The Evolution of Constitutional Federalism in Australia: An Incomplete Contracts Approach

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Abstract

The interest in, and the appeal of, fiscal federalism and fiscal decentralization have been increasing in recent years. At the same time many mature federations continue to evolve towards greater centralization, as Australia has evolved in the last one hundred years. The reasons for the evolution of fiscal federalism towards greater centralization remain unclear, and the traditional theories of fiscal federalism shed little light on the factors that might be important in this process. This paper suggests that the insight yielded by the new institutional economics – that the motivations and incentives of economic agents, and the options available to them, are influenced in a fundamental sense by the incompleteness of contracts – may throw considerable light on the evolution of federalism in Australia over the past one hundred years.

1. Introduction: Australia's Federal System One Hundred Years On

In Australia, the distribution of legislative powers between the Commonwealth and the States is vastly different today from the original distribution enshrined in the federal constitution adopted on 1 January 1901. Whereas in 1901, power over most public sector functions was assigned exclusively to the States, it is now shared with the Commonwealth, with the result that legislative competence of the Commonwealth government has expanded significantly over the last century and that of the States has declined.

Similar trends towards greater centralisation may be observed in other federations, e.g. the USA, Canada (notwithstanding some significant reversals in the trend in this country since the 1960s), Germany and India. In each of these federations, the people originally chose a certain degree of fiscal and legislative decentralisation, which could only be changed by them according to specified procedures of constitutional amendment. In each case, however, the balance of power has shifted to dilute the chosen degree of decentralisation, and the authority of subnational governments has weakened over time.

Considered in this context of international empirical evidence, the long-term stability of fiscal decentralisation appears to be in doubt. Yet, there currently exists no clear explanation of why such a transformation of federalism should occur, what particular forces drive this transformation, and whether the future course of the evolution of federalism can be predicted or controlled. The purpose of this paper is to seek preliminary answers to some of these questions.

Although a significant body of economics literature has been developed over the past fifty years dealing with a wide range of issues that arise in a federalized public sector, a review in the following section finds that the current literature sheds little light on why federalism evolves towards greater centralisation. Meanwhile, given the increasing interest in decentralisation, devolution and

federalism around the world - not only in the wake of the demise of the Soviet Union, but also recent fiscal developments in the East European countries and in the European Union, the implementation of fiscal decentralisation in China, and of fiscal devolution in Scotland and Wales – the questions raised above have become ever more important and pressing. We propose in this paper an explanation of the longer-term evolution of fiscal decentralisation with the aid of the concept of incomplete contracts (2). We are not addressing here the question of whether changes to federalism are desirable or undesirable. We are concerned solely with explaining why and how the changes have occurred.

In Section 2, we provide evidence of the erosion of decentralization in the course of the past one hundred years. The inability of the traditional economic theories of fiscal federalism to offer meaningful explanations of the evolution of federalism is discussed in Section 3. The concept of incomplete contracts is introduced and its implications for the evolution of federalism are drawn in Section 4. In Section 5, a new interpretation of revenue sharing – a key institution of federalism and one that has been particularly important in Australia – is developed in the context of the theory of incomplete contracts. The proposition that Australia's Constitution is an incomplete contract is considered in Section 6. The main driving forces of the evolution of federalism in Australia are discussed in Section 7. Section 8 provides a summary of the main conclusions and their implications.

2. Australia: A Changing Federal System

The Constitution adopted in 1901 distributed legislative power over public policies between the Commonwealth and the State governments in a highly decentralized pattern. Only a limited number of substantive heads of power had been assigned to the Commonwealth in Section 51; the remaining functions were reserved for the States (3). In the event of a need for reassignment, the Constitution could be amended in a manner prescribed in the Constitution (Section 128), according to which a referendum for amendment must be supported by not only a majority of voters but also by a majority of States. The aim of this condition of double majority was to protect the interests of the voters in the less populous States by ensuring that voters in only New South Wales and Victoria could not by themselves alter the Constitution. But the Section 128 procedure for amendment has proved to be so difficult that during the past 100 years, the constitution has been amended on only eight occasions, although a total of 42 Constitutional Amendment Bills have been presented to the people of Australia on 18 referendum days. Indeed, in itself, Section 51 has proved to be extremely stable and has been amended only twice during the past one hundred years. In 1946, a new clause (xxiii A) was inserted to Section 51, empowering Parliament to make laws with respect to the provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services, benefits to students and family allowances. The second amendment was made in 1967 but it did not affect the balance of power of between the Commonwealth and the States (4).

The current distribution of powers of legislative power is vastly different from the original design, however, and has become highly centralized at the Commonwealth level. For the most part, this increase in centralization has occurred without formal alteration of the Constitution, i.e. without the express approval of the majority of voters in majority of States, as originally required.

Fiscal centralization and decentralization are normally measured in respect of the shares of subnational governments in national taxation revenues and public expenditures (see, for example Bird, 1986, and Hunter and Shah, 1996). Information shown in Tables 1 to 3 in this section provides evidence of a steep decline of fiscal decentralization in Australia, particularly after the Second World War. Figures in Table 1 show that the share of total tax revenues collected by the State and local governments (States herein after) from their own taxes has fallen from 87 per cent at the time of the inauguration of the Constitution to 18 per cent in 2001-02. Given their expenditure responsibilities for community services, the centralization of taxation revenue has made the States heavily dependent on Commonwealth funding. Figures in Table 2 show that not only are the States heavily dependent upon Commonwealth funding, which amounted to nearly $52 billion in 2001-02, but more than 40 per cent of Commonwealth payments to the States are currently in the form of specific purpose payments (SPPs) that must be spent in accordance with conditions and directions imposed by the Commonwealth. As shown in Table 3, the extensive role of specific purpose payments has changed the nature of most of State functions into functions of shared responsibility.

Since July 2000, when Commonwealth Government introduced the new goods and service tax (GST), the States have been receiving all the GST revenue (net of administrative costs to the Commonwealth) instead of general revenue grants of the previous years. This arrangement came into effect as a part of the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Reforms 1999*, which followed the invalidation of State Business Franchise Fees on tobacco, petroleum products and alcoholic beverages by the High Court on 5 August 1997 (see, Section 7 below for detail). Although this arrangement makes the States feel more secure in respect of access to a broad-based and growing source of revenue, Constitutionally and legally, GST is a Commonwealth tax (and is treated as such by the Australian Bureau of Statistics) and for this reason, the States are now more dependent on Commonwealth funding than they have ever been in most of their peacetime history.

Table 1. Share of total taxation revenues by level of government

Year	*State and local*	*Commonwealth*
1898-99	100	0
1901-02	87	13
1909-10	78	22
1918-19	27	73
1928-29	37	63
1938-39	41	59
1948-49	12	88
1958-59	17	83
1969-70	17	83
1979-80	20	80
1985-86	19	81
1989-90	22	78
1998-99	23	77
2001-02	18	82

Sources: Mathews and Jay (1997, reprint of 1972 edn), pp. 54, 58, 83, 100, 152, 194, 230, 282; Mathews and Grewal (1997); and ABS, various years, Cat. no. 5512.0.

Table 2. Commonwealth payments to or for the States, selected years

Year	*Total payments ($m)*	*Conditional payments ($m)*	*Conditional payments as % of total payments*
1918-19	12.9	0	0.0
1924-25	16	1	6.3
1929-30	25.2	6.2	24.6
1938-39	30.7	8.6	28.0
1945-46	100.4	6.4	6.4
1948-49	157	34	21.8
1958-59	582	141	24.2
1968-69	1620	424	26.2
1975-76	8555	4152	48.5
1978-79	10720	4485	41.8
1988-89	24745	11515	46.5
1994-95	30322	17041	56.2
1998-99	33673	16652	49.5
2001-02	51729	21020	40.6

Sources: Mathews and Jay (1997, reprint of 1972 edn, Tables 17, 23, 33, 46); Mathews and Grewal (1997, Tables 4.1, 8.5, 12.1); and Commonwealth of Australia (1999, 2002).

Table 3. Government expenditure on selected purposes by level of government, 2001-02

Purpose	*All governments ($m)*	*Commonwealth Government ($m)*	*State and local governments ($m)*
Social security & welfare	74551	69080	7099
Health	44327	27613	24230
Education	37546	21507	27070
General public services	16243	9950	7536
Public debt transactions	15636	10535	5336
Transport & communications	14098	2647	13241
Defense	12017	12017	---
Public order & safety	11535	1855	9777
Housing & community amenities	10011	2210	9287
Other economic affairs	8107	3895	4216
Recreation & culture	6535	2030	4550
Agriculture, forestry & fishing	3905	1691	2381
Fuel & energy	4105	3052	1073
Mining, manufacturing & constr.	2614	1686	929
Other	801	33625	853
Total	262032	203392	117578

Notes: 1. All figures are GFS expenses. Figures for the university sector have been added into Commonwealth Government expenses.
2. Row totals do not add up due to intergovernmental transfers.
Source: Australian Bureau of Statistics, Government Finance Statistics 2001-02, Cat. No. 5512.0, June 2003.

The historical ascendancy of centralization in Australia is sketched in Table 4, through an outline of the major landmarks – intergovernmental events or High Court decisions – that led to the erosion of the States' Constitutional authority. It is clear that a significant measure of the Constitutional degree of decentralization has been lost during the first hundred years after Federation.

Table 4. Major changes in the constitutional division of powers, selected landmarks

Year	*Selected events*	*Impact on decentralisation*
1908	The States lost their Constitutional right to at least 75% of the Commonwealth surplus revenue under Section 94	Greater dependence of States on Commonwealth
1920	New legal doctrine established by the High Court in the Engineers' case, favouring Commonwealth government	Expansion of Commonwealth powers
1923	The power of Section 96 begins to unravel when road grants are introduced	Expansion of Commonwealth powers
1927	The Financial Agreement sets up Australian Loan Council, which would diminish States' borrowing powers	Expansion of Commonwealth powers
1942	Commonwealth gains exclusive power over income taxation	Greater dependence of States on Commonwealth
1951	States cannot raise sufficient borrowings and become dependent on Commonwealth Special Loans	Greater dependence of States on Commonwealth
1969	State receipts duty declared invalid by the High Court	Loss of States' independent revenue sources
1970	The High Court rules that the States cannot levy a tax on any stage of sales of a product	Loss of States' independent revenue sources
1971	Transfer of Commonwealth Payroll tax to the States, with corresponding reduction in tax sharing grants	States gain independent source of revenue
1973	Commonwealth specific purpose grants mushroom under Whitlam administration	Expansion of Commonwealth powers
1974	Commonwealth takes over financing of tertiary education from the States	Expansion of Commonwealth powers

Table 4. (cont.)

1976	Commonwealth stops sand mining on Fraser Island using external affairs power	Expansion of Commonwealth powers
1981	Commonwealth stops, under international treaty obligations, the proposed dams in Tasmania	Expansion of Commonwealth powers
1985	Transfer of Bank Account Debits Tax to the States, with corresponding reduction in tax sharing grants	States gain independent source of revenue
1988	Commonwealth threatens to reduce Queensland's financial assistance grants for not cooperating in the Loan Council	Unconditional grants no longer without conditions
1990	Corporations power is coordinated at the Commonwealth level, although problems remain	Expansion of Commonwealth powers
1997	The High Court declares invalid State business franchise fee on tobacco, alcohol and petrol	Greater dependence of States on Commonwealth
1998	Commonwealth introduces 'safety net' arrangements to save States' finances	Greater dependence of States on Commonwealth
1999	Intergovernmental Agreement on Commonwealth –State Financial Relations	Greater dependence of States on Commonwealth
2000	States receive GST revenue instead of revenue grants from the Commonwealth	Greater dependence of States on Commonwealth

Irrespective of the merits or demerits of this change, it cannot be denied that much of this change has not occurred as a result of formal amendments of the Constitution – and is not for this reason based upon the required approval of Australian voters. Instead, the change has occurred through reinterpretations of the particular sections of the Constitution, initially by the Commonwealth Government which enacted certain laws that were based on hitherto uncertain constitutional grounds, but eventually by the High Court of Australia, which validated those laws that were considered to be consistent with the Constitution. Although in all such cases the verdict of the High Court is final, it is important to note that the Court does not initiate new interpretations of the Constitution on its own volition; it only responds when constitutional validity of an existing law has been challenged.

It is the governments, therefore, not the High Court, which initiate the process of change in the constitutional division of powers. It remains to be explained, however, why governments should seek to change the constitutional balance of powers, and why the constitutional degree of decentralization gave way to a highly centralized federal system in Australia. We consider in the next

section whether the established economic theories of federalism can shed any light on these questions.

3. Economic Theories of Federalism

Three distinct economic perspectives constitute the theoretical literature on federalism, viz., the public goods theory of federalism, the organizational costs theory of federalism and the public choice theory of federalism. All three are normative theories, however, concerned with providing an economic rationale for fiscal federalism, not with explaining why an initial assignment of powers in a federation would change over time.

3.1 Public goods theory of federalism

The main focus of the public goods theory of fiscal federalism is on developing efficiency enhancing properties of fiscal decentralization. Early in the development of the modern theory of public goods it became clear that market pricing of public goods would be impossible due to the free rider problem and that voting procedures would have to be developed to ascertain the consumers' preferences for such goods. Tiebout (1956) suggested, however, that for public goods that are provided by the subnational governments the free rider problem might not be insurmountable, as consumers would move between local government areas to choose that particular jurisdiction in which the provision of public goods best matches their preferences. This mobility between local jurisdictions has been likened to the act of 'voting with feet' and is considered to serve as a signaling mechanism for revealing consumer preferences for subnational public goods. Viewed in this light, fiscal federalism is considered to be an efficiency enhancing structure of the public sector, although the Tiebout hypothesis has been shown to be valid only under highly restrictive conditions (see, e.g. Pestieau, 1977; Sinn, 1997).

The notion that different public goods have different geographic domains has been crucial in addressing the next question: Which public goods should be provided at the national level and which at subnational levels? Public goods are distinguished from private goods on the criteria of non-rivalness and non-exclusion. The public goods theory of fiscal federalism is based on the premise that any public good retains its 'publicness' within a particular geographic domain, beyond which it no longer remains nonrival in consumption. Different public goods have different geographic domains. Thus, a public good like national defense remains nonrival and equally available to all citizens of a nation. In contrast, a public good like street lighting retains its publicness only when it is consumed within a relatively small geographic area.

The notion of geographically based public goods in turn provided the basis for establishing a hierarchy of public goods (Breton, 1965). Public goods that retain their publicness over only a local government area may be labeled as 'local' public goods those that retain their publicness over wider areas may be appropriately labeled as 'regional' public goods, 'state' public goods, and 'national' public goods. Indeed, by the same logic, public goods such as continental peace or world environment can be included in this hierarchy as 'continental' and 'world' public goods.

Once a hierarchy of spatially arranged public goods has been established, it can be demonstrated that optimal provision of public goods requires a

federalized public sector in which the hierarchy of public goods perfectly corresponds with the hierarchy of the governance structures. Such perfect correspondence between the two hierarchies is considered to ensure that all objective benefits of local public goods are exhausted within the boundaries of the local governments, who are empowered to make all decisions regarding the production and supply of these local public goods. Similarly, the benefits of 'state' public goods should be exhausted within the boundaries of state governments. And so on. Allocative inefficiency would arise in the absence of such perfect correspondence due to interjurisdictional spillovers of benefits and costs, and the supply of public goods would be sub-optimal (Brainard and Dolbear, 1967; Pauly, 1970; Thurow, 1970). On this reasoning, it was claimed that 'the best distribution of authority is the one which exists in a federation' (5).

Following Musgrave's classification of governments' economic functions into the stabilization function, the redistributive function and the allocative function (Musgrave, 1959) the received wisdom has been that in countries with federal constitutions responsibility for the first two functions should be assigned to the national governments whereas for the allocative function it should be shared with the subnational governments. The assignment of functions in this theory turns essentially on the geographic boundaries of different public goods. It is possible to infer, accordingly, that a change a in a given assignment pattern would be warranted only if geographic boundaries of public goods have also changed. Presumably, such a transformation of public goods is either considered to be unlikely or unimportant, with the result that this theory does not deal with the issues of evolution of a given assignment of functions over time.

3.2 Organizational costs theory of federalism

The driving force in this theory is provided by the organizational costs of the public sector. The proponents of the organizational costs theory of federalism reject the claim that a theory of federalism can be erected on the notion of geographic boundaries of public goods. They argue that as long as the organizational costs are assumed to be zero, *a priori* case for fiscal decentralisation cannot be made. In the absence of positive organizational costs, the assignment problem becomes indeterminate, as there can be in principle as many political jurisdictions as there are public goods or only one jurisdiction can provide all public goods. Thus, the starting point of the organizational costs theory is that the essential nature of a structure for the public sector is to be found in the recognition of positive organizational resource costs, not in public goods or externalities (Breton and Scott, 1978) (6).

The institutional framework of this theory includes 'constituent assemblies', whose function is to review preferences of the voters and cost structure of public goods, and to reassign functions as necessary so as to ensure that organizational costs are kept at the minimum possible level. Defined broadly to include all costs that may be incurred by individuals and governments in satisfying collective wants of the people, organizational costs in this theory comprise costs of signaling, mobility, administration, and co-ordination. These four categories correspond to the four kinds of activity in which individuals and governments engage for the purpose of providing public goods.

The organizational costs theory is an improvement over the public goods theory of federalism in two ways. First, it recognizes the cost constraints of the assignment problem that had been overlooked in the public goods theory. Secondly, it introduces an explicit objective function of the governments in terms

of power. The objective function of governments is defined in the organizational costs theory in terms of their desire to be re-elected to power. In other words, governments seek to ensure that the probability of their re-election remains above a certain critical level (7). To this end, governments aim to provide public goods that are in accordance with the preferences of the voters, and involve minimum possible cost to the taxpayers, subject to the specifications of the production function. These requirements lead governments to invest in administrative activities (e.g. search for preferences as well as technologies) and in co-ordination.

3.3 Public choice perspective on federalism

Inspired mainly by the writings of James Buchanan and Gordon Tullock, the public choice literature is based on the premise that in the absence of appropriate institutional constraints, the natural tendency of a government is to use its power over taxation to exploit the electors. In favouring fiscal federalism over a unitary form of government the public choice theorists are not concerned with allocative efficiency, which is the main focus of the theories noted above. Instead, the public choice approach favours fiscal federalism because the multiplicity of governments is considered to be helpful in restricting the power of each level of government and thereby in increasing the welfare of the voters. In a recent debate on the subject, the founder of the public choice theory, James Buchanan (2000, p. 178) emphasized that:

> Even if division of powers between the central government and a set of local governments should not be efficient, there would still be an argument in favor of delegating some power to those governments as a means of controlling or checking the central government authority. So within some threshold, you would still want a federal structure.

Fiscal federalism not only provides greater scope for the satisfaction of heterogeneous preferences for public goods, which would not be possible in a centralized public sector. The multiplicity of governments at the subnational level also contains the threat of potential mobility from one jurisdiction to another, which in turn acts as a constraint over their exploitative power. It follows that, other things being equal, the greater the degree of fiscal decentralization in a country, the greater will be the scope available for the voters to escape from coercion of centralisation and to improve their welfare.

3.4 Summing up

In summary, the traditional theories of federalism are not concerned with the descriptive questions about how and why a given distribution of political authority in a federation evolves over time. Nonetheless, each of these theories provides valuable concepts, which together may contribute towards the development of a positive theory of the evolution of federalism. Thus, the public goods theory provides the critical mass of an economic theory of the public sector. The economic rationale of the public sector remains the regulation of the private sector, management of the economy and the provision of public goods. The public goods theory of fiscal federalism deepens our understanding of the geographic nature of public goods, and of the efficiency conditions that must be met in the provision of public goods with geographic spillovers.

Recognition of the costs of various types involved in the provision of public goods remains the most important contribution of the organizational costs theory of federalism. An important contribution of this theory also is the recognition of the entrepreneurial role of governments in seeking out information about peoples' preferences, in shaping these preferences and in implementing technologies for the least cost provision of the required goods and services.

The story of the evolution of federalism is still incomplete, however, because the objective function of a government has not yet been properly defined and integrated into the dynamics of federalism. The traditional theories impose a normative objective function upon the governments, according to which governments do what the theorists want them to do, not what the governments naturally would like to do. This explains the absence of a positive economic theory of the federalized public sector.

4. The Theory of Incomplete Contracts

In contrast to the earlier neoclassical tradition, which was primarily focused on the operation of markets, the new institutional economics is focused on how institutions impact on the operation and the outcome of exchange, and on how institutional inducements are reflected in the development of markets. Institutions are described in this literature as humanly devised constraints that shape human interaction, and include both formal constraints such as rules, laws, and constitutions, and informal constraints such as norms of behaviour, conventions, and self-imposed codes of conduct ((North, 1990, p. 3; 1994, p. 360). While institutions embody rules of the game, organizations are the players of the game. Organizations are defined as 'groups of individuals bound by some common purpose to achieve objectives' (North, 1990, p. 5). Thus, the Australian constitution is an institution formally created with the deliberate intent of defining the constraints on the Commonwealth Government's legislative authority. Similarly, the Federal Parliament, State legislatures and the High Court of Australia are important organizations.

Both institutions and organizations change over time in interactive ways. While institutions determine which organizations are created and for what purpose, organizations influence through their decisions and operations the evolution of institutions. Both may change in response to external factors or to changes in enforcement. Although the emphasis on institutions as being at the heart of the economy is not new, it is one that had been largely lost to mainstream thought for several decades. Its re-emergence in the work as North, David and others, especially in conjunction with an awareness of feedback mechanisms and path dependence, implies quite new directions for economic and policy analysis.

The concept of incomplete contracts is based fundamentally on the need to transact business among separate entities, none of which can foresee and predict the future completely (Williamson, 1996; Hart, 1995; Sheehan, 2001). If it were possible to observe all actions and events without error or uncertainty, and to foresee with assurance all future events, or to identify, plan for and contract for all future circumstances without incurring costs, parties engaged in economic activity could enter into comprehensive or complete contracts. These would be contracts that did not have to be revised at any time in the future, because they identified and provided a contractual response to every situation that arose. Of course it is not possible either to observe the present without error or uncertainty

or to foresee the future. Even if the latter were possible, it would be wildly expensive to contract for every future contingency. Nor is it generally possible to identify and monitor all of the actions of all parties to a contract. Thus actual contracts are of necessity incomplete, in at least one of the two senses. Either future circumstances will arise which are not covered by the contract, and in which a new decision will have to be made, or present or future inputs by, or benefits to, parties will not be completely observable or measurable.

The economic significance of incomplete contracts derives from the responses and strategies of the agents in dealing with this reality of incomplete contracts. As pointed out by Hart, a firm may now prefer ownership of assets to contract-based exchange, as ownership also provides the firm with residual rights of control over the assets, which contract-based exchange does not. Ownership thus becomes 'a source of power when contracts are incomplete' (Hart, 1995, p. 29). The residual control rights over assets are also the key consideration, according to this viewpoint, in determining whether a private firm should be regulated or nationalized:

> If contracting costs are zero, there is no difference between the optimal regulation of a private firm on the one hand, and nationalization or public ownership on the other. ... In contrast, in a world of incomplete contracts, public and private ownership are different, since in one case the government has residual control rights over the firm's assets, while in the other case a private owner does. (Hart, 1995, p. 12)

Once it is recognized that federal constitutions are also incomplete contracts, useful new insights can be gained for explaining the dynamics and the evolution of federalism.

4.1 Federal Constitutions as incomplete contracts

In the fundamental sense, a federal constitution is a contract between the state and the people of a country, according to which specific powers to make laws are assigned between national and subnational governments. Like most other contracts, a federal constitution is also an incomplete contract, as legislative domain of neither national nor subnational governments is fixed forever and there is always room for disputation over the meaning and intent of some clauses, and for future amendments. Within this incomplete contractual framework, numerous intergovernmental grants and agreements are conducted under separate incomplete and implicit contracts between national and subnational governments. This incompleteness of the constitutional contract adds a new dimension to the objective functions of governments in a federation. Whereas the objective function of a government in a unitary country relates only to the voters, in a federation it also relates to the other governments. This is because incomplete contracts create opportunities and incentives for intergovernmental struggle and power play over the scope of legislative competence.

This power play for legislative authority in a federation is conducted within the democratic constraint that all legislators need to be periodically elected by the voters, who are not only consumers of public goods but also taxpayers. The motivation to ensure that public goods match the preferences of voters and that the tax cost is kept to the minimum would force the governments to remain fully informed about the voters' preferences and to be able to effectively respond to their demands. Accordingly, each government would seek to ensure

that: (a) it can do more for the voters than the competing governments and (b) it has maximum support and minimum opposition from the competing governments in implementing its policies and programs.

5. Revenue Sharing: A New Interpretation

Intergovernmental financial transfers are an important feature of federal finance in most countries that have more than one level of government. As noted above in Section 2, revenue sharing between the Commonwealth and the States is a key feature of Australian federalism, given the highly centralised pattern of taxation revenues and the considerable extent of decentralisation of public expenditures.

5.1 Revenue sharing in traditional literature

Intergovernmental financial transfers also feature prominently in the normative literature on the economics of fiscal federalism. Even if a system of government could be designed strictly according to the principle of perfect equivalence (Oates, 1972), the existence of interjurisdictional spillovers would make prevent the achievement of optimal output of subnational public goods unless all such spillovers are somehow incorporated into the decision calculus of subnational governments. When the benefits (and costs) of public goods are not completely confined within the boundaries of the government providing it, there may be spillovers into other jurisdictions. It is generally recognized that if each subnational government acts independently in deciding how much of a public good it should produce, each government will stop production at a point where the marginal cost of production equates with marginal benefits to its own residents. Thus the spillovers do not form a part of the decision process of the government generating them. Matching grants from governments of those jurisdictions that receive such spillovers to those governments that generate them are considered to be an effective solution to this so-called undersupply hypothesis (see, Grewal, Brennan and Mathews, 1980). Matching grants work essentially as the 'Pigovian' subsidies with the result that output can be expanded beyond the point of local equilibrium. Such matching grants must not only be conditional (so they are spent on the designated public goods only), but also be open-ended grants, so that optimum level of output can be produced (Oates, 1999).

An additional rationale for intergovernmental grants emerges out of the recognition that subnational governments may not be able to raise sufficient tax revenue from the taxes that are assigned to them under a federal constitution. It is generally recognized that in a federation, not all taxes are equally suitable for national and subnational governments. Thus, for example, taxes that are suitable for economic stabilization should be assigned to the national government. Similarly, progressive taxes for redistributional purposes should be mainly national. Subnational governments should impose taxes on tax bases that are not highly mobile between jurisdictions; otherwise, base flight and competition among subnational governments for mobile tax bases would generate inefficiencies (see Musgrave, 1983). The upshot of this literature is that revenue sharing (through unconditional grants from national to subnational governments) provides an ideal mechanism for combining the benefits of centralized taxation and decentralized public expenditure (Oates, 1999).

5.2 Revenue sharing and incomplete contracts

In the traditional literature, revenue sharing poses little risk to fiscal decentralization because national governments are assumed to act benignly without any preferences for centralization. In the context of incomplete contracts, however, governments actively seek to acquire for themselves a position of power over their contractual partners, so that they can influence the future shape of intergovernmental relations. Considered in this light, revenue sharing becomes a potent weapon of gaining such power and wielding such influence. From the standpoint of the evolution of federalism over time, therefore, revenue sharing can no longer be considered a neutral transaction; it is rather a powerful instrument of intergovernmental control.

The traditional distinction between conditional and unconditional payments becomes far less important in the context of incomplete contracts, as it is the total dependence of one level of government on another that determines the dynamics of intergovernmental relations and power play.

6. Australia's Constitution: An Incomplete Contract

The Constitution of Australia abounds in examples of incomplete or open-ended assignment of powers, presenting a fertile ground for intergovernmental power play. Thus, for example, Section 87 required that during the ten years after the establishment of the Commonwealth a maximum of one-fourth of net revenue raised from customs and excise duties could be applied annually towards Commonwealth expenditure; the balance was to be paid to the States. What should happen after the expiry of the ten year period was left entirely at the discretion of the Commonwealth Parliament: *'and thereafter until the Parliament otherwise provides*'. Section 94 provided that after five years from the imposition of uniform duties of customs, *the Parliament may provide, on such basis as it deems fair*, for the monthly payment to the States of 'all surplus revenue of the Commonwealth'. Once again, the neither the obligation of the Commonwealth nor the particular method of determining the payments to the States were expressed in categorical terms, leaving much to the discretion of the Parliament.

Similarly, Section 96 requires that 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*. Furthermore, the lack of precision in the wording of Section 90, which assigns exclusive power to the Commonwealth over 'duties of customs and of excise', has been a source of considerable intergovernmental dispute and judicial debate for decades. It remains unclear, therefore, whether the Commonwealth's exclusive power is to be over all excise duties (which is the prevailing majority view of the High Court) or only on those goods that are also subject to customs duties (as was suggested by some judges of the High Court on several occasions).

There are many other examples of this type of ambiguities in Australian Constitution (8).

7. Main Driving Forces Behind the Evolution of Australian Federalism

7.1 Centralization of revenue powers

The Commonwealth responded to the opportunities provided by the incompleteness of the constitutional contract soon after the inauguration of the Constitution. In 1908, it passed two pieces of legislation with the intention of diverting the Commonwealth budget surplus into trust funds (9). The trust funds were dedicated to the financing of old age pensions and coastal defense in subsequent years, thus ensuring that there was no surplus revenue left to be distributed among the States, as it was required to distribute under Section 94. When the constitutional validity of the legislation was challenged, the High Court ruled (*The Surplus Revenue Case* (1908), CLR 179) that money so appropriated was indeed 'expenditure' for the purpose of the Constitution and did not constitute a surplus, even though it had not been actually spent. As one observer subsequently commented, this decision of the High Court signaled that the financial policy of the Commonwealth towards the States would be guided by Wordsworth's 'good old rule, the simple plan, that they should take who have the power, and they should keep who can' (Hannan, 1961, p. 252).

Although there is no constitutional prohibition on the States' authority to impose income tax (indeed the States levied income taxes simultaneously with the Commonwealth from 1915 onward), the States have been virtually excluded from this field since 1942. The Court's decision in the second uniform income tax case (1957) held that liability for Commonwealth income tax had precedence over liability for State imposed income tax. Unlike the experience of Canada, where the federal government made 'tax room' for provincial governments by reducing federal income tax rate, Commonwealth Government in Australia offered no such concession for the States. If any State government wanted to impose an income tax, it would have to impose that on top of the existing Commonwealth rates. None of the States has contemplated imposing a state income tax under these conditions.

Section 90 of the Commonwealth Constitution prohibits the States from imposing customs duties and excise duties. In the absence of a clear definition of excise duties in the constitution, the task of interpreting what constitutes an excise duty rests with the High Court. The Court's interpretations in this area have denied the States entry not just into the narrow field of taxes on production of goods (as most economists would interpret excise duties) but also the broad field of sales taxes.

Time and again, the States developed tax legislation carefully so as not to offend the Court's previous interpretations of Section 90, only to find the new legislation would be eventually struck down by the High Court under a new interpretation of Section 90. In the 1970s, the States developed new taxes, which came to be known as 'business franchise fees', on petroleum products, tobacco and alcohol. In due course, these fees grew into a significant source of revenue for the states. Although levied at increasingly high rates, the fees were considered to have satisfied the criteria expounded by the Court in previous cases until the Court struck them down on 5 August 1997 in *Ha v NSW* (1997) 146 ALR 355.

On 6 August 1997, the Commonwealth introduced a rescue package to protect the State finances, under which it increased the rates of customs and excise duties on tobacco and petroleum products, and the rates of wholesale sales tax on alcoholic beverages, and agreed to return all revenue thus collected (net of

administrative costs) to the states in the form of revenue replacement payments (RRPs) (Commonwealth of Australia, 1999). This so-called safety net arrangement in turn contributed to the states' support when the Commonwealth announced in August 1998 its plan to introduce a goods and services tax (GST). In April 1999, the Premiers' Conference announced the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, under which the safety net RRPs would cease at the end of 1999-2000 when the states would receive, from 1 July 2000, all GST revenue.

The vertical fiscal imbalance in Australia, which could not have developed without the support of the High Court of Australia, has been a welcome source of power over the States for the Commonwealth Government, because the imbalance created the need for revenue sharing at a large scale. The Commonwealth Government fully used the leverage of revenue sharing to its advantage. A former federal Treasurer and Prime Minister, Mr Keating once argued that the national perspective dominates Australian political life only because the national government dominates revenue raising (10). Combined with the Commonwealth power to give open-ended grants to the States under Section 96, the Commonwealth eventually gained the dominating financial position over the States (Mathews and Grewal 1997).

7.2 The High Court of Australia

The Commonwealth Government and, after the World War I, the High Court of Australia found the Constitutional assignment of powers to be unworkable in building the nation. The Court's judgment in the *Engineers' Case* in 1920 is the landmark ruling, in which the court rejected the two fundamental doctrines on which its rulings had been based until then. The first of these was the doctrine of reserved powers, which meant that legislative power over those functions that are not specifically inserted in Section 51 of the Constitution was reserved for the States. The second was the doctrine of implied immunities of instrumentalities, which meant that the two levels of government were immune from each other's laws. According to an eminent expert, in sweeping away both these principles of judicial review, the Court purported to express once and for all *the true relation of federal legislative power to the States* (Dixon, 1965, p. 116). This 'true relation' would now be of a hierarchical nature in which the States did not enjoy the same status of sovereignty as the Commonwealth Government.

In 1923, the Commonwealth passed legislation under which it proposed to provide grants to assist the States in building roads. Victoria challenged the Constitutional validity of this legislation on the ground that its intention and effect was to enable the Commonwealth to engage in road construction, which was not an activity included in the list of Commonwealth powers given in Section 51 of the Constitution. The High Court rejected the State's objection stating that the Federal Aid Roads Act was warranted by the provisions of Section 96 of the Constitution and did not contravene any other section of the Constitution. This judgment had important implications for the expansion of Commonwealth's spending power into State functions. Since then the Commonwealth Government has used specific purpose payments in relation to school education, tertiary education, health care, social services, State railways, urban and regional development and a whole range of other areas. As noted in Table 2 above, specific purpose payments now account for nearly half of the total Commonwealth payments to the States, and have allowed the Commonwealth to influence expenditure policies across a wide range of State functions.

In so far as it is possible to find a general principle underpinning the High Court's decisions affecting the balance of fiscal power in Australia, the Court appears to have been guided by the notion of indivisible sovereignty, instead of a model of co-ordinate federalism. Consistently, the Court has viewed the Commonwealth Government as not just the 'federal' government but also the 'national' government, whose responsibility it is to forge a national identity for Australia and to develop national policies as necessary. Whenever the issue before the Court has required a judgment on the role of the Government *vis-à-vis* the individual, the Court has generally sided with the latter (as, for example, in rejecting Commonwealth legislation for the nationalization of airlines in 1945 and of banks in 1948). On the other hand, when the issue at hand has been to determine the legislative authority of the Commonwealth as opposed to that of the States, the Court has generally sided with the former.

Thus, the broad thrust of the High Court's rulings has been, on the one hand, to resist an expansion in the role of the public sector and, on the other hand, to assist greater centralization of power within the public sector. In broadening the legislative authority of the Commonwealth Government, the High Court has exploited a particular feature that makes Australia's Constitution even more like an incomplete contract, namely the interdependence between governmental functions. A recent example of this can be found in *Ha v. NSW 1997*, in which the Court argued that an objective of the movement to Federation was to achieve free inter-colonial trade on the basis of a uniform tariff. That objective could not have been achieved, the Court added, if the States had retained the power to place a tax on goods within their borders. It was not made clear, however, why the objectives of internal free trade and a common external tariff would be jeopardized if a State tax did not distinguish between taxed and untaxed goods on the basis whether the good in question had been imported, or whether it had been produced in one State and sold in another. Indeed, the dissenting judges had argued that business franchise fee on tobacco in New South Wales did not discriminate between tobacco on the basis of whether it was manufactured overseas, in another State or in New South Wales. Hence it violated neither the common external tariff nor internal free trade (see, Grewal 1997 and 1998 for detail).

The Court cited support for the majority ruling from an earlier case in which Justice Owen Dixon had said that 'in making the power of the Parliament of the Commonwealth to impose duties of customs and of excise exclusive it may be assumed that it was intended to give the Parliament a real control of the taxation of commodities and to ensure that the execution of whatever policy it adopted should not be hampered or defeated by State action' (*Parton* (1949), 80 CLR 229).

7.3 Disunity between Australian States

The States have also unwittingly contributed to the ascendancy of fiscal centralization in Australia. First of all, the mutual mistrust of the colonies did not end with the inauguration of Federation. Indeed, the States remained deeply suspicious of one another. The less populous States often acted together against the larger States and frequently sided with the Commonwealth in the ongoing power plays. Victoria and New South Wales, in turn, had their own differences, which prevented them from forming a single approach on many important issues.

In part, these interstate rivalries were based on economic disparities between the less populous states on the one hand and the larger States on the

other. Fiscal equalization grants to the former group of States, which started in 1933, gave additional influence to the Commonwealth over these States.

The almost total absence of horizontal co-operation among the States gave additional reason for the Commonwealth to be involved in many issues that were not truly of national significance but were simply matters that transcended State boundaries and should have been resolved by the States themselves.

8. Conclusions and Implications

In this paper, we have provided sufficient evidence in support of our main premise that there has been a fundamental shift towards greater centralization in Australia since it adopted the federal constitution in 1901. It has also been shown that the traditional economic theories of fiscal federalism provide little guidance in explaining why such a shift should have occurred. From these premises, we have suggested that some of the insights gained from the theory of incomplete contracts offer a plausible explanation for the evolution of federalism. Given the uncertainties of a world of incomplete contracts, each level of government in a federation actively seeks to gain some form of control over the other levels with a view to reducing potential resistance to, or increasing support for, its own policies and programs. Thus, there is an inherent rationale and a role for intergovernmental competition in every federal type constitution. The nature of this new competition is different from intergovernmental competition in the Tiebout world, where horizontal competition occurs among local governments for attracting mobile economic resources from one jurisdiction to another. Intergovernmental competition triggered by incomplete contracts occurs, in contrast, vertically between national and subnational governments for legislative power over governmental functions.

Three important conclusions flow from this insight. One, every pattern of assignment of powers in a federation must evolve over time. Secondly, the evolution of federalism is shaped not only by exogenous forces, such as wars or economic depressions, but also by endogenous forces of intergovernmental competition. In the case of Australia, path dependence of the evolution has also been in evidence. Once the process of centralization got under way, it gained momentum and became stronger. Thirdly, the traditional distinction between conditional and unconditional intergovernmental financial transfers loses its significance in the world of incomplete contracts. It is the overall financial dependence of one level of government over another that ultimately matters in the new intergovernmental competition, not only conditional transfers.

In analytical terms, there are potential implications for the *stability*, *optimality* and *efficiency* of federations. The incompleteness of contracts introduces an element of instability into every constitutional assignment of fiscal powers in a federation. Whether a federation ultimately becomes more or less centralized over time will depend upon the respective power and objective functions of the various governments, and the institutional safeguards that exist in each country. The case of Australia's federalism suggests that the control of a particular level of government over financial powers plays a crucial role in the evolution of federalism.

Australia's experience also suggests that, even if a particular federation were to initially represent an optimal distribution of powers, the reality will be shaped eventually by the influence of intergovernmental competition, and may or may not be able to retain the original optimality. There is no theoretical reason

for presuming that intergovernmental competition would preserve the optimality properties of the original constitution. In terms of efficiency, it is often argued that the evolved Australian federation permits a wide range of inefficient, overlapping and inconsistent roles for different levels of government, which in turn impede economic development and community welfare (see, e.g., Mathews and Grewal 1997).

These conclusions have important implications for policy in terms of both the reform of existing federations and the establishment of new federal constitutions (such as for the European Union). Any review and reform of an existing federation must consider not only the current assignment of powers but also the dynamics underlying the process, and the powers and objectives of the parties contributing to those dynamics. There also appears to be a lesson for those countries which are now embarking on the road to fiscal decentralization: formal assignments of fiscal powers are bound to change over time and their spirit can only be protected with the help of an appropriately designed institutional framework based on an understanding of the forces that are likely to be at work.

There is no question that much remains to be done to develop a formal theory of federal constitutions as incomplete contracts, and to understand the application of this approach to a particular federation such as Australia. The aim of this paper has been to make a modest contribution in this direction by addressing some of the key questions.

Endnotes

1. There is a large literature on the implications of incomplete contracts for the theory of the firm and for financial contracting. See, for example, Aghion and Bolton (1992), Williamson and Winter (1991) and Hart (1988, 1995).
2. Garnaut and FitzGerald (2002) interpret the Constitutional division of functions as being consistent with what we now know as the principle of subsidiarity. 3. The wording of Section 51, clause xxvi, ('The people of any race, other than the aboriginal race in any State, for whom it is necessary to make special laws') was changed to 'The people of any race for whom it is necessary to make special laws'.
4. Breton (1965) and Olson (1969) called this the principle of 'fiscal equivalence'.
5. It should be recalled that Breton's earlier work, especially his paper 'A Theory of Government Grants', was largely responsible for deriving the public goods theory of federalism. To that extent the Breton-Scott formulation rejects that earlier work.
6. But as we argue below, this specification of the objective function does not explain the dynamics of intergovernmental power play that is always present in a federation and that shapes its evolution in the long run.
7. The incompleteness of the constitutional assignment also resulted from certain deliberate decisions made at the time when the contracting parties wanted to avoid an impasse in the negotiations (see La Nauze, 1972).
8. *Old Age Pensions Appropriations Act 1908*, and the *Coast Defence Appropriation Act 1908*.
9. Address to the National Press Club, *The Commonwealth and the States and the November Special Premiers' Conference*, 22 October 1991, Canberra.

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