

Chapter Seven

Making Federalism Flourish

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The 1980s were a time of dramatic change in Australia. The 80-year-old "Australian Settlement", offering protection and other government-provided certainties, collapsed. By now, it is widely accepted that Australian industries will simply have to compete with the best, both at home and in world markets. Even the nexus between the end of protectionism and the need to reform archaic, centralised ways of wage fixing is now reasonably well understood.

Adjusting to the Open Economy: Government and Transaction Costs

What is not fully understood as yet is that the opening of the Australian economy also requires adjustments far beyond industry. We need to adjust to the deeply-ingrained rules of how we interact in all spheres of life and, above all, in government administrations. Governments are now under challenge to become competitive. For a long time, social institutions, attitudes and government could develop unchecked on this island, without the discipline of world-market competition. Now, the legacy of these private and public institutions and attitudes stands in the way of turning financial and trade liberalisation into a success.

We know that the formal and informal institutions of society have great influence over the costs of doing business, the costs of information gathering, business transaction and organisation — what economists call "transaction costs". Nowadays, at least 40 per cent of the cost of producing the Gross Domestic Product is made up of such transaction costs. In Australia, many of these costs have been artificially inflated by administrative practices and political deals that could proliferate in the past. Now, the inherited high costs of doing business in Australia are destroying economic opportunity and jobs.

Politicians and their advisers have not woken up to what harm the Australian 'transaction cost handicap' is doing in some areas. Only this week did the Commonwealth Cabinet compromise on the procedure of dealing with Aboriginal land claims. The proposed procedure opens the door for endless, costly arbitration, consultation, litigation, uncertainty, delay and, incidentally, a further centralisation of political powers. In the open Australian economy of the 1990s, I fear, the lack of clear, definitive rules and property rights will destroy competitiveness and will soon inflict economic pain.

The central economic challenge of the 1990s is to undo the cost handicaps created by the pervasive politicisation of economic life that was possible under the long-lasting economic isolation. Now, administrators can no longer ignore the costs of their actions; and politicians can no longer yield with impunity to pressure groups, creating yet higher costs. In the open economy, lack of cost control all around and cost-plus pricing are the way to national bankruptcy. Our success or otherwise in facing up to the challenge of institutional innovation will determine future living standards and the entire quality of private and public life.

What is at stake in the opening-up of the economy has unexpectedly turned out to be much bigger than expected, because advances in transport and communications have made it possible for the owners of capital, knowledge and enterprise to move internationally as never before. Investors now go to where they can expect favourable returns on their assets — a phenomenon that has been labelled "globalisation". It requires the controllers of production factors that cannot

move internationally — land and resources, unskilled labour and government administrations — to behave so as to attract and retain the mobile resources.

The East Asian societies learnt to make themselves attractive at an early stage and have benefited handsomely. Likewise, Australian governments and unions now have to compete with Singaporean, Californian or New Zealand government agencies and unions in the global market place for capital, knowhow and enterprise. If they fail to rise to the challenge — for example, because they persevere with self-centred, awkward and costly international arrangements — mobile capital and talent will simply tippy-toe away to more rewarding climates. And we will all become less productively employed and poorer.

Having to compete is certainly an unprecedented experience for Australian legislators and administrators. The long tradition of protectionism has bred Marxian illusions of the "primacy of politics" (and the primacy of single-issue politics) over economic life and individual aspirations. The rulers do not readily give up such a position. The results are Australia's declining attractiveness to mobile capital, insufficient exports, and a mounting foreign debt. If we want the inspiring dynamism and the optimism that so many admire in East Asian countries and New Zealand, then institutional reform has to be put at the top of the agenda and tackled expeditiously.

The Right Institutional Innovation will not come from the Centre

Government administration — the solving of shared tasks by collective means — will be central to achieving institutional reform. We have to develop world-best practice in public administration and policy making. This requires giant steps and often revolutionary breaches with past practice.

As a student of economic history and international experience, I am convinced that societies succeed in international competition only if they are governed by transparent, stable and simple rules, and when governments confine themselves largely to setting a fairly stable framework. Then, individuals are free to compete confidently and expediently within a set of clear rules. Good government acts on the principle that confidence is capital and time is money.

This lesson must now be learnt quickly by Australian legislators and administrators. They — as well as the Australian public and opinion-makers like the ABC — must shed illusions that government can act as the Universal Problem Solver, intervening in all walks of life.

The challenge of administrative innovation is unprecedented, diffuse and manifold. Coming up with the right solutions requires much experimentation, creativity and breaking of new ground. We know that successful innovation is most likely to occur when the search for solutions is organised as a competition amongst independent rivals. The great task of the 1990s can be mastered most quickly and best if Australian jurisdictions and administrations begin to compete actively with each other.

States and local administrations should therefore be given much greater freedom to compete in inventing administrative solutions now to enhance the business climate, cutting everyone's business costs and attracting industry. If competing administrations are allowed to come up with differing rules and devices, the proven successes can later be imitated, and Australia will prosper. Marching in lock-step to the tune of a central industry policy designed and imposed by Canberra Centre is unlikely to hit upon the right institutional solutions which we now have to find in a hurry!

I therefore beg to disagree with Mr Keating who is reported to have said that "if we are to meet the economic challenges of the decade and of the new century in a global trading economy, we will also need more central authority to shape our economy and not less".

To find out how administrations can best compete, we must hand the States more sovereignty over how they administer their own destinies — and how they wish to respond to the highly

attractive administrative arrangements now offered to internationally mobile businesses by the likes of New Zealand and Singapore.

Whilst I have based the argument for decentralisation on economic grounds, I hasten to add that decentralisation of course also has important non-economic benefits. Much freedom would be gained if Australian citizens — as well as foreign investors — were allowed to choose freely between, say, a Green, stagnant Tasmania, a highly taxed, intensively governed South Australia, and a low-tax, lightly and expeditiously governed Queensland. Once some of us are able to vote with our feet, we can also show those who govern us what we, the sovereign people, really want! The electorate would have a say far beyond the rare and compulsory trip to the ballot box. Probably, there would be fewer administrative and political schemes of social engineering (like the trendy National School Curriculum) which now so often annoy and alienate the majority of Australians.

To a much greater extent than the Swiss Cantons or the American States, Australian States have been emasculated by a long history of fiscal centralisation. State governments have been trained to adapt with a "handout mentality". This often leaves little incentive for regional governments to build their own revenue base, but much incentive to clamour for Federal funds. Now, there is little incentive to vote for imaginative and responsible leaders in local and State governments — after all, the funds are handed down irrespective of what irresponsible mob has been voted in.

We have now reached a stage where the States have been disenfranchised and put on a central financial drip to an extent that one must fear for their survival. And it is quite credible now that the hidden agenda of republicanism includes the abolition of the States, as Mr Hawke and other Federal Labor leaders keep reminding us. If Australia were turned into a centralised republic, I would fear for our traditional liberties and our capacity to become economically competitive.

The Four Principles of Competitive Federalism

To face off the danger, we must think about injecting new life into State and local government. To that end, we should, in my opinion, adopt four essential and complementary principles that constitute what I shall call "Competitive Federalism": subsidiarity, a clear assignment of government tasks, fiscal equivalence, and the rule of origin. Let me elaborate.

(a) The principle of subsidiarity (which presently plays a big role in the debate of a future European constitution) is based on the observation that centralisation normally lessens the efficiency of public administration and alienates the citizen. Because the central administration of large countries requires complex information gathering — which is often impossible, as they discovered even in Moscow — government tasks should only be administered centrally when centralisation produces proven welfare gains. Such gains can be expected when there are strongly shared common interests (as, for example, in defence and foreign affairs), or when a diversity of rules would cause high and avoidable transaction costs (as, for example, when each State has a different monetary system or different traffic rules).

On the whole, general rules, which determine the overall legal and economic order and which cut transaction costs, should be set at the higher level of government, whereas more specific interventions in market processes and the public provision of infrastructures are best left to the lower levels of government. At a lower level, the costs and consequences tend to be more immediately obvious, and the citizens are involved more directly. There, it is harder to make policy anonymously, as the providers of public services tend to be watched more closely.

(b) This is so, in particular, if the second principle of Competitive Federalism, fiscal equivalence, is observed. Equivalence means that each level of government should finance its assigned and chosen tasks with the funds that it raises itself. This principle derives from the rule that those who are the beneficiaries of a public service should be, as far as possible, identical with those who are asked to pay for the service. Inefficient compromises, free-riding and much political

conflict are then avoided. It is well known that greater responsibility and administrative efficiency are ensured if those who make expenditures are also bound to raise the revenue.

Fiscal equivalence would create many incentives for State and local governments to cultivate their own tax base by pursuing good, far-sighted development policies and by competing to attract mobile capital and talent. Fiscal equivalence would of course also force all governments to live with the long-term consequences of their blunders in development and taxation.

(c) The third principle of Competitive Federalism says that the various responsibilities for collective action must be assigned exclusively, clearly and explicitly. Part V of the Constitution enumerates a very long list of Federal powers, but Canberra has usurped functions far beyond this list, e.g. in industry regulation, education, welfare, environmental matters and land rights. Before long, no doubt, the external affairs power will be used by the High Court to regulate our bedtime in the national interest! The current messy overlap, contradiction and costly duplication between various levels of government has created legal uncertainties and compliance costs. It detracts directly from Australia's international competitiveness, a luxury we can now ill afford.

My own choice would be for the Commonwealth to look after foreign affairs, defence, monetary probity, rules for nation-wide transport and communications, laws and regulations concerning civil and business interaction, and not much else. These functions could be financed from a low tax on personal and corporate incomes.

The States should look after matters such as transport infrastructures, general industrial conditions, and the environment. And financially autonomous local governments should be given the freedom to shape more detailed living conditions, including the obligations of public welfare provision and education. Just imagine the attention that would be dedicated to the local poor if local taxes had to provide for them! And how much attention local politics would earn if the local micro-climate were held largely responsible for job creation (rather than some abstract macroeconomic policy)!

Given the centralist bias of the High Court, local and State functions will probably have to be protected from the grip of the Centre by explicit constitutional stipulation. This might be coupled with a constitutional provision that allows the transfer of a function to a higher level of government only as and when clear proof of a welfare gain has been furnished. It may also be wise to allow transfers of government functions for a provisional five-year period, after which the claimed gains of centralisation are re-examined.

(d) As a fourth principle of Competitive Federalism, a rule of origin should be adopted. This means that a product or service is automatically acceptable throughout the Commonwealth if it meets the health, safety and other conditions in the State or local community where it has been produced. At present, each State and Territory tests and licenses a wide array of products. We suffer from a cartel of administrators who have imposed unnecessary, costly and excessive regulations because the regulators go unchecked. Under a rule of origin, State and local governments, which want to attract industry and jobs, would rival each other in developing the best-possible set of regulations. This puts an immediate competitive check on the regulators.

At the moment, we hear a lot about efforts to harmonise standards and negotiate between the States and the Commonwealth to obtain uniform regulations. But experience (for example in the European Community) shows that such negotiations give administrators and industrial lobby groups endless opportunity to talk and to impede competition. Such harmonisation will be discussed till the cows come home! If we are serious about raising Australian competitiveness and removing regulatory cost handicaps, business compliance costs can be reduced immediately by many millions annually by adopting the rule of origin.

Regulatory competition will not lead to unacceptably low standards of regulation. If, for example, products made in a State with poor safety standards were to hurt consumers, that State

would soon lose its attractiveness to industry, which would seek certification of its products by a State with appropriate standards.

These four principles are complementary. If they were implemented, we would soon get constructive competitive responses from Australian States and localities – unfettered by the centralist shackles, which were imposed under the "Australian Settlement".

Competitive Federalism would, for example, enable States and communities that now feel threatened by the New Zealand challenge to respond constructively. It is no secret that, increasingly, enterprises located in Australia are tempted to move to New Zealand, where an independent government behaves as an internationally competitive government should: confining itself to setting clear rules, providing stable money and helping to mobilise productive resources. Let us remove the handicaps on the States that want to take the New Zealand challenge head-on!

Some Possible Objections

The proposed reforms of government administration would of course affect deeply entrenched interests. One can therefore expect great sophistry among self-interested groups in putting forward seemingly disinterested objections to Competitive Federalism.

It may be argued, for example, that State and local politicians would borrow to subsidise industry now in order to win the next election, trusting that a higher level of government will bail them out eventually. The danger of "moral hazard" in public borrowing is of course always present. To contain it, higher levels of government will therefore have to be given explicit powers to impose additional taxes on lower-level jurisdictions, when these have gone broke. If this rule were known from the outset, the citizens would keep their local and State governments better under control. To make such sanctions effective, we also need more transparent accounting rules throughout the public sector.

Another objection may be that well-connected lobbyists and powerful public sector unions would gain more influence over political decisions. I do not share this fear, as long as all four principles of Competitive Federalism are implemented. Political favouritism would trigger the out-migration of not-so-well-connected producers and undercut revenue growth, making the selective preferment of certain interest groups economically and politically costly. Let us not forget that arbitrary rules and privilege have invariably been the creatures of closed systems.

People may also oppose a decentralisation of political powers on the grounds that work is duplicated. This argument was recently used by Mr Hawke. But the centralisers always conveniently forget about the possibility of central blunders. They tend to attribute superior knowledge and motivation to the central powers, which in reality they rarely have. In reality, it is much less risky to have decentralised experiments in policy making. We should also keep in mind that the cost of duplication in competitive government is often more than off-set by the likelihood of finding better solutions. Competition is not cost-free, but it is the best discovery procedure yet invented by mankind!

There can be no doubt that the quality of sub-national government would be enhanced by Competitive Federalism. The business of State and local government would become a much more challenging task, and better talent would be attracted into local and State government once it is again given greater responsibility.

Competitive Federalism is Ultimately about Liberty and a Healthy Democracy

As behoves a professional economist, I have dwelled mainly on the economic arguments. But — as already indicated — turning back the trend to centralisation is ultimately also about wider, non-material issues.

Over the past eighty years, Canberra has claimed more and more power to solve problems—which it has consistently been unable to solve. This has bred much cynicism and alienation from our ageing democracy. As an educator of young people, I am acutely aware how they are thinking about democracy: "Government of the people, by those people and for those people at the top"! It concerns me deeply that often, when challenged by my students, I can only point to the anarchy of power plays, and Byzantine deals without honour which are so reminiscent of the Weimar Republic! There is woefully little in the Canberra experience to inspire the young!

I put it to you, in conclusion, that the reforms of Competitive Federalism which external economic circumstances will — in one way or another — foist upon us, should be promoted actively in order to inspire new life into Australia's ageing democracy. A flourishing Competitive Federalism would turn Australian citizenship and democracy again into an asset worth having and worth defending.

Endnotes: