CONSTITUTIONAL LAW FORUM 2009

The National Economy and the Constitution

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Thank you for inviting me to talk today, on the topic of the national economy and the Constitution. The task is to look at the role the Commonwealth Government has played to manage the economy and how that role fits with its constitutional powers. This topic blends economics and law and the basic frame of this talk will be an economic perspective. This involves starting with an argument about a desired outcome, given the facts, and asking whether the law delivers the desired result[1].

The economic circumstances over the past year have thrown this question into relief, particularly through the forum of the Pape case. Like any good case, Pape answers some fundamental questions and then raises some more. We apparently live in a more complex and uncertain legal environment than previously thought, at least from a Commonwealth perspective.

The Great Depression and Now: The difference policy makes [Chart 1]

I will begin by briefly setting the economic scene and policy response.

Australia has been substantially cushioned from the Global Financial Crisis and the so called Great Recession over the last 18 months. The global economic story and financial collapse is no longer daily headline news, so it may surprise you that the performance of the global economy over the past year in fact looks remarkably similar to the first year of the Great Depression in terms of GDP, unemployment and asset prices. A year ago when governments began to ramp up a major global

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[1] As a caricature, that is broadly the reverse of a legal approach.

macroeconomic stimulus, the economic outlook was highly uncertain and the stability of the global financial system was in doubt. This chart shows the performance of the advanced economies over the past year – Australia is the single economy, on the right of the chart, showing growth.

Although our relative performance looks good and indeed has been better than expected it remains the case that economic conditions have been weak. The experience in many other countries has been grim indeed but, thankfully, there are now signs of the beginnings of a recovery in the major economies.

The key reason why we are now looking at the beginnings of a global recovery rather than the ongoing deterioration experienced in the Great Depression is, without doubt, the difference in the policy response today.

In the Great Depression, governments world wide were forced by prevailing thinking and global and domestic policy frameworks to move to a more restrictive policy stance as the economy weakened. Broadly, government spending was cut, taxes were raised, bank lending became more restrictive and social safety nets were very limited. Each of these played a role in exacerbating the downturn.

Today the policy response is broadly the reverse and governments have moved to stimulate economies with both monetary and fiscal policy, in the form of lower interest rates and increased government spending. Intervention to stabilise financial markets has also been very important.

The Australian monetary and fiscal policy frameworks are built around credible medium term anchors and this provides the capacity to respond flexibly and, if needs be, aggressively to short-term shocks.

In usual times it is generally thought that monetary policy has a comparative advantage over fiscal policy for macroeconomic stabilisation. In the extraordinary times of the past year, we had a clear

and early warning sign when the sub-prime crisis fed into a global financial crisis more serious than anything since the Great Depression. In this thankfully rare circumstance, there is an opportunity for discretionary fiscal policy to respond in a timely way and play a key role to cushion the economy from a major shock.

The Australian Government took that opportunity. That is how we came to have the case of *Pape vs The Commissioner of Taxation* and it is why we are here on this topic today. Looking back it is perhaps regrettable in some respects that preparation and argument of the Pape case had to be done in such a hurry. Still, speed of policy implementation was the essential challenge of the times.

The Pape case was fought on the issue of whether the Commonwealth government had the power to pay certain specified individuals a one off lump sum payment of money unconditionally, but with the implicit purpose that this would quickly stimulate consumption and help to underpin the economy.

The Constitution provides no direct head of power specific to such a purpose, nor an explicit power to "manage the national economy". The question of the validity of the payment rested on the interpreted extent of other general or specific powers. I am going to come back to look at some of the issues raised by the Court's answers to that question. But firstly a brief historical detour will help to set the context.

The idea of national economic policy

At the time the fathers of Federation were drafting the Constitution, Australia was recovering from the 1890s depression. After a long economic boom the depression was a very nasty episode with widespread unemployment, business failures, collapsing asset prices and wealth destruction. Its triggers have a familiar echo – essentially financial excess and a subsequent international credit squeeze. It is perhaps no accident that the Constitution gives a specific power to the national level of government to regulate banking. The Constitution also includes a power to pay invalid and old

age pensions, perhaps motivated by the fact that many elderly people were left in poverty after the 1890s recession.

Today, governments in all countries take responsibility for the broader management of national economies. Yet, our Constitution which forms the basis for a national economy contains no specific power to manage it. It is relevant to ask why that may be and whether that it is odd or deliberate, particularly given the 1890's context in which the Constitution was drafted. This is not merely an academic question, as it may inform interpretation of the scope of the powers that are in the Constitution.

I have not had the opportunity to go back and examine the Convention debates on this matter. But I would suggest that there is an obvious reason that a specific power to manage the national economy is not, indeed could not have been, included in the Constitution. At that time, the very idea that governments could comprehensively measure the economy and should intervene to smooth economic fluctuations had yet to emerge in any systematic way. Today, macroeconomics is the study of why economies grow and fluctuate. In 1900, that conception of macroeconomics had not been invented.

There were two key developments which subsequently created macroeconomics and underpinned the emergence of government responsibility for economic management.

The first was construction of the national accounts framework in the early decades of the 1900s which provides a cogent framework to ***measure*** the economy. Before this there was a basic absence of information for a government at any level to be able to make decisions to manage an economy. GDP was simply not part of the lexicon.

Second was the development of the macroeconomic theory which explained the role of government in aggregate economic relationships and the monetary and fiscal mechanisms that a government can use to intervene in the economy at an aggregate level. The Great Depression prompted a basic

rethink of the role of government in economics and this was crystallised in John Maynard Keynes' seminal work *The General Theory of Employment, Interest and Money* published in 1936. This emphasised a role for government spending (and taxation) in managing the economy and led to the view that "full employment" was an achievable policy objective by means of government intervention in the economy.

So, when Constitutional conventions were being held there was little expectation that the Commonwealth would bear responsibility for the economic performance of the federation of States.

I am not arguing that the federation Fathers would have included a specific economic management power in the Constitution had they been aware of modern macroeconomics – only that they couldn't.

What this means for current constitutional interpretation about the existence or extent of an implied "national power", however so conceived, is perhaps one element informing the differences between the majority and minority judgements in Pape.

To be clear, the Court unanimously rejected the idea that a **broad** implied power to manage the national economy can be found in the Constitution. It is clear in the judgements that there is considerable caution about the desirability of such a broad national economy power. Lawyers will reflect on the possible limits of such a power and how it might impinge on implied State guarantees or the idea of a "federal balance", however that may conceived.

And, some macroeconomists would protest the great theoretical innovations and controversies that came after Keynes, particularly in respect of the use of counter-cyclical fiscal policy. That said, much of the practical accommodation that has developed in the profession about the use of fiscal policy is specifically founded on views about the reasonable basis for and limits on discretionary policy. That has been enacted in the Charter of Budget Honesty Act.

The foundation for fiscal policy after Pape

We can end our historical detour there. The fact is that governments do intervene to manage the economy and the more pressing question is the actual constitutional basis of those interventions. Clearly, microeconomic matters – such as the regulation of financial markets - fall within the various heads of legislative power in section 51. Similarly, in the macroeconomic field monetary policy is founded on the banking and currency power. These points need not detain us further.

What was in issue in Pape was the validity of a Commonwealth spending program estimated at $7.7 billion involving a transfer of money to certain taxpayers with the intent to provide a fiscal stimulus. This was upheld by a majority, based on the specific terms of the program given the context of the response to the global financial crisis. Beyond this, the Court's judgement resolves a longstanding constitutional controversy. The implications of this are difficult to state precisely – it appears that the Commonwealth's power to spend may be more circumscribed than previously asserted and the actual extent of that power is inherently uncertain.

I have the luxury of leaving much of the legal analytical detail to others who will be speaking later. So continuing in economic mode for the moment, let us imagine a hypothetical government which was fully sovereign in the sense that its constitution provided unrestricted powers to spend, to tax and to regulate[2]. [Chart 2 ….] These are the essential ***instruments*** of government in that all activities of any government are directly or indirectly related to these three ***means***. A government unrestricted in these three "instrumental powers" could conceptually achieve any economic ***ends*** it wished.

Real constitutions grant powers in more limited way – substantively, it is common that there is a partial grant of an instrumental power which is limited by the requirement of some ends or ***subject***

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[2] Taxing and spending are defined as extracting and utilising resources. The meaning of regulation is intended in a very broad sense to be "making and giving effect to rules or restrictions that affect human or societal behaviour".

matter. An example of one of the "subject matter powers" in the Constitution is the banking power – it permits regulation which has something to do with banking.

So, how does our Constitution map within this instrumental framework, particularly in light of the Pape case? So far as taxation is concerned, it seems clear that the taxation power granted by section 51(ii) is close to a full instrumental power – it is limited in some respects by required parliamentary form and process, limits on discrimination and implied guarantees in respect of the states – but it is otherwise not constitutionally restricted.

In the regulation field there is no instrumental grant of power – the Commonwealth has power in this field through the combined scope of the various subject matter powers, in sections 51, 61 and elsewhere. The scope of those powers has evolved and grown through Referendum and as interpreted in successive cases.

The existence of a spending power was the headline ground of argument in *Pape.* Reduced to its simplest, the Commonwealth argued that it was granted a full instrumental power via the appropriations provisions in section 81 and 83, in effect to spend for any purpose that it saw fit and the Court unanimously rejected that proposition. It seems that the Commonwealth only has a power to spend via section 96, effectively through the agency of the states, or by reference to the use of some legislative power and the executive power. The challenge for the Commonwealth is uncertainty about the extent to which the executive power extends a consequential power to spend beyond the limits of the legislative powers (other than the incidental power).

A majority in Pape accepted that the executive power extended to a power "to engage in enterprises and activities peculiarly adapted to the government of a nation and that cannot otherwise be carried out for the benefit of the nation". The Tax Bonus Act, enacted pursuant to the incidental power (section 51 (xxxix)) was found to be valid on this basis, in the particular factual circumstances of the urgent need to support the economy in response to the global financial crisis.

It is of interest that there is an echo between this formulation – "peculiarly adapted and can not otherwise be carried out" - and what might conceivably have been part of the subject matter of a power to manage the national economy. However, clearly this formulation is more restricted than generalised a national power which the court unanimously rejected. Read ***literally***, the test poses quite a challenge for the Executive. That is because to show that something "cannot otherwise be carried out" would require the Executive to prove a negative. And, with imagination and time the States could conceptually achieve almost anything of a domestic national character through co-operation, except matters exclusively reserved to the Commonwealth or otherwise contrary to valid Commonwealth laws. Read ***practically***, the test is quite uncertain in its application, with the Court split 4 to 2 on whether this formulation was met in the circumstances before the Court.

Beyond the particular circumstances of Pape, the Court did not set out a specific formulation of the bounds of the executive power. There are some hints in the majority judgements that there may be a broad executive power beyond execution of legislative functions, which if so would carry over to a commensurately broad power to spend. For example, Chief Justice French noted that long established expenditure for national purposes may lie within the executive power, rather than the asserted but rejected appropriations power. This was contrasted with the extension of regulatory powers via the executive. No doubt, this will remain a point of debate.

We are left with uncertainty about the validity of some existing Commonwealth spending programs and uncertainty about the scope and means of future fiscal stimulus done without clear reference to a legislative power.

The Court held concerns about the possible breadth of a generalised spending power, similar to those relating to a generalised power to manage the national economy – that is concerns about its potential scope and implications for state guarantees and the "federal balance". It therefore seems that part of the price of our federation is a gap of uncertain dimensions in the powers of the Commonwealth. The Constitution is as it is – subject to any change by Referendum or through

referral of powers - and it may be that the balance between the States and the Commonwealth has been reset to some degree.

Concluding comment

The practical question for economic policy makers is whether this creates major problems for economic policy and fiscal federalism. Certainly, there were already significant issues in the current structure of fiscal federalism before the Pape case. After Pape, there is added uncertainty and that is inconvenient for policy makers. However, it would be hard to argue that Pape alone creates burning platform which demands constitutional reform. To illustrate, if further discretionary fiscal stimulus to consumption were to be necessary at some point, with time (and I emphasise that point, with time) it could be done in a variety of ways. We are giving some though in the current Henry Review into Australia's Future Tax System about the implications of the Pape case as one element in the mix of issues that complicates fiscal federalism.

In closing let me pose a number of questions for future discussion.

For the lawyers, is it possible or desirable to resolve the uncertainties that remain after Paper concerning the extent of Commonwealth powers? In particular:

- How serious might a prospective economic downturn have to be before the executive power could be used to deliver a fiscal stimulus that, for some reason, could not be delivered by another means?

- Were they so minded, could the States refer an instrumental power to spend or a specific subject matter power to manage the national economy to the Commonwealth?

For the economists, the degree of vertical fiscal imbalance in the federation has been long discussed but now we have an added dimension that there are uncertain limits on the Commonwealth's power to spend. It could be argued that a federal structure where the central government did all taxation

and the State governments did all spending would operate to constrain growth in the size of government. Our Federation is clearly nowhere near that extreme, except in some specific instances such as the arrangements for the GST. However, if post-Pape we discover that the Commonwealth power to spend is more circumscribed, might we see such a constraining effect on the size of government in Australia?

I suspect the answer is broadly – no. The size of government is essentially a matter of political choice in a democracy. In the form of COAG we have a mechanism through which such political choices can be given form.

Thank you.