South Australia's new bank levy, projected to earn A$370 million over four years , seems to be constitutionally valid but it remains hostage to political machinations.

While precise details are sparse, the Major Banks Levy will target those institutions liable for the Commonwealth bank levy (Commonwealth Bank, ANZ Bank, Westpac, National Australia Bank and Macquarie Bank). It will impose a state levy of 0.015% per quarter of South Australia's share (about 6%) of the total value of bank liabilities subject to the federal government levy.

By making Commonwealth grant payments conditional on the removal of a levy, the federal government could force South Australia to abandon its bank levy.

It's here that South Australia can benefit from the cover provided by the federal government's bank levy. The federal government would be forced to tread a very tight line if they try to argue that it is fine for them to tap the banks' honeypot but not for the states to do it too.

With new sources of state funding rare, South Australian treasurer Tom Koutsantonis has exploited this political opportunity, potentially signalling a shift of power back to the states . Unsurprisingly, the banks have reacted with fury, mounting their own attack campaign and threatening reprisals.

Taxation powers in Australia

The constitutional validity of South Australia's bank levy rests on the distribution of taxation powers in the Australian federation. The power of the states has been eroded over time as the Commonwealth gradually came to dominate the federation.

The Constitution assigns almost equal power over taxation to the states and the federal government. Under Section 51(ii) the federal government is granted a power to enact laws with respect to taxation, but "not so as to discriminate between states or parts of states".

However, Section 90 grants the federal government the exclusive power to impose "duties of customs and of excise". So a state tax will generally only be constitutionally invalid if it's characterised as a duty of custom or excise, or if it is incompatible with a Commonwealth Act.

Back in 1942, the federal government used its power under Section 96 to gain an effective monopoly on income tax. Under the scheme, the federal government levied a uniform tax on income, then gave a grant to the states equal to the income tax they had collected on the condition they cease collecting income tax.

In South Australia v Commonwealth (1942), the High Court upheld this effective takeover of income tax. While states retain the right to levy income tax, the risk of losing Commonwealth grants (together with administrative cost and competitive pressures) has made the proposition unattractive
.

The federal government has consolidated more power through the expansive definition given by the High Court to the meaning of "duties of excise" in Section 90. For example, in the court case Ha v New South Wales (1997) a majority of the court held that duties of excise are taxes on the production, manufacture, sale or distribution of goods. As this is an exclusive federal government power, the states are effectively prohibited from taxing goods – such as sales tax.

The states have instead been forced to rely on a range of relatively inefficient transaction taxes (that is, stamp duties on certain written documents), on land taxes, and on payroll tax (levied on the wages paid by employers). The narrow base of these taxes has seen the federal government come to dominate taxation revenue – collecting more than 80% of tax revenue in 2015-16.

This "vertical fiscal imbalance" leaves the states dependent on federal government grants, together with any conditions attached to such grants. As Professor Alan Fenna has observed , the states are left:

…scrounging for revenue in economically inefficient or socially undesirable ways and going cap

in hand to the Commonwealth.

With opportunities for the states to introduce new forms of taxation being so limited, the proposed South Australian bank levy is something of a game-changer .

The legality of South Australia's bank levy

The levy's structure doesn't appear to involve the taxation of goods in a way that would go against Section 90 of the Constitution. The banks are being taxed on the basis of the value of an asset class they hold – in a way that is comparable to land tax.

Given the small percentages involved, this levy does not seem to interfere with the federal government's levy, and would arguably not be incompatible with it. While relatively novel, the tax appears on its face to be constitutionally valid.

However, the politics of the issue is far more vexed, as the dark shadows of the federal government tied-grants scheme loom over all matters involving state tax. As Western Australia has learned, raising state taxes can have catastrophic unintended consequences . After that State raised mining royalties during the mining boom, the Commonwealth Grants Commission drastically reduced its share of GST payments - down to 34 cents in the dollar .

The fate of the state levy remains uncertain, with the politics very much in flux . What is clear is that the other states are taking notice .

With growing frustration over fiscal dependence on the federal government, it seems we may be entering a new phase of innovation in state taxation. Perhaps the federation is not yet dead.

Joe McIntyre does not work for, consult, own shares in or receive funding from any company or

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