priority to the liability to pay such taxation over the liability to pay State taxation."⁴⁸

As noted above, McTiernan J relied not only on the taxing power, but also the defence power in finding this Act to be a valid exercise of Commonwealth power.

Post-war challenge

The Commonwealth success against the judicial challenge of the States had the substance, if not the form, of effectively centralising the income taxing power in the hands of the Commonwealth government. However some of the newly validated Acts, in particular the *State Grants (Income Tax Reimbursement) Act 1942* which provided grants to States which levied no income tax, and the *Income Tax Assessment Act 1942* giving priority to Commonwealth income during the currency of the war, were temporary Acts with a limited life.

The *State Grants (Income Tax Reimbursement) Act 1942* was to continue until the end of the war, and it was then replaced by the *State Grants (Tax Reimbursement) Act 1946-1948* with unlimited duration. The *Income Tax Assessment Act 1942* was also a war-time measure, being replaced by the *Income Tax and Social Services Contribution Assessment Act 1936-1956*, this Act being for the "... better securing to the Commonwealth of the revenue required for the purposes of the Commonwealth."⁴⁹

⁴³ *Constitution* s 51(vi)

⁴⁴ Above note 27, at 431

⁴⁵ Above note 27, at 447

⁴⁶ Above note 27, at 445

⁴⁷ (1932) AC 514

⁴⁸ Above note 27, at 435

⁴⁹ Section 221(1) *State Grants (Income Tax Reimbursement) Act 1942*

Not surprisingly the States took the opportunity of the new enactments to mount one last onslaught against what was seen as the centralist grab for income taxing power by the Commonwealth.

The final campaign

Yet again the Commonwealth found itself defending its income tax legislation against a State challenge,⁵⁰ this time before a differently constituted High Court⁵¹ in *Victoria v The Commonwealth*.⁵²

While the challenge was directed towards specific sections of the Acts, the aim being to establish invalidity of key sections and thus undermine the whole scheme, the arguments did not differ significantly from those used in *South Australia v The Commonwealth*. The States argued that the operation of the enactments effectively converted taxation into an exclusive Commonwealth power, with the States being coerced practically, rather than legally, into not exercising their powers.⁵³

The Commonwealth response suggested that the development of Commonwealth-State relations had been in the direction of interlocking responsibility rather than mutual non-interference, and "... the raising of substantial sums by the Commonwealth and their distribution by way of grants to the States is consistent with the letter, spirit, and essence of the Constitution."⁵⁴

As with the previous discussion, the decisions are examined in relation to each of the challenged Acts.

State Grants (Tax Reimbursement) Act 1946-1948

This Act was held to be valid by the whole Court, its basis being in s 96 of the *Constitution*,⁵⁵ with Dixon CJ, with whom Kitto J concurred, finding that the power to grant financial assistance to any State is "... susceptible of a very wide construction in which few or any restrictions can be implied."⁵⁶

McTiernan J also found that the power conferred by s 96 was a general power limited only by the scope and object of the power, and even if the Commonwealth created the

⁵⁰ While the tactical aim of the State challenge was directed towards challenging key sections in the hope of undermining the entire legislative scheme, it is possible to be left with the impression that the heart had gone out of the States fight - only two States were involved in the challenge, and only two Acts were under challenge; it may be that after some years in operation the other States had accepted that there were some practical benefits of centralisation.

⁵¹ Dixon CJ, McTiernan, Williams, Webb, Fullagar, Kitto and Taylor JJ; only McTiernan and Williams JJ remained on the Court from the first State challenge

⁵² *The State of Victoria & Another v The Commonwealth; The State of New South Wales v The Commonwealth* 99 CLR 575

⁵³ Above note 52, per Sir Garfield Barwick QC for the State of Victoria at 583-4, 586

⁵⁴ Above note 52, per K H Bailey, Solicitor General of the Commonwealth of Australia, at 592-3

⁵⁵ Section 96: During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

⁵⁶ Above note 52, at 605

need which it then met by a grant, the character of financial assistance remained unchanged.⁵⁷

Having been involved in the earlier case of *South Australia v Commonwealth*, Williams J found that the principle of *stare decisis* required the earlier judgement be followed.⁵⁸ This allowed for a wide interpretation of the s 96 power, being sufficient to validate the Act.

Income Tax and Social Services Contribution Assessment Act 1936-1956

This enactment did not fare as well in the High Court, with a 4:3 majority determining that s 221(1) of the Act, being the priority provision, was ultra vires, not being incidental to the Commonwealth taxation powers under s 51(ii).

Having noted the grave responsibility in departing from the decision in *South Australia v Commonwealth*, Dixon CJ was prepared to do so with this Act, finding that the earlier decision stood alone without authority, and without the defence power as a basis the enactment no longer had a constitutional foundation. His Honour also considered that the previous decision had given an application to the constitutional doctrine of incidental powers which he believed to be unsound.⁵⁹

Being one of the two judges to have sat in both cases, McTiernan J followed his decision in *South Australia v Commonwealth*, finding that the taxation power alone was insufficient to validate the Act, and the defence power had provided validity for the 1942 Act, but this was no longer an available power. On this basis his Honour found the Act invalid.⁶⁰

Williams J, as the other judge from the earlier case, found no reason to depart from his decision in the earlier case, thus dissenting in the instant case and finding the Act to be valid. Fullagar J, also in dissent, found no reason to depart from the earlier decision, as the substance of the legislation was precisely the same as that previously challenged, there being insufficient reason to overrule *South Australia v The Commonwealth*.

Despite the High Court finding the priority section of the *Income Tax and Social Services Contribution Assessment Act 1936-1956* to be constitutionally invalid, the resultant practical effect has been the effective exclusion of the States from imposing income tax since 1942.

All States ceased to impose income tax and began to receive grants based on the average tax revenue raised by the States over the previous two years. This basis of calculating the grant was however unfavourable to both Victoria and New South Wales. In particular Victoria had imposed low tax rates (and made a low level of tax expenditure) despite its high tax capacity. The arrangement was neutral for South Australia and Tasmania. Queensland and Western Australia, in relative terms were better off.

⁵⁷ Above note 52, at 623

⁵⁸ Above note 52, at 629

⁵⁹ Above note 52, at 616

⁶⁰ Above note 52, at 625

STRIKING A BALANCE: THE DISTRIBUTION OF FUNDS

The experience gained through the consideration and negotiations of grants from 1901 to 1941 in many ways impacted on the development of the funding machinations used to compensate the States for lost income tax revenue.

Tax Reimbursements (1946-59)

When the war ended, the Commonwealth announced at the 1945 Premier's Conference that war time arrangements were to continue. However in 1946 the Commonwealth offered a new basis of tax reimbursement based on the existing grant plus the excess of the 'adjusted social services expenditure' in 1944-45. This proposal was flatly rejected. After much discussion a subsequent proposal was accepted for a flat reimbursement for two years.⁶¹ For subsequent years the total was to be increased according to a formula which accounted for growth in State population after 1947 and wages growth over the level of 1946-47. The division of the amount however was left to the States. The then Prime Minister, Mr Chifley asked States to confer, and to propose a possible formula for that division.

The war time approach based on previous State income tax collections was clearly an unacceptable method of distribution of Commonwealth funds given the inequities, especially in respect of Victoria. While a per capita distribution was favoured, it was considered that composition and density of population should also be taken into account. These views were endorsed by the Commonwealth Grants Commission and were supported by all States except Victoria. The use of 'adjusted population' was consequently used. Actual population was adjusted for children of school age (between 5 and 15 inclusive), and relative scarcity of population.

An additional complication was introduced to appease the States that were favoured by the existing allocation. The agreed 'adjusted population' formula was introduced by a gradual transition over ten years.

This arrangement was never considered adequate. In none of the ten years it operated after 1946 did the total paid to the States correspond to what the formula would have provided. However the formula was only changed once, in 1948, when the basic grant amount was increased, the impact in change in wages was increased from 50 percent to 100 percent and the base wage year was changed to 1946-47.

States repeatedly made claims of severe financial needs. At the time, the Commonwealth had a particular concern for the impact the world turmoil might have on defence and had a wish to retain its dominance in finance. However the Commonwealth governments did make ad hoc annual additions to the reimbursements and frequently changed the basis of distribution of these additions as a result of the annual plea. Reasons supporting the claims included financial losses occasioned by the coal strike in 1949 and the basic wage increase in 1950.

In 1953 the distribution debate peaked when the Under-Treasurers put forward a table of five distribution methods that had in some form been used for supplements. The

⁶¹ Originally £37m was offered but after long debate it was set at £40m.

Commonwealth chose a basis much like that used in 1952-53. Yearly supplements continued to be made and distributed by a formula which by now closely approximated adjusted population. In 1957-58 new 'additional assistance grants' were made. They were new in name although really were simply supplements.

Attempts at resumption of State income tax

As the 1946 arrangement drew to an end there was much discussion about the possibilities of a new scheme to replace what was considered to be the completely unsatisfactory current system. Not surprisingly the resumption of State income taxes was raised and initially keenly supported by all States. Gradually however, the poorer States such as Tasmania expressed concerns. Tasmania for example would need to tax on average 50% more than New South Wales to raise the same revenue per person. The diminishing ability of tax reimbursements from the Commonwealth to meet State expenditure needs, however, maintained the richer States desire to secure growing revenues from income taxes.

In July 1952 at the Conference of Commonwealth and State Ministers, the Prime Minister declared that serious consideration should be given to the resumption of income taxation by the States. The then Prime Minister, Mr Menzies was of the opinion that the current situation was unsatisfactory and that States should be given the opportunity to control their own budgets. Such an arrangement would not impact on special grants under s 96 of the *Constitution*, as recommended by the Grants Commission for Tasmania, Western Australia and South Australia.

The Secretary of the Commonwealth Treasury and the State Under-Treasurers were instructed to prepare a report on the technical problems envisaged by the imposition of income tax by the States. Some issues raised were whether:

- income be calculated on the basis of origin or residence – unless agreement was reached double taxation, complex administration and higher taxpayer compliance costs would occur;
- State tax rates were to be related to Commonwealth rates and would there be a limit in combined State and Commonwealth tax rates; and
- a coordinated form of assessment could exist given the inability of one Parliament to bind another.⁶²

The number of unresolved problems raised secured the existing position of unitary taxation and Commonwealth reimbursement.

1959 Agreement (Financial Assistance Grants)

A special meeting of Commonwealth and State Ministers was held in March 1959 precipitated by the continued unrest of States with the financial relations with the Commonwealth. Queensland was on the brink of applying to the Grants Commission for a special grant and even Victoria threatened to apply on the basis that current distributions were made to the detriment of its population.

⁶² Commonwealth and State Treasury Offices, *Resumption of Income Tax by the States*, January 1953.

At the 1959 meeting several proposals were launched, only emphasising the lack of agreement among the States. New South Wales and Victoria were the only States in favour of the reintroduction of State income taxes by this time.

The Commonwealth decided to build a new scheme based on the existing structure while incorporating parts of different proposals put forward. This ‘new’ scheme comprised the following features:

- A new basic grant in place of the existing tax reimbursement grant and supplements;⁶³
- Western Australia and Tasmania could continue to claim special grants via the Grants Commission;⁶⁴
- The grants were renamed ‘financial assistance grants’ to remove any connotation of reimbursement. Clearly the grants were not reimbursements and had a distinctive redistributive nature;
- A single formula would be used to calculate the grant for each State (as opposed to the previous system which required two formulas, one to calculate the aggregate and one to allocate this aggregate to the States);
- The grant for each State after the base year, 1959-60, was to be increased in proportion to the annual increase in population from 1 July and the increase in average wages plus ten percent for Australia during the preceding financial year. The ‘betterment factor’ of ten percent added to the overall wage increase was partly in compensation for the time lag and partly a bonus; and
- The arrangement was to continue for six years.

Despite the fixed nature of the six year agreement, circumstances were such that the States fought for and received supplementary payments in three of the six years.

1965 Agreement

In April 1965 a preliminary conference was called to consider what should replace the 1959 agreement. In June 1965 the Commonwealth proposed a similar arrangement with an increased betterment factor of twenty percent to apply to both population and average wage increases. After discussion and an agreement to increase the base for both Queensland and Victoria, this proposal was accepted for another five year period.

During the 1960s, the States had explored the possibilities of indirect taxation. However the constitutional restraints on State revenue raising powers have been exaggerated by the Court’s narrow interpretation of the State’s taxing powers under the *Constitution*.⁶⁵ A string of High Court cases had defined excise duties very broadly to include any levy imposed on goods at any point in the production chain, thus severely limiting the State’s options.⁶⁶

Given the Court’s broad definition of ‘excise duties’, a sales tax, retail tax or goods and services tax cannot be levied by the States. The States tried to work around the constitutional and political restrictions by inventing levies that did not offend the

⁶³ The basic grant was set at £242.5m, in replace of the two grants which for 1958-59 totalled £205m.

⁶⁴ Queensland and South Australia were to retain the right to apply to the Grants Commission only if circumstances were such that their financial positions declined relative to the other States.

⁶⁵ See for example, *Parton v Milk Board (Vic)* (1949) 80 CLR 229.

⁶⁶ *Parton v Milk Board (Vic)* (1949) 80 CLR 229

Constitution. To this end a stamp duty on receipts was levied, until challenged in *Western Australia v Hammersley Iron Pty Limited (No1)* in 1969.⁶⁷ In that case, the validity of the legislation was said to be dependent on its criterion of liability, being the receiving of money or the issuing of a receipt.⁶⁸ This view was not accepted however. The duty was held unconstitutional and withdrawn from State taxes. The States experienced a similar result with respect to business franchise fees imposed on tobacco, petrol and alcohol in a later attempt to supplement revenue.⁶⁹

Stamp duty on receipts for wages and salaries did remain valid, and two States levied such duties. However the Commonwealth in 1968 warned these States that this duty was an unacceptable form of income tax and if not repealed their financial assistance grant would be reduced in 1970. The Commonwealth itself had imposed a pay-roll tax since 1941.⁷⁰

Searching for alternatives in the 1970s

In the late 1960s and early 1970s the system of financial assistance came under increasing criticism from State governments and academics. The States were concerned with the growing dependence upon Commonwealth grants. In the 1950s Commonwealth payments to States for recurrent purposes made up approximately 36% of State revenues. By 1974 these payments made up almost 50% of revenues. Moreover the specific purpose payments were increasing from less than 9% of revenue in the early 1960s to almost 25% in 1974. So the States not only relied on the Commonwealth for almost half their revenue but were also required to spend an increasing portion of it as directed by the Commonwealth. Suggestions for improvement in a system considered to be grossly inefficient were made, including:

- the introduction of a broad based growth tax by the States;
- a partial withdrawal of the Commonwealth from income tax to allow the States to resume income taxation; and
- allocation by the Commonwealth to the States of a certain proportion of tax collections from one or several sources.

The States turned firstly to the possibility of regaining some access to income tax and in 1970 unanimously suggested the financial assistance grants be replaced with a new scheme. This scheme would see the base of general revenue grants increased with future increases linked to increases in income tax yield, pending the partial withdrawal of the Commonwealth from income taxation to allow the States to levy their own. The Commonwealth rejected this plan although did agree to increase financial assistance grants. It also offered to partially take over State debts and make capital grants.

In 1971 the States finally were able to access a growth tax to compensate for lost revenue from the withdrawal of the receipts duty when the Commonwealth decided to

⁶⁷ *Western Australia v Hammersley Iron Pty Limited (No1)* (1969) 120 CLR 42

⁶⁸ Above note 67, at 63

⁶⁹ The High Court of Australia brought down a combined decision in the cases of *Walter Hammond and Associates v State of NSW and others* and *HA and anor v State of NSW and others* in 1997 which declared franchise fees on tobacco invalid. As a result the States were forced to cease imposing this tax. Given the similar nature of charges imposed on petrol and alcohol the States also removed those fees at that time.

⁷⁰ *Pay-roll Tax Assessment Act 1941*.

transfer pay-roll tax to the States for an offsetting reduction in the financial assistance grants. The States agreed, and on taking over the pay-roll tax all States unanimously increased the tax rate.

When the financial assistance grants were reviewed in 1975 the States no longer suggested their own income tax. Instead they suggested amending the formula for calculating grants by substituting the wages element for 1.5 times the percentage increase in average wages. While this was rejected, the Commonwealth did increase the financial assistance grants and increased the betterment factor in the formula from 1.8 to 3 percent.

Income tax sharing (1976)

Premiers' conferences were held in February and April 1976 to agree the details of the new government's 'new federalism' policy. These meetings culminated in thirty five 'Points of Understanding.'⁷¹ As a result, the financial assistance grants were replaced in 1976 by a system of personal income tax sharing. In accordance with the Points of Understanding the States received a fixed percentage of the personal income tax collected by the Commonwealth.

In the second stage of the scheme introduced in 1978, each State was able to impose a surcharge or grant a rebate in the Commonwealth rates of taxation.⁷² In either case the Commonwealth was to act as agent for the State. None of the States imposed a surcharge or granted a rebate. This power was removed in 1985.

The decision as to how much of the personal income tax revenue would be available to the States was a political decision. The Commonwealth Grants Commission would determine the distribution of tax among the States and the allocation of each State's share to individual local governing bodies was to be carried out by State grants commissions, to be established under State legislation.

For the first four years there was also a guarantee made that the amount received by each State would not be less than that payable under the previous arrangement. Every State except Queensland required additional payments under the guarantee in the first year. Problems also arose in respect of timing and certainty of amounts for budget purposes which brought about a change in the arrangement. The Commonwealth and the States subsequently agreed that the fixed percentage would be applied to the previous years personal tax collections rather than those of the current year. Although the Commonwealth decided to make 33.6% of personal income tax collections in a year available to the States in that year, a total of 39.87% of the previous years personal income tax collections was actually paid since the guarantee was invoked every year (until it ceased in 1980).

Review of distribution

Although the distribution among the States was initially based on the previous financial assistance grants, the Points of Understanding provided for a review of the

⁷¹ The Points of Understanding were released in Commonwealth Budget Paper No 7, *Payments to or for the States and Local Government Authorities 1976-77*, pp15-18.

⁷² Under the *Income Tax (Arrangement with the States) Act 1978*.

arrangements as a whole periodically, with the first review to take place before the end of the 1981 financial year. The Commonwealth and the States were unable to agree upon a suitable review body until late in 1977. It was then agreed that the task should be undertaken by the Commonwealth Grants Commission. The Commission's review, which took more than two years, was completed in June 1981.

The Commission's report recommended a change in relativities on the basis that the shares of New South Wales, Victoria and Queensland were inadequate and the shares of the other three States were excessive. After consideration of the report of the Commonwealth Grants Commission at a Premiers' Conference, the States did not accept the findings unanimously. The Commission was directed to review its findings in the light of a further year's data, any evidence presented by the States, and the new distribution arrangements for health grants.

As a result of the recommendations, and following discussions, the Commonwealth Government decided to change the arrangement, shifting from personal income tax sharing to total tax sharing. The main taxes included in the base were income taxes, sales tax, customs duty and excise duties.

Special grants could still be claimed by the four claimant States up to 1981, the completion date of the first review. According to the review the special grants could no longer continue and were consequently removed. Queensland was the only State to apply for and receive such a grant during the period 1967-1981.

When the second review was considered in 1982, a system of triennial reviews of the relativities was introduced and a Third Review Report was produced in 1985. When the third triennial review was underway in 1988, governments agreed there would be a change to a system of annual updates of the calculation and regular reviews of the methods of assessment to reduce the use of out of date information.

The return of financial assistance grants (1985 to 1999)

In 1985 the arrangement again changed. The concept of financial assistance grants growing at a specified rate was restored in the May 1985 Premiers' Conference. The grants continued to grow until the 1999 year with the exception of 1990-91 year when the grants were capped as a result of the recession experienced in that year.

Towards 2000 and beyond

In 1991, the then Prime Minister, Bob Hawke suggested to the State Premiers a new 'Fiscal Federalism', where the Commonwealth would still collect the taxes, but predetermined amounts of revenue would then be distributed to the States, which they would be able to spend in any manner they choose. Although no agreements were made, discussions along these lines continued.

In 1998 the Commonwealth Government, led by Prime Minister John Howard, announced its plan to reform the Australian tax system. The Government indicated "A key element of *A New Tax System* was a landmark reform of Commonwealth-State

financial relations.”⁷³ One of the significant outcomes of this initiative has been the introduction of a goods and services tax (GST) on 1 July 2001. As indicated previously, the States are precluded constitutionally from imposing a goods and services tax, so the Commonwealth Government has agreed with the States to effectively levy such a tax on their behalf. Some of the conditions of that agreement include the abolition of various State taxes in return for a share in the GST revenue.

Financial assistance grants ceased on 1 July 2000, however the replacement revenue (generated from the GST) is distributed to States on the same basis. Consequently the Commonwealth Grants Commission’s work will continue in determining relativities between States based on the equalisation principle. The amount to be distributed is to be determined by the Commissioner of Taxation in accordance with Appendix B of the Intergovernmental agreement.

The Intergovernmental agreement is contained in *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*. The agreement specifies that all proceeds net of cost of collection will be transferred unconditionally to the States. The allocation will be based on a formula set out in the agreement. Additionally, any changes to the base and or rate of GST must be agreed amongst the States in accordance with the Agreement.⁷⁴

In the first three years the Commonwealth has also undertaken to ensure that no State will be worse off, in that they will not receive less from the GST revenue than they would have otherwise received as a financial assistance grant. Any payments under this agreement are made based on what is referred to as the guaranteed minimum amount.⁷⁵ Payments made to ensure the minimum amount is received are included in the Commonwealth budget as budget balancing amounts. Budget balancing amounts were paid in the first two years of operation of the GST and are budgeted for 2002-2003.⁷⁶ The Commonwealth will also continue to pay the States special purpose payments (SPP).

THE NEW NIRVANA?

The impression left from the above may be that of down-trodden State Parliaments being restrained from imposing their own income tax by a power-grabbing Commonwealth Parliament and the High Court. However the reality may be somewhat different. In a strange twist, the *Income Tax (Arrangements with the States) Act 1978* provided the machinery for the Commonwealth to administer any State personal income tax that a State wished to impose. The States proved somewhat reluctant to take up the offer, perhaps in the belief that, in the terminology of Sir Humphrey Appleby (the mythical but consummate British civil servant of television fame), it would be a

⁷³ Commonwealth Budget Papers 2000-2001, Paper No 3, Chapter 1, p5.

⁷⁴ In accordance with Part 3 of Schedule 2 of the Intergovernmental Agreement. Also note the States currently have an appointed representative as a member of the GST Rulings Panel (consisting of seven permanent members in total. The panel consider administrative rulings on the interpretation of the GST law.

⁷⁵ Schedule 1 – Transitional Arrangements to *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*.

⁷⁶ Budget balancing assistance paid 2001-02 was \$3,856.8m and a payment of \$1,741.2m is budgeted for 2002-03 according to Commonwealth Budget Paper No 3, Chapter 2, p 12, 2002-03.

‘courageous decision’ to impose a State income tax, and after some years without use the Act was repealed as otiose.

As a result of the tax reforms Australia has implemented, some State taxes have been replaced by a transfer of GST revenue on an equalisation basis. This will result in very significant redistributive benefits to some States without a significant overall increase in total available revenue in the short term. Furthermore, while the total GST revenue is guaranteed to the States collectively, no individual State can be certain of its share. Consequently, States remain reliant upon the Commonwealth. Special purpose grants will be particularly important.

After a century of traversing the long and winding road, the States, which started the 20th century as ‘masters of their own destiny’, find themselves at the end of the century as effectively almost totally beholden to the Commonwealth in terms of revenue. The Commonwealth, for practical purposes, has established a stranglehold on the two major forms of revenue raising, having effectively centralised income tax, and constitutionally having a monopoly to impose a GST. Interestingly, in the midst of all this, the Commonwealth Government has ostensibly abandoned its control over GST revenue collection and consequently a major fiscal policy tool. However, the States do not actually gain control over that revenue. All State Governments must firstly agree to any change, and then the Commonwealth must accept the decision of the States and pass the relevant legislation to effect the change.

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