

GOVERNANCE DEFICIT : A FUNDAMENTAL CHALLENGE TO AUSTRALIA'S ECONOMIC FUTURE

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The transmission of information is noisy and incomplete. I cannot, to use modern computer language, give you a complete dump of what is in my brain, and even if I tried, what you receive would coincide only imperfectly with what was in my brain. Indeed, in this lecture, I can only give you but broad hints of what is on my mind. (You may find this reassuring, for you may be asking yourself—surely there must be more than he has succeeded in conveying. The answer is, there is ; whether I succeed in conveying it is another matter.)

Joseph E. Stiglitz, *Whither Socialism?* P. 157

1. Introduction and Background

At the threshold of the 21st Century, and after nearly one hundred years of the adoption of the constitution of the federal commonwealth of Australia, Australia's economy is faced with the new challenges of globalisation, the onset of the knowledge-based economy and rising regional disparities. The nature of these challenges as well as their policy implications are only partially understood at present. But it is increasingly becoming clear that the institutions of Australia's public sector are poorly equipped for addressing these challenges.

* This paper was presented at a seminar at the Center for Australian Studies, Otemon Gakuin University in April 1999. Some of the data referred to in the paper has since changed, particularly in relation to the unemployment rate. This does not affect, however, the main contentions of the paper.

The central contention of this paper is that Australia's economy is suffering from a governance deficit (to be defined below), which lies at the core of the country's inability to effectively deal with its pressing economic and social problems. It is argued that over the past 25 years or so, the effectiveness of the institutions of public governance in Australia has declined, and the quality of governance outcomes has deteriorated. This deterioration is evident in the inability of the national economy to shake off the chronic problems of high unemployment, large current account deficits, rising income inequalities—among both regions and income categories—and a dysfunctional system of fiscal federalism. It is further suggested that the contextual imperatives of governance in the new global knowledge economy have changed in a fundamental sense and a return to traditional solutions of the past will be neither feasible nor appropriate. Instead, new strategies, policies, structures and institutions need to be developed. The capacity of the public sector institutions for policy development has declined at all levels of government, and needs to be restored. New ways of better policy coordination across traditional boundaries—public-private, Commonwealth-State and national-international—are required for maximising the cooperation and involvement of all economic agents. In short, the governments need to transform themselves into 'learning organisations' in the same way as the private sector firms are doing by breaking the traditional moulds of corporate governance and developing new models to deal with the changing requirements of the global knowledge economy.

2. The Governance Deficit of Australia

Much has been written about Australia's achievements in implementing structural change and microeconomic reform during the 1980s and the 1990s.¹⁾ The once high rates of tariff have been virtually removed. Public sector consolidated deficit has been replaced by a surplus. Public sector borrowings and debt have been substantially reduced. In the meantime, financial deregulation was implemented in the mid-1980s and a national competition policy was introduced in mid-1990s. A collective sigh of relief was let out when it was realised that Australia's economy had weathered the Asian financial crisis and the subsequent global financial turmoil

1) See for example, Hawke R. J. (1994), and Walsh P. (1995).

reasonably well, exhibiting flexibility and competitiveness in quickly finding new markets for its exports.

While these achievements cannot be denied, it must be recognised that they have been achieved at considerable economic and social costs. The full extent of these costs is not clear to all, partly because the costs and benefits of these changes fall on different groups of the community but also because the full costs are not yet clear in any case. The changes noted above were also accompanied by a transformation in the processes of governance in Australia, not just in the outcomes of the public sector. The full implications of these changes are slowly but surely becoming apparent. This paper focuses on some of these costs by introducing the concept of governance deficit, which captures the key challenges of the Australian governments. As it is not a familiar concept in the literature, the concept of governance deficit needs some explanation. Governance deficit in this paper refers to the failure of the public sector to meet adequately and effectively the community's needs for collective goods and services. The consequential build-up of the unmet demand for these services is manifested through a variety of economic and social problems, such as unemployment, inequalities, alienation of certain groups of population, environmental neglect and so on.

When judged in terms of the number of parliamentarians and bureaucrats per thousand of population, Australia might rank among the most highly governed countries in the world. It would be difficult to argue on this basis that the country has a deficit of governance. It is necessary to point out, therefore, that the concept of governance deficit is concerned not with the size of the public sector *per se* but with the quality and effectiveness of the process of governance and its outcomes.

Governance is the process through which a group or a community meet their collective needs and solve collective problems.²⁾ On behalf of their communities, the governments (or management teams in the case of firms) act as agents who create and operate the process of governance to achieve the desired outcomes. Thus, the success or failure of a government must be judged on the basis of both the final outcomes and the processes of governance. It is important for a community to ensure that its governments not only provide sufficient quantities of the desired public goods but also maintain the principles of democratic governance (such as

2) See for example, Osborne and Gaebler, (1992).

equity of access to different sections of the population in processes of public choice, observance of the due process and the rule of law). Analogous to the familiar concept of fiscal deficit, a governance deficit thus represents a situation of insufficient governance—a situation in which the outcomes or the processes of governance or both fall short of the community's needs.

Poor outcomes of the public sector may result from inadequate process of governance or insufficient resourcing of the public sector. But the process cannot be a substitute for the resources and *vice versa*. In other words, if the process itself is deficient, allocation of additional resources to the public sector would not solve the problem. Indeed, unless the process is improved to a certain level of competency, increasing the size of the public sector in such a situation would be wasteful.

The evidence of Australia's governance deficit can be seen in the failure of the country to reduce the unemployment rate to acceptable levels, to reduce income inequalities in the country, to reduce regional disparities and to turn the current dysfunctional federalism into effective system of government. The more important

Table 1 Manifestations of Australia's Governance Deficit

Economy	Society
• Unemployment • Income Inequality • Regional disparities • Dysfunctional Federalism	• Environmental Degradation • Youth Suicides • Drug Abuse • Ethnic Alienation • Aboriginal Issues

economic aspects of Australia's governance deficit are depicted in Table 1 below.

Admittedly, these problems are not solely created by the failure of the public sector, as private sector decisions and exogenous constraints of international trade and finance also impact on these outcomes. However, as noted above, the role of governments in democratic societies is to develop policies and strategies for the achievement of collective outcomes that include full employment, equitable distribution of incomes across income categories and regions. None of the major political parties in Australia would deny the legitimacy of these objectives.

Almost one hundred years ago Australia became a *federal* commonwealth when the six separate Crown colonies voluntarily adopted the Constitution, after the draft constitution had been ratified in each colony in a referendum. The constitution assigned specific roles and responsibilities for governance to the Commonwealth government and the State governments. Over the years, the pattern of fiscal

federalism has changed dramatically and bears little resemblance to the original constitutional assignment of functions, reflecting partly the changing nature of the tasks of governance and partly certain innate intergovernmental rivalries. In recent years, particularly in the past 15 years, the increasing centralisation of fiscal power in the hands of the Commonwealth has turned Australia's fiscal federalism into a dysfunctional system. The scope for decentralised policies reflecting the diversity of conditions and objectives has been virtually eliminated by the Commonwealth's uniformly applied policies, irrespective of their appropriateness for local conditions (see, Mathews and Jay 1972, and Mathews and Grewal 1997).

2.1 Unemployment

Over the past three decades, the ability of Australian economy to provide full employment to its workforce has progressively declined. The rate of unemployment averaged at 3.7 per cent during the 1970s, increasing to 7.7 per cent in the 1980s and to 9.0 per cent in the nine years to 1998 (see Table 2). The low rates of economic growth, that are responsible for the higher unemployment have not helped in improving Australia's current account deficit either. As a percentage of GDP, the current account deficit averaged 1.7 per cent during the 1970s, increasing to 4.7 per cent in the 1980s and not falling appreciably from the high level during the 1990s. Together, these two sets of figures demonstrate the double jeopardy of the Australian economy, which is also the major challenge for its governments. On the one hand the economy is not able to produce enough for its population to consume and trade with and, on the other hand, it is unable to provide work for its entire workforce.

The full story of Australia's unemployment is worse than suggested by the rate of unemployment alone. Those who are unemployed are taking increasingly longer before they can find new jobs. In 1978, for example, average duration of unemployment was 21 weeks. Ten years later, in 1988 it had increased to more than 48 weeks. In 1998, average duration of unemployment had further risen to nearly 60 weeks. As the nature of the job market and the skill requirements for new jobs are changing at the same time, those who have been unemployed for more than a year (ie classified officially as the long-term unemployed) are known to experience additional difficulties in finding new jobs.³⁾

3) Gregory, R. (1995).

Table 2 Aspects of Unemployment in Australia 1978 – 1998

	Rate %	Average Duration in Weeks	Share of Part-time jobs (%)
1970	1.4	7.4	10.6
1971	1.7	7.3	10.4
1972	2.5	6.6	11.1
1973	1.8	9.7	11.9
1974	2.4	9.3	12.4
1975	4.6	6.5	13.6
1976	4.7	12.7	14.6
1977	5.7	17.5	15.0
1978	6.5	20.9	15.6
1979	6.1	26.2	15.5
1980	6.2	28.4	16.0
1981	5.8	32.0	16.2
1982	7.0	34.9	16.8
1983	10.2	32.6	17.2
1984	8.8	41.4	17.5
1985	8.2	45.5	17.9
1986	8.3	49.5	18.7
1987	8.1	48.6	19.9
1988	7.1	48.3	19.9
1989	7.2	51.3	20.7
1990	6.0	44.5	21.1
1991	9.8	43.7	22.3
1992	10.9	43.0	24.2
1993	11.1	51.2	23.6
1994	9.5	57.1	24.1
1995	8.3	60.2	24.4
1996	8.7	54.0	24.7
1997	8.7	50.0	25.4
1998	8.1	59.7	25.9

Source : Australian Bureau of Statistics

The number of those on part-time jobs has been increasing steadily and now accounts for nearly 26 per cent of all employed. In 1987, the corresponding figure was 20 per cent and it was even lower at a little over 10 per cent in 1970. Part-time jobs have allowed higher participation rates of those who cannot, for one reason or another, work full-time (eg students, housewives, women caring for young families or those suffering from kind of disability). Additional figures released by the Australian Bureau of Statistics reveal, however, that more than 26 per cent of those in part-time employment would prefer to work for more hours. This proportion has indeed fallen from 29 per cent in 1993, but it was much lower at 18 per cent in 1987. Similarly, the unemployment rate among the young (aged 15 – 19 years) is also higher (23 per cent in 1998) than it was in 1990.

As a result of the structural change that has occurred since the early 1980s in Australia, not only the industrial base but also the location of new jobs has changed

significantly. Certain regions have experienced high growth in new jobs while some other regions have suffered major reduction in employment as they have missed out in attracting new industries.

Thus, the various dimensions of unemployment in Australia reveal the existence of a chronic problem, with serious economic and social consequences that are likely to get worse in the future due to the impact of globalisation.

2.2 Income Inequality

A major objective of the public sector, and an important test of the effectiveness of governments, is to ensure that inequalities in economic outcomes in a society do not increase over time. In Australia, the primary responsibility for income redistribution rests with the Commonwealth government due to its exclusive power over income taxation and dominant role in social security payments, although State and local governments also play an important role through various outlays on social welfare activities within their respective jurisdictions.⁴⁾

The distribution of household disposable income in Australia had become more unequal 1994 than it was in 1984 (see Table 3).

Households receive gross income from a variety of sources, including wages and salaries, business and investment income and government cash benefits such as age pensions, family allowances and unemployment allowances. Disposable income refers to gross income less direct taxes paid (income tax and Medicare Levy in Australia). In 1994, households in each of the lowest three quintiles received a smaller share of income than in 1984. In contrast, households in the top two

Table 3 Distribution of Household Disposable Income 1984 and 1994

Income Quintile	Income Share (%)		Average per week (\$)	
	1984	1994	1984	1994
Lowest	6.3	5.8	114.9	174.8
Second	12.1	11.4	218.6	340.1
Third	17.9	17.4	324.8	517.8
Fourth	24.8	25.0	449.2	745.8
Highest	38.8	40.4	703.4	1,205.5
Total	100.0	100.0	362.0	596.8

Source : ABS, Australian Social Trends 1997, Cat. 4102.0

4) For discussion of an expansion in the role of the States in social welfare expenditures in recent years see Grewal and Davenport (1999).

quintiles received a correspondingly larger share of disposable income in 1994. Households in the highest income quintile registered the largest increase in their share of income. As a result, average weekly income of households in the lowest income quintile fell from 31.7 percent of the national average in 1984 to 29.3 percent in 1994. On the other hand, average weekly income of households in the highest income quintile increased from 194 percent of national average in 1984 to 202 percent in 1994.

2.3 Regional Disparities

As regional disparities are discussed in greater detail in a separate paper,⁵⁾ reference is made here only to selective figures that reveal the fundamental nature of the problem of regional diversities in Australia.

Only a few studies have examined the phenomenon of convergence or divergence among the States in Australia over a reasonably long period. This is largely due to the absence of consistent series for data on State incomes over sufficiently long period of time. Using data on regional money stocks to reconstruct national income aggregates for states of Australia for the period 1861 – 1991, Cashin (1993) reported that although there was evidence of convergence among Australian States during this period, almost all of this convergence had occurred, however, in the 19th century, with little further convergence occurring since federation.

Another recent study, which relies on official data that on per capita output of states economies covering the period from 1954 to 1994 also found little evidence of convergence among Australian States (Harris 1998). This study found that dispersion in state output per capita has been increasing since 1979 and that although dispersion had fallen between 1965 and 1979 but when time series tests of significance were applied no evidence of convergence throughout the forty-year period could be observed.

The degree of dispersion in per capita output (real GDP) among the states has varied over the years (Figure 1). From a high level in the mid-1960s, it fell sharply until 1979, although statistical significance of this fall has been questioned (Harris 1998). After that it resumed its upward movement and by 1994 it had risen to roughly where it was in the early 1960s.

5) See Grewal (1999).

Interstate Convergence and Divergence in Australia

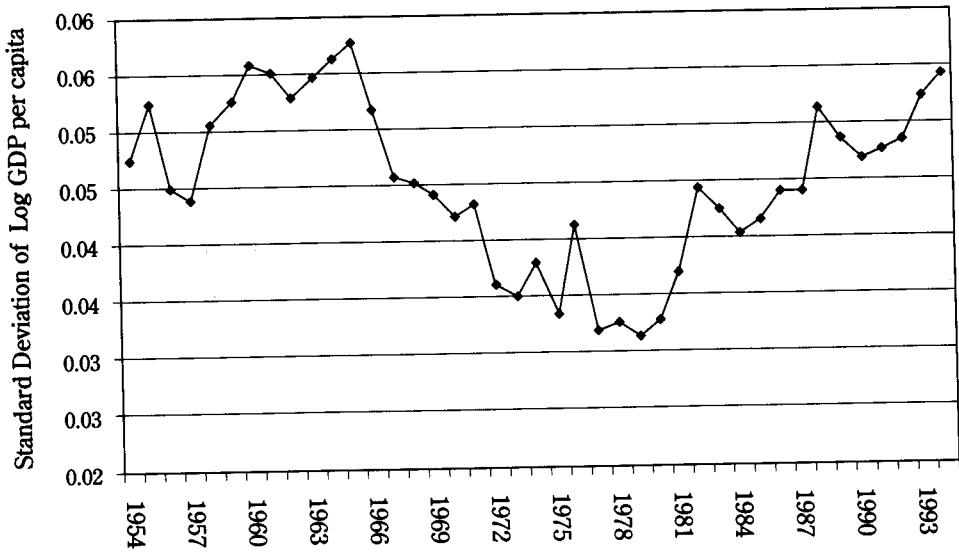


Fig. 1

Multi-peaked Growth of Australian States

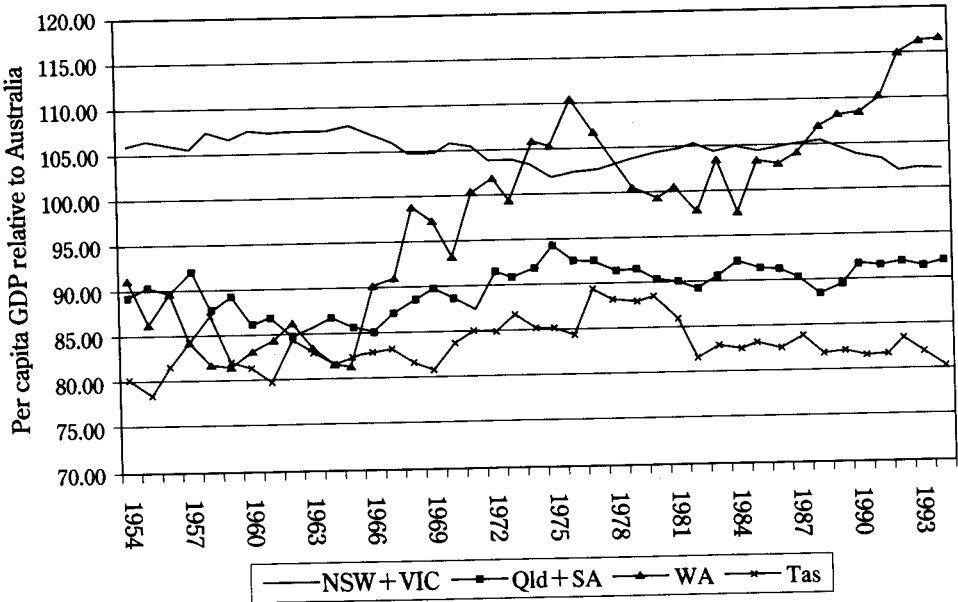


Fig. 2

Indeed, there is a strong indication of twin-peak growth among Australian states (Figure 2). Per capita output in the two most populous states—New South Wales

and Victoria—has remained consistently above the national average throughout the forty years since 1954. In Queensland, South Australia and Tasmania, on the other hand, per capita output has remained consistently below the national average throughout this period. Only one state, Western Australia, has made a transition from below average to above average output status, initially around 1974 but consistently after 1984. Indeed, Western Australia achieved the top level of per capita output in the country in 1994. These findings raise a number of questions about the persistence of regional disparities in Australia and their rise in recent years.

One interpretation of these findings is that regional divergence rather than convergence has been occurring in Australia, as in many other parts of the world.⁶⁾ Alternatively, it could be argued that perhaps each State has a different steady state equilibrium, derived from its specific and distinctive economic structure, and that it is converging towards that equilibrium not towards other States with higher incomes (this is the interpretation of the so-called 'conditional convergence hypothesis'). Both interpretations raise important issues about regional economic policy in Australia. First, it is clear that economic policies that ignore inter-State income differences and treat the Australian economy as a point economy (or regionally homogeneous economy) are obviously inappropriate.

Regional disparities in Australia also exist at substate level. The Productivity Commission in Australia has released a recent study (Productivity Commission 1998) in which it has examined the impact of structural change since 1981 on the economies of 113 sub-state regions. The regions in this study are defined broadly on the same basis as statistical divisions of the Australian Bureau of Statistics although the Productivity Commission has compressed the metropolitan statistical divisions into larger regions. The study found wide variations among the regions in respect of household income, unemployment rate and growth of employment between 1981 and 1996. Thus, for example, the unemployment rate in 1996 ranged from 4.1% in the Campion region of Western Australia to 17.1% in Clarence in New South Wales. Campion also had the lowest unemployment rate in 1981. Although the rate of unemployment in Clarence in 1981 was not the highest, it was among the highest four rates in the country. The range of the regional rates of unemployment had

6) See Sheehan and Grewal (1998) for more on this interpretation.

increased from 8.6 percentage points in 1981 to 13 percentage points in 1996.

Similarly, average household income in 1996 ranged from \$17,200 in Yorke (South Australia) to \$68,700 in Lefroy (Western Australia). Once again, the region with the lowest average household income in 1996 also had the lowest household income in 1981 (\$9,000). Once again, the difference between the highest and the lowest household incomes had increased from a multiple of 3.6 in 1981 to a multiple of 4 in 1996.

The above discussion confirms that regional disparities at interstate and substate level have increased during the period of structural change in Australia. The government policies have failed to address these disparities for several reasons. One of the main reasons was the faith of the Commonwealth government, particularly during the 1980s and 1990s, in market-based outcome rather than interventionist policies pursued in the public interest. The high degree of fiscal centralisation at the Commonwealth level effectively tied the hands of State and local governments in implementing any economic policies that did not conform to the Commonwealth government's own preferences. It is also true that the regional dimension of public policies and concerns has been virtually ignored in most policy making circles.

It is widely acknowledged that a major virtue of federalism is its ability to deal with regional diversities. As Australia's experience shows, however, regional disparities do not automatically disappear by merely installing a federal constitution. The States will have to be able to develop and implement policies that are specifically tailored for the conditions of each State or region. The implications of these diversities for policy roles of the States and the regions need to be drawn clearly.

2.4 Australia's Dysfunctional Federalism

In 1902, barely a year after the federal constitution was adopted, Alfred Deakin sounded his now famous warning that financial provisions of Australia's constitution had effectively tied the States to the chariot wheels of the central government. At the time, the only threat to the fiscal security of Australian States was the potential threat that the Commonwealth might abuse the power bestowed over it by section 96 of the constitution, which says: "the Parliament shall make grants to a State under whatever conditions it deems fit". Deakin did not know that

in later years the States would not only lose their power over income tax but would also be denied access to commodity taxation by the High Court.

In spite of Deakin's warning, the Constitution of Australia did not establish a dysfunctional federalism. The Constitutional assignment of tax powers did not create the extreme fiscal dependence of the States on Commonwealth that exists today. Except for the customs duties and excise duties, both of which were assigned exclusively to the Commonwealth, the States had access to all other taxes. It is true that customs duties and excise duties were the dominant sources of revenue at the turn of the last century. Exclusive assignment of these to the Commonwealth accordingly created the need for financial transfers from the Commonwealth to the States. Nevertheless, the States continued to raise substantial revenues from public lands and their business monopolies (post & telegraphs, and railways and tramways). Even revenue from their own taxes grew strongly in the early years after Federation (see Mathews and Jay 1972).

Australia's federalism started to become dysfunctional after the Second World War. The exclusion of the States from income taxation since 1942 was the first decisive step in this direction. The High Court's interpretations of section 90 under which the States were subsequently excluded from levying excise duties and virtually any form of tax on the sale of goods were the second major blow to the States' fiscal security. In the initial years of Federation, the High Court's decisions on excise duties were not unreasonably confining for the States when, in the *Peterswald* case (1904), for example, excise duties were interpreted as taxes paid on goods produced or manufactured in a State. The Court's judgment in the *Parton* case (1949)⁷⁾ extended the definition of excise duties so widely as to literally cover the whole field of commodity taxation other than customs duties. The line of authority developed in *Parton* has since cast a long shadow over the subsequent cases involving State levies on commodities and was reasserted by the majority decision of the Court in the most recent *Ha* case in August 1997.⁸⁾

An immediate consequence of this judgment was that it effectively invalidated business franchise fees on tobacco, petroleum products, and liquor in all States, as the constitutional objections accepted by the Court in the *Ha* case applied equally to

7) (1949) 80 CLR 229.

8) *Ngo Ngo Ha & Anor v State of New South Wales & Ors and Walter Hammond & Associates Pty Limited v New South Wales & Ors*, (1997) 146 ALR 355.

all these fees, which had been framed under similar legislative provisions. This wiped off the source of nearly \$5 billion, or one-sixth, of total taxation revenue of the States.⁹⁾

In order to avoid a major disruption to the State revenue stream, the Commonwealth government agreed to collect, under its own legislation, additional revenue from the same three commodities, and reimburse the States for the loss of revenue. The movement to this arrangement was not altogether smooth. There was confusion about the refunds of unconstitutionally collected revenue and pre-payments of fees covering the period after the Court's decision. Three manufacturers of tobacco had to temporarily suspend trading in their products and shares in the midst of such confusion. There was also uncertainty about the effect of the new arrangements on prices of the taxed products, especially in Queensland, where the State government imposed no franchise fee on petroleum products but where the new Commonwealth taxation would apply just the same.

That revenue-raising power in Australia is extremely centralised is well documented.¹⁰⁾ The share of tax revenue raised by the Commonwealth government is far higher than the corresponding situation in other major federations. The High Court's decision in the Ha case has finally made Australia's federalism dysfunctional by further tilting the fiscal balance in the favour of the Commonwealth.

In the meantime, Deakin's fears about the misuse by the Commonwealth of section 96 grants to the States have also been realised. Specific purpose grants made under that section of the constitution have now grown beyond recognition both in size and in variety. The tax reimbursement grants, which were established in 1942 for compensating the States for the loss of income tax revenue, have since lost their identity over the years and, despite being general purpose grants, have been on occasions subjected by the Commonwealth to specific conditionality and threats.

The Commonwealth government has used the resulting concentration of fiscal power in its hands to gaining a dominant role for itself in making national policy. There is no clearer statement of this than the following admission of Mr Keating, who at that time had presided over the period of arguably the greatest turmoil in

9) In 1995-96, the States and Territories raised \$4,889.4 million from these three business franchise fees, nearly 54% of which was raised from tobacco and 31% from petroleum products.

10) See, for example, Mathews and Grewal (1997).

the history of Australian States :

Economic management has had to develop from the Commonwealth's power over revenue and the creation of a monetary authority. The national perspective dominates Australian political life because the national government dominates revenue raising, and only because the national government dominates revenue raising.

Important though it is, fiscal security alone will not lead to effective federalism. The States will also need to secure a role for themselves in developing regional and national responses to the emerging economic challenges, as well as to develop their own sets of capabilities as required by their new roles and responsibilities. The major challenges arise from globalisation, the onset of knowledge economy and persistent and worsening regional disparities. Meeting these challenges successfully would require innovative State-based policies, interstate cooperation, national coordination and international partnerships.

Box 1 : Federalism and the High Court of Australia

The line of authority established by Justice Dixon in *Parton* reflects the anti-federalism sentiment that was popular during the 1920s and 1930s. Even in 1927, while giving evidence before the Royal Commission on the Commonwealth Constitution, he had said (then as Mr Dixon) that a federal form of government represented a compromise and the theory upon which it rested included the supposition that it would serve during a period of transition, while people separately governed may find it possible to unite more closely under a less rigid constitution.¹¹⁾

In the latter part of the 19th Century, an influential group of political theorists, including Alexis de Tocqueville and James (Lord) Bryce had proclaimed the ultimate demise of federalism. Harold Lasky's influential paper *The Obsolescence of Federation* was published in 1939. In Australia, a distinguished political scientist, Gordon Greenwood published a major book in 1946 in which he also put forward the view that Australia should move to a unitary system of government.

11) Quoted in K. H. Bailey (1929) as reproduced in Prest and Mathews (1980), p. 91.

Although these writers were commonly proclaiming the end of federalism, the reasons for their proclamations varied and were in some cases mutually inconsistent. Thus, while Tocqueville's view was based on his belief in 'the inevitable spread of equality among human beings', Bryce was convinced of the unifying effects of the easier and cheaper communications, commerce and finance. Lasky, on the other hand, approached the issue from an ideological perspective. For him, federalism was fundamentally flawed, as it was incapable of dealing with the issues raised by giant capitalism. He regarded the state governments (in the United States) as mere creatures of capitalist enterprises. He is reported to have said that Delaware was merely a pseudonym of the du Ponts and Montana little more than a symbol of the Anaconda Copper Corporation.

By the time of the *Parton* case in 1949, the Great Depression and the Second World War had exposed the weakness of the state governments in dealing quickly and effectively with major crises, further cementing the superiority of a unitary government. The influence of Keynesian economics was also spreading fast through Australia, Great Britain, Canada and the United States. In Australia, this was reflected in the release of a White Paper on Full Employment in 1945. Many people at the time shared a feeling of frustration, despair and antagonism towards state governments and regarded the federal system of governance to be a drawback. Some, like Justice Dixon, must have felt an urge to nudge federalism towards, what was in their view, its inevitable demise.

Although federalism did not disappear, the nudge given to it by Justice Dixon in the *Parton* case still continues to frustrate the development of a functional and effective federalism in Australia.

Sometimes it is argued that Vertical Fiscal Imbalance does not really matter because the States still spend their own money at the margin. This argument appears to be based on a misconception of the effect on the States' choices when they spend the money received through Commonwealth grants, some of which is captured by the substantial literature on the so-called fly paper effect. The fallacy of this argument can also be exposed by asking if the States would be equally well off if the Commonwealth financed 99% of their outlays, instead of 60%. The argument seems to suggest that it does not matter if the States do not own the whole fiscal dog; so long as they own some part of its tail they can still wag the

dog.

The past record of Australia's States in dealing with fiscal autonomy is far from perfect. More often than not State autonomy has degenerated into narrow and parochial outlook resulting in wasteful competition and lack of interstate cooperation. This record may also have contributed to a perception that the States cannot be trusted with greater autonomy in policy making.

3. How Did the Governance Deficit Develop in Australia?

At the Commonwealth level, the governance deficit arose as a consequence of economic policies adopted over many years, particularly since the early 1970s, in relation to (a) the control of inflation, (b) financial deregulation and structural adjustment and (c) microeconomic reform. At the State level, microeconomic reforms and the fiscal straitjacket of vertical fiscal imbalance are largely responsible for the emergence of governance deficit, although the State governments in Australia must share the blame for some complicity in the perpetuation of the vertical fiscal imbalance for such a long period.

Inflation in Australia had averaged at 2.5 per cent between 1953–54 and 1969–70 but increased sharply in the later years. The real break in the trend rate of inflation came during the Whitlam years, 1973–74 and 1975–76, when increase in the Consumer Price Index averaged 14.5 per cent. In part, the inflation rate in Australia reflected the worldwide effect of the Arab oil embargo of 1973 but it was also fuelled by local factors, in particular the massive increase in public sector outlays and the sharp increases in wages and salaries.

The fight against inflation started with the Commonwealth Budget of 1975–76, brought down by the newly appointed Treasurer, W.G. (Bill) Hayden, in which Commonwealth outlays increased by half the rate of the previous year. The Whitlam government was replaced in late 1975 by Liberal-National Country Party coalition government of Prime Minister Malcolm J. Fraser, which targeted inflation as its number one priority. The Fraser government was never able to control the high growth in wages and the annual rate of increase in average earnings had surpassed 13 per cent in the last three years to 1982–83. Unable to control wage growth, the government pursued its anti-inflation agenda through fiscal restraint and tight monetary policy. The Commonwealth budget deficit had been reduced

from 4.7 per cent of GDP in 1975–76 to 0.3 per cent of GDP in 1981–82, before it increased again to 2.6 per cent of GDP in 1982–83 due to the onset of the recession of the 1980s. Thanks to the tight monetary policy, the interest rates remained high throughout the Fraser period, with the five-year bond rate remaining in double-digit numbers every year except in 1977–78, when it was 9.1 per cent. By the time the Fraser administration was ousted by the Labor government led by R.J. (Bob) Hawke in March 1983, the rate of inflation, having fallen to 8.2 per cent in 1978–79, had again risen to 11.5 in 1982–83. The rate of unemployment had also risen by 1982–83 to 10.2 per cent, which was the highest it had been since the Great Depression of 1930s.

During the March 1983 election campaign, the Labor Party promised to fight unemployment and inflation both simultaneously, unlike the Fraser government which had concentrated its efforts on fighting inflation and virtually ignored the problem of unemployment. In the first two years of its tenure, the Hawke government pursued an expansionary fiscal policy and the rate of unemployment fell from 10.2 per cent in 1982–83 to 8.2 per cent in 1984–85, helped also by the economic recovery after the recession. The fight against inflation was helped greatly by the Prices and Incomes Accord that had been negotiated by the Labor Party with the Australian Council of Trade Unions (ACTU) before the 1983 election and which helped in breaking the wage-price cycle and keeping the wage growth under control. The Accord secured an agreement from the ACTU on the maintenance of real wages through wage indexation, combined with a commitment to wage restraint by linking wage increases to productivity gains, discounting of price increases for the adverse movements in terms of trade and depreciation of the Australian dollar. The rate of growth in average earnings fell from 12.9 per cent in 1982–83 to 5.0 per cent in 1983–84. The rate of inflation fell from 11.5 per cent in 1982–83 to 4.3 per cent in 1984–85.

It was also in 1985, however, that Commonwealth government introduced financial sector deregulation, which had, together with the floating exchange rate introduced in December 1983, “profound implications for employment, because of the loss of government influence in the economy and consequent reduction in its capacity to influence employment.”¹²⁾ The new measures included the removal of most

12) Langmore J. and J Quiggin (1994), p. 68.

of the controls on deposits, lending, interest rates, maturity structure of interest-bearing deposits and cheque facilities. Banking licences were also issued to foreign banks and Australian credit unions and building societies. The deregulation of the financial sector in Australia was very much in accordance with the recommendations of the Campbell Committee's Report on the Australian Financial System. Although the Campbell Committee had been set up by the Fraser government and had reported in 1981, its recommendations were not implemented by the Fraser government and had been vehemently opposed by the Labor Party while in opposition.

In the wake of the financial deregulation, economic policy in Australia became extremely sensitive to the actual and perceived reactions and preferences of the financial and foreign exchange markets, which had decided, in the words of Fred Argy—formerly the Secretary of the Campbell Committee and as such one of the principal architects of financial deregulation—that the natural rate of unemployment in Australia was around 7.5 per cent¹³⁾ and asserted that the Government should cease trying to reduce unemployment and concentrate on avoiding inflation.¹⁴⁾ Control of inflation indeed became the primary and the only aim of economic policy of the Commonwealth government from this period onwards. The Labor government followed the combination of extremely tight monetary policy and severe fiscal restraint single-mindedly between 1985–1991. The rate of inflation was certainly brought down to 1.2 per cent in 1991–92, but not without increasing the rate of unemployment to 10.5 per cent in that year and to 10.7 per cent in 1992–93.

In the meantime, the Commonwealth government had also introduced several changes in Australia's tariff regime and the system of budgetary assistance to industry. In 1988, a five-year program of reduction in tariff protection to Australian industry was announced. Sectoral plans for tariff reduction for the automotive industry, and the textile, clothing and footwear industries had been announced earlier in 1984 and 1986. As a result, the effective rate of tariff protection for the manufacturing industry fell by 68 per cent between 1986–87 and 1996–97.¹⁵⁾ Together with the removal of budgetary assistance to manufacturing industry, these measures led to a significant reduction in manufacturing activity in Australia. Thus, the share

13) Argy F. (1995), p. 31.

14) *Ibid.*, p. 37.

15) Productivity Commission (1996).

of manufacturing output in Australia's GDP fell from 24 per cent in 1970 to 19 per cent in 1980 and to 15 per cent in 1990 —this reduction was greater than in any of the G 7 countries during the same period.¹⁶⁾ The largest contraction occurred in the textiles, clothing and footwear, and fabricated metal industries in which employment fell by 197,200 during 1970 – 1990.

A select group of manufacturing industries also recorded impressive growth in exports between 1985 and 1993.¹⁷⁾ Nevertheless, this export growth did not succeed in making any inroads in the rate of unemployment, as GDP growth was “more than ever constrained by a weak balance of payments and growing external debt”.¹⁸⁾ These constraints were in turn made worse by the combination of a floating dollar, a deregulated financial system and the policy of high domestic rates of interest which the government felt obliged to follow at the time in order to sustain the currency and to control inflation.

From the mid-1980s onwards, the Commonwealth government pursued a relentless programs of fiscal restraint, privatisation of public assets and downsizing of the public sector through retrenchments and redundancies of the public servants at an unprecedented scale. Driven by the aim of reducing public sector budgetary deficits at all costs, the Commonwealth used its dominant fiscal position to force the same measures on the state governments. Altogether a total of 685,400 public service jobs were affected by these measures (see Table 4). Although all jurisdictions in the country were affected by them, some states like Victoria, where the conservative parties had replaced Labor in government in 1993 and had since

Table 4 Retrenchments & Redundancies (to 30 – 6 – 97)

	000	%
NSW	182.8	26.7
VIC	183.7	26.8
QLD	149.5	21.8
WA	68.8	10
SA	66.5	9.7
TAS	17.7	2.6
NT	3.3	0.5
ACT	13.1	1.9
AUS	685.4	100

16) See Mathews and Grewal (1997), p. 704.

17) See Sheehan, Pappas and Cheng (1994).

18) *Ibid.*, p. 41.

Table 5 Public Sector Employment 1987 and 1997

	1987	1997	Commonwealth	State	Local
NSW	27.5	20	3.3	14.9	1.8
VIC	27.1	18.7	3.7	13.2	1.8
QLD	30.1	24.1	3.1	17.8	3.2
WA	28.8	21.4	3.1	16.4	1.9
SA	30.5	24.1	4.2	18.3	1.6
TAS	33.7	25.9	4	19.4	2.5
NT	37.4	31.6	4.9	21.9	4.8
ACT	56.1	49.2	36.5	12.6 ...	
AUS	30	21.7	4.1	15.5	2.1

took a lead in reducing the size of the public sector, went harder than the others in implementing these policies. In 1987, public sector provided 30 per cent of total employment in Australia. As a result of the policies of fiscal restraint and privatisation, that figure had fallen to 21.7 per cent by 1997 (Table 5). In Victoria, for the reasons noted already, the share was the lowest in the country, both for total public sector employment and for state public sector employment.

4. New Imperatives of Governance in Global Knowledge Economy

The key features of the emerging global knowledge economy include the following :

- The increasing openness of the national economies
- The increasing knowledge intensity of goods and services
- Internationalisation of production, and
- The decreasing costs and increasing speed of transferring large volumes of information worldwide.

The economic effects of these facets of global knowledge economy are both profound and wide-ranging. Thus, it is no longer possible for a country, except at a very high cost to the welfare of its people, to insulate itself from the world economy. Not only international trade is increasingly important for economic growth of the nations, but the rules of international trade have become more liberal and their application more widespread. Traditional trade restrictions and barriers are on their way out. International institutions such as the World Trade Organisation, the World

Bank and the International Monetary Fund are promoting and monitoring the reduction of tariffs and non-tariff restrictions to trade. National policies ranging from workplace safety standards to budgetary subsidies to specific producers can come under scrutiny in ensuring compliance with international standards. Restrictions on international movements of capital and people are also progressively being liberalised, although the recent global financial turmoil has raised important issues in managing this process to the mutual advantage of capital importing and exporting countries.

The second aspect of global knowledge economy is the increasing knowledge intensity of production. The importance of physical materials such as coal, iron ore, oil or wood etc. has declined steadily and has been replaced by the value of knowledge that is compressed into a good or a service. The higher relative prices of knowledge related inputs—technology, cognitive skills, research and development, and management—in comparison to the prices of bulky physical materials reflect the changing demand patterns and relative scarcities of the two groups of inputs.

The economic significance of knowledge economy is not localised in only some countries but is affecting economic activity worldwide. Computers, telecommunication systems, satellites and the internet are all making the world a much smaller place than it was a few years ago. Massive volumes of information—data, text, audio and video images—can be transferred instantaneously from one corner of the world to another.

This phenomenon, which has been labeled by some as 'the death of distance', is reinforcing the third facet of globalisation—the internationalisation of production. Together with the increasing intensity of knowledge in production, the ease with which knowledge and information can be carried across nations is making it possible to locate the production of different segments of goods and services in many different locations, even in different countries, strictly in accordance with economic considerations. Trillions of dollars can be moved from one country to another, also seeking higher returns, within seconds. The Chairman of the US Federal Reserve Board Dr Alan Greenspan observed recently that these advanced means of communication have added much the same type of value that railroads¹⁹⁾ added in transporting the more physical goods of an earlier century. It could be

19) Greenspan, Alan (1999).

added that advanced communications are also promoting international linkages in production in much the same way as railroads linked different cities and towns within individual countries. As Robert Reich noted in his important study *The Work of Nations*, finished products these days incorporate so many components made in turn in different countries that it is not possible anymore to speak of the nationality of goods.²⁰⁾ Increasingly the production of services, financial services for example, is also becoming an international activity.

Globalisation of production has brought two types of change for governance in its wake. On the one hand, it has broadened the opportunities available to the firms, regions and countries for producing and marketing their production. On the other hand, it has increased several-fold the potential competition for their products. The increased competition has created predictable uncertainty and insecurity and has increased the pace of change within firms, in job markets and in regions. Production techniques and systems are changing rapidly to stay ahead of the competitors.

Old skills, like old technologies, are becoming obsolete more quickly than in the past. Jobs for life have already become a thing of the past, not just for workers but also for managers. Acquisition of new skills appears to be the key to success for workers and managers alike. Increasingly, the firms and the governments need to provide the institutional and organisational support for developing the skills that are necessary for global knowledge economy.

The full implications of the globalisation for specific policies are not yet fully clear. Indeed, a part of the challenge for the firms and the governments is to figure out these implications and develop best ways of capitalising on the available opportunities. A good example of the confusion over specific direction of policies is provided by the choices to be made in the field of education. While the role of science and technology and research and development can hardly be overemphasised, the importance of liberal arts in education systems has also been stressed by some in the context of the knowledge economy. Dr Alan Greenspan put this case very persuasively, when he said :

The roots and nature of how human mind innovates have always been subject to controversy. Yet, even without hard indisputable evidence, there is a

20) Reich. (1991).

remarkable and broad presumption that the ability to think abstractly is fostered through exposure to philosophy, literature, music, art, and languages. Liberal education is presumed to spawn a greater understanding of all aspects of living—an essential ingredient to broaden one's world view by "vaulting over disciplinary walls," as my good friend Judith Rodin put it, and exploring other fields of study. Most great conceptual advances are interdisciplinary²¹⁾ and involve synergies of different specialties.

5. Conclusions

This paper started with the assertion that the core of Australia's policy challenges lies in what is suggested here as the governance deficit. This being a new and unfamiliar concept, an attempt was made to describe it and define it in such a way that it is not immediately confused with an argument for enlarging the public sector. The aim of this paper has been to show that although Australian economy has made significant progress in the past two decades, it has also accumulated a burden of equally significant and diverse problems that cannot be solved by relying on market-based outcomes. Indeed, the problems have arisen from an excessive and misplaced faith in market-based outcomes. Solutions for these problems have to be found now in the context of global knowledge economy, which requires more than just refurbishment of the old public sector. What is needed is the creation of forward looking, strategic initiatives for developing new public sector institutions, processes and policies so as to take maximum advantage of the emerging opportunities and to minimise the risks of losing in global competition.

21) Greenspan (1999).