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# Building prosperity

Wolfgang Kasper

## Australia's Future as a Global Player

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# Building Prosperity

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2000

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## AUSTRALIA'S FUTURE AS A GLOBAL PLAYER

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On a few occasions I have chosen to remain obstinate and have not accepted the advice of my friends, nor have I followed the advice to include many more statistics. Admittedly, Australian data are more reliable than Soviet nut production statistics. But to predict the future of an open service-orientated economy, they are about as useful as Soviet nut statistics were to planning the USSR's future. I therefore claim full responsibility for this study, including all errors of fact and judgement.

***Wolfgang Kasper***

# About the Author

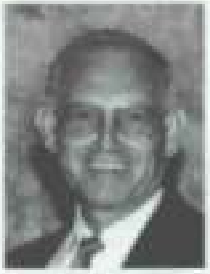
Wolfgang Kasper is Emeritus Professor at The University of New South Wales. He joined The Centre for Independent Studies as a Senior Fellow at the beginning of 2000.

Professor Kasper has consulted widely for industry and governments in most countries in the Asia Pacific, and has also worked at the Reserve Bank of Australia, the Federal Reserve bank of San Francisco, and the Organisation for Economic Cooperation and Development in Paris.

In 1980 he co-authored, with R. Blandy, J. Freebairn, D. Hocking, and R. O'Neill, *Australia at the Crossroads—Our Choices to the Year 2000*, in which alternative futures to the year 2000 were examined by analysing past trends and identifying major changes and trend breaks.

His most recent book, *Institutional Economics: Social Order and Public Policy* (1998), co-authored with Prof. M.E. Streit, has been published in the UK and USA to high public acclaim; a Mandarin translation will come out shortly in Beijing.

His latest publication for CIS was *Gambles with the Economic Constitution: The Re-Regulation of Labour in New Zealand* (2000), in which he examined the impact of New Zealand's labour market reforms in mid 2000.



# Foreword

Wolfgang Kasper comes to a critique of the Australian economy with strong credentials. In 1978 with Tom Parry in *Growth, Trade and Structural Change in an Open Australian Economy* and again in 1980 with Blandy, Freebairn, Hocking and O'Neill in *Australia at the Crossroads—Our Choices to 2000*, he drew attention to the poor performance of the Australian economy at a time when most Australian economists were smugly satisfied with the status quo. Ignoring Australia's dismal slide in relative living standards from the 1960 to the 1970s, they were congratulating themselves on what they saw as the peak of economic performance to which Australia could aspire. If the Australian 'cake' was not growing, it was being sliced evenly. Only a handful of economists, mainly open trade advocates, supported Kasper in his urgent pleas for reform. The first chapter of this book revisits those dismal times only to conclude that, having undertaken micro and macroeconomic reforms in the 1980s and mid-1990s, Australia is again falling behind in productivity and hence in income per head. The United States is still the clear leader. The case for a vigorous reform program so as not to be left behind is as urgent as it was in 1980.

To deny that the Australian economy is in poor shape in the year 2000 is even more ridiculous than it was in the 1970s. The Australian dollar is worth little more than 50 United States cents. Treasury and Reserve Bank bureaucrats, business and academic economists, and the sycophantic media blame international capital markets. But the international capital markets have played a sterling role, as they did in East Asia in 1997 in identifying overvalued exchange rates, in pointing to low productivity in Australia. Australian exports are only viable at a low Australian exchange rate because, directly and indirectly, they face institutional barriers to high productivity at every turn.

The effort to reform taxation has been has been turned into a parlous muddle by the intervention of narrow interest groups in the Senate. The attempt to improve Australia's sclerotic industrial relations has fared even worse in the same hands. Raising productivity in the public services sector has slowed to a timid pace. 'Industrial policy' that seeks to pick winners through 'R and D' is again raising its self-promoting head in lieu of freeing up the economy.

The economists who denied that Australia urgently needed to reform in the 1970s have trained a generation of students who now dominate the profession in academia, the bureaucracy and business. They pander to those who resent change, using dubious statistics to bleat about worsening income distribution. Yet standards of living of low-income recipients have risen markedly as a result of the liberal reforms that have taken place during the past two decades. They refuse to recognise that wage and salary earners and entrepreneurs are held back by a pervasive overhang of past industrial regulations. The industrial relations 'club' continues to exert a downward pressure on productivity, incomes and profits. A new army of unproductive bureaucrats shelters in so-called 'unfair dismissal' and 'equal opportunity' institutions.

Australia may not be very different from European countries in these respects, but this is no cause for celebration. The Euro has plummeted with the Australian dollar. And Australia remains a long way behind the potential for rising standards of living for new generations of Australians. Education, health and welfare policies continue to languish in spite of their importance to both productivity and living standards. The 'clever country' is as far off as ever.

Wolfgang Kasper has always had a serious interest in long-term trends and swings in the world economy. He points out that Kondratieff was not an Olympic gymnast, but a contributor to the understanding of long-term economics. Population, immigration and defence policies only make sense in the long term. The past year has drawn attention to the weakness of Australian policy formulation in these areas.

Wolfgang Kasper's monograph is short but it has depth and breadth. He indicates the benefits that would accrue to a renewed liberal reform agenda. He recognises, unlike many of his economic colleagues, that Australians are not fools. The superb performances of Australian athletes over the years that brought the Olympics to Australia for the second time, the imaginative but structurally sound build up that made the many venues work as never before, and the vast good natured crowds that made the Sydney Games the best ever showed what Australians can do. They can be relied on to face up to and take tough decisions and put in the hard work to make Australia an economic leader. Kasper's analysis shows the way this can be made this happen.

***Helen Hughes AO***
*September 2000, Sydney.*

# Preface

Major technological developments, globalisation and the aging of the population are placing a high premium on economic and constitutional reforms in Australia. It is likely that the present phase of rapid worldwide innovation and high economic growth will peter out before long. When it does, flexible and creative responses in free and open markets will be the only way for Australians to avoid the consequences of a slowdown in world economic growth.

Considerable progress in the direction of greater economic freedom has been made in the past 20 years. But the reform momentum appears to be flagging. It is not easy to gain renewed political support for reform because we are going through a strong growth phase—as predicted in the 'Crossroads study', which this author helped to compile in the late 1970s. Yet periods of plenty are the best times to prepare for eventualities by cutting back on unnecessary government activity and placing economic liberty on more solid foundations.

Over the last two decades, Australians have had to cope with a dual adjustment burden. First, innovation, globalisation and internationalisation progressed rapidly and all economies had to adjust. Second, Australians had to digest the consequences of the liberalisation of international trade and capital flows after seven decades of protectionism and politically sheltered rigidity. All of a sudden, industrial and employment structures had to adjust.

On the whole, the outward orientation and greater competitiveness have been a success. But the adjustment costs were considerable because the sub-orders that govern various aspects of economic life were reshaped at uneven speed. Thus, international trade as well as product and capital markets were subjected to free market rules in the 1980s, whereas labour markets are still centrally guided. Important decisionmakers in the government sector have yet to realise that they too will now have to behave in lean and internationally competitive ways.

Over the past 20 years, the world economy has been riding a vigorous growth wave thanks to the worldwide deregulation and privatisation of the late 1970s and 1980s, innovations in energy saving, advances in biotechnology and material sciences, and, above all, the communications revolution. The Internet is beginning to have a pervasive impact on the organisation of human activity; its impact can be compared to the spread of combustion power or electricity, maybe even book printing. Cheap information and data processing are now empowering the individual, the small group and the fast learners, but are creating novel challenges for governments and the nation state.

In the decades to come, energy and other resource bottlenecks may again emerge, or global capital markets may once again be sources of instability as rising volumes of credit and debt become unmanageable. We can also expect a recurrence of more intense distributional conflicts among households, governments, foreigners and businesses—and this at a time when the progressive aging of the population imposes additional burdens on the producers of wealth.

After a generation of easy growth, economic progress is being taken for granted and such problems are not readily anticipated. Policy typically switches from giving priority to economic growth to favouring redistribution and the conservation of old structures. In addition, single-issue interest groups become more vocal and aggressive in opposing competition, responsibility and innovation. We are already witnessing the emergence of a new alliance against free trade and investment, the very factors that have been among the key driving forces in past accelerations of worldwide economic growth, such as the 1950s.

The years after 2005 could therefore resemble the late 1880s, late 1920s/early 1930s or the 1970s, when growth faltered badly and a crisis in the capitalist system heralded one or two decades of economic disappointments. Much rests on the capacity to discover new opportunities and the flexibility to adjust to changing circumstances. And this in turn depends on widespread entrepreneurial confidence grounded in a truly free, open and competitive economy.

The purpose of drawing attention to long-term waves of accelerating and decelerating growth is not to be a doomsayer, but to suggest that now is the time to prepare for a change in the tide. If the constitutional debate is revived, as is likely, it will be important to consider a number of institutional provisions that constrain political opportunism and promote economic freedom—for example, a rule to limit the public sector's claim to no more than 25% of the national product (the share it took in the 1950s and 1960s); direct constraints on the parliament's capacity to churn out prescriptive and contradictory regulations for the benefit of pressure groups; and a devolution of tasks and revenues from the Commonwealth to competing State and local governments.

It will also be necessary to prune back government where it has proliferated most over the past quarter century, causing all sorts of unforeseen and deleterious side effects, namely the redistributive welfare state. As long as governments remain committed to the welfare state, despite its many failures, they will not be able adequately to protect private property and those economic liberties essential for competitive success and prosperity.

Old rules are normally good rules, but the preservation of traditional institutional arrangements that fit poorly with the new global conditions would be foolhardy. The transition to a freer, more open economy and the advent of global competition for mobile resources will force us to review the size and functions of government. If this task is tackled actively and the reforms are based on a constitutionally entrenched concept of economic freedom, the next generation of Australians will prosper. Our resource endowment is excellent, and Australia's location in the world is favourable. Per-capita incomes in real terms could then grow by about 3½ % p.a. over the next 25 years.

If, on the other hand, group egotism, habitual parliamentary power plays and selfish interest groups are—again—allowed to hold up timely adjustments, the common wealth will suffer. Per capita incomes will grow slowly, maybe by about 1% p.a. The most vulnerable in our society would suffer most. The traditional can-do optimism, which has been a hallmark of earlier generations of Australians, will then be a mere memory.

Much is therefore at stake. And much can be done now whilst the going is still good.

# INTRODUCTION

## Growth, Change and Economic Freedom

### *At the Start of the New Century*

Much has changed in the economy and society of Australia since 1975, when 'a young schoolteacher, Greg Lindsay, established, from nothing, a think tank to promote the cause of economic freedom' (Arndt 1985: 97). Average living standards have risen by some 70%. This is roughly double the worldwide average rise over the same period and slightly more than in 'the West' as a whole. At the start of the 21st century, Australians are living fairly secure, longer and healthier lives than ever before and, for that matter, more than most people on earth. Of course, plenty of problems remain, and there seems little room for Millennarian triumphalism. But, overall, one has to wonder why so many of our fellow citizens subscribe to the messages of the 'fear industry'.

The country has undergone a dramatic transformation over the past quarter century. One only has to look at 25-year old photos of the Sydney skyline to appreciate the change. Australia's population has gone from 13.9 million in 1975 to nearly 19 million in the year 2000. People have become more self-assured and cosmopolitan. The population has aged, but among the aging, affluent democratic nations, ours is now still one of the youngest. The economy has been transformed from a protected backwater on the global periphery to an outward-looking player. Many Australian producers are competing successfully on the international stage. Competition among banks has led to wider choice and better service for consumers. Petro-efficient small cars cost less. Import liberalisation has brought cheaper clothing and hardware made in Asia. We can now enjoy world-class wines made in Australia, portable computers, credit cards, ATMs, yellow highlighter pens, mobile phones, email, and many more novel everyday items. In the process, manufacturing industries have shrunk in relative importance and the service sector has expanded—almost unbelievably—to about three-quarters of the national product.

Many of these transformations have, of course, occurred worldwide, and some have disrupted familiar habits and expectations. However, over the past quarter century, Australians (and New Zealanders[1]) have had to master more

[1] This essay is about Australia, but there are so many parallels between Australia and New Zealand that much that will be said can be applied, mutatis mutandis, to New Zealand. The two cousins are bound together by location, history and culture to a greater extent than many nationalistic New Zealanders want to acknowledge, and Australians, whose world ends at Cape Byron, realise. In New Zealand, doubts about the traditional nation state are stronger and the readiness and capability to experiment with different rules have been greater. For them, the invitation in the formal Australian Constitution of 1901 to join may some day in the future be of greater relevance than it is to Australians.

structural change than either Americans or Europeans. The reason for this is the coincidence of political moves in Australia to tear down the traditional protective barriers around the national market for goods, capital and services and worldwide technological change and globalisation. Australians therefore had to cope with pent-up adjustment needs, postponed since Federation by an overly interventionist policy, at a time when the pace of global change accelerated. Seen in such a historic and global context, the task has been handled with surprisingly little disruption. Australian society has remained cohesive, civil and peaceful, and many have embraced and benefited from the changes.

## *Globalisation and Economic Freedom*

Globalisation is now a reality. Since 1948, when the General Agreement on Tariffs and Trade (GATT) came into force, world trade has grown sixteen-fold, a key reason for the sixfold growth of global production[2]. As a consequence, more and more workers, managers and sellers are now competing daily in foreign markets and facing new competitors from elsewhere. At least two million Australian jobs now depend more or less directly on foreign trade, tourism and the export of education services.

At the same time, savers are now at liberty to invest their funds and nest-eggs in different countries and currencies, and they do so increasingly in order to spread their exposure to political risk. Direct investment in foreign countries has become routine: every nation on earth is now being 'taken over by multinationals'. Cash and information travel at the press of a button, and the Internet has ensured that all this can be done virtually anywhere in the world for the price of a local call.

This does not mean that our local neighbourhoods do not matter to us, but people increasingly network across the boundaries of jurisdictions. More and more enterprises directly experience how difficult or easy it is to work together, trade, invest, research and innovate under different cultural and national conditions. They are able to compare the benefits of alternative sets of social habits, work practices and laws that bind communities together (internal institutions), and can better evaluate the quality of legislation and the courts (external institutions).

In a more dynamic and open world, such institutions are becoming more important. In particular, the fast-growing knowledge industries and the burgeoning service sector depend more on good rules than on raw materials or labour, because services are about coordinating people in teams and firms to utilise fast-changing knowledge in complex markets. In economies with an

2 The world population grew 2.5-fold during the same period (or 1.8% p.a.), and average per-capita incomes 3.5-fold (or 2.5% p.a.), i.e. faster than ever before in the history of mankind over such a long time span.

advanced division of labour, such as Australia, transaction and organisation costs nowadays amount to more than half of all the costs of producing and distributing the national product. These are determined mainly by the quality of institutions (Kasper-Streit 1998: 125-130). The most dynamic growth now occurs in transaction-facilitating services, such as trade, logistics, finance, accounting, and computer support, and in activities that improve the division of labour, such as stock exchanges and futures markets. These services mushroom in places and networks where institutions create trust and expedite business.

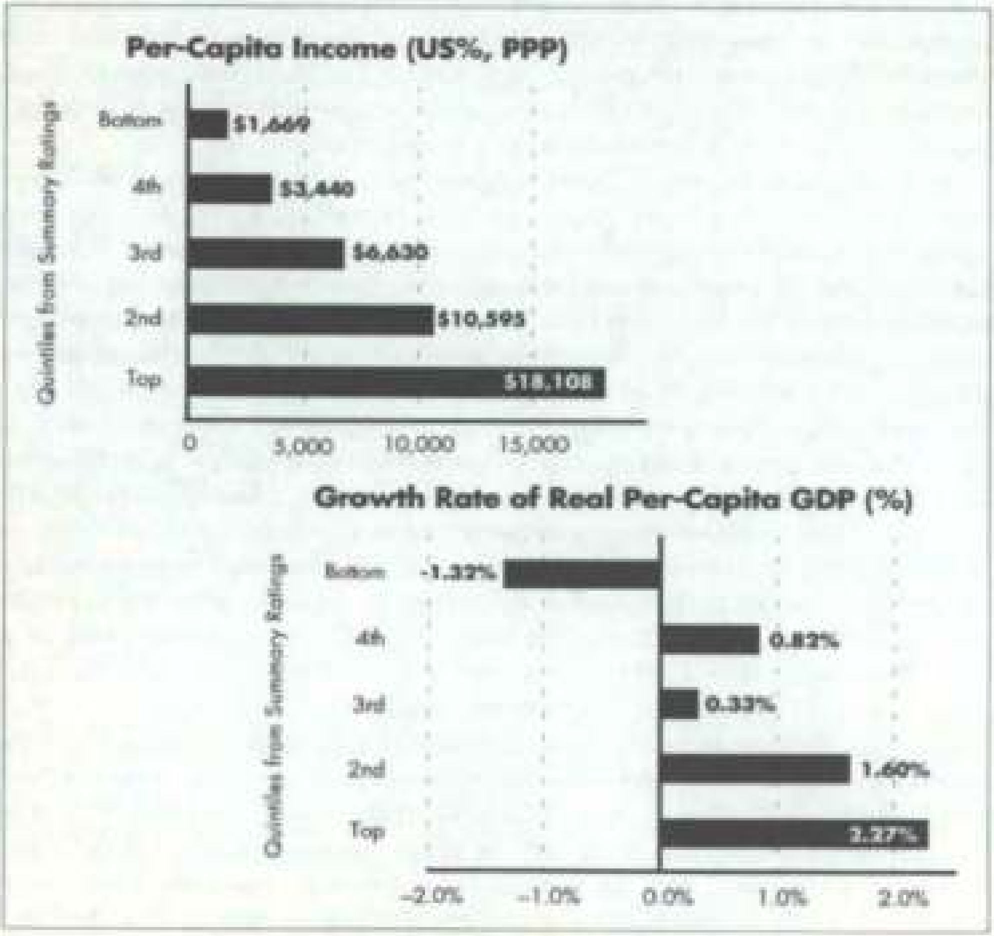
The costs and associated risks of coordinating people and firms vary enormously between jurisdictions and communities, as does the openness of networks to outsiders and newcomers. Where economic activities are protected, highly regulated and depend on complicated and arbitrary rule systems, the coordination costs are high. Where the ground rules are easily knowable, stable and consistently enforced, the costs of coordination are competitive. This is where transaction-intensive and coordination-sensitive activities gravitate. Regimes with secure property rights, stable money and the rule of law encourage competition, and have become the centres of fast economic growth, high employment and optimism. They are the hubs from which global networks radiate and in which most innovations are tried out first.

Free and competition-friendly ground rules—what we shall call free 'economic constitutions'—facilitate business as well as the exploration and testing of potentially promising knowledge. This is because interaction is largely based on trust, a great transaction cost saver. By contrast, regimes with an uncertain commitment to economic freedom—i.e. obscure, prescriptive and proliferating regulations; arbitrary political decisionmaking; and discriminatory preferences for specific tribes or organised interest groups—impose high costs and risks on producers, employers and innovators. The owners of mobile capital, knowledge and enterprises are deserting these places. It is therefore not surprising that the quality of economic freedom is reflected in the growth and level of per-capita income (see Graph 1 on next page). The Graph is based on a large range of indicators of economic freedom—how well private property is protected, whether people are free to contract or whether intrusive regulations interfere, whether the economies are open to the world, and so on—and have been cross-checked with the assessments of prominent observers who make international comparisons (Gwartney-Lawson 2000).

National borders are now less of an obstacle to trade and investment than a generation ago. Globalisation—the integration of markets in many parts of the world—started in earnest in the 1970s and 1980s. It now affects concepts of nationhood and national sovereignty in profound ways. Some speak of the demise of the nation state. Others are outraged that democratically elected parliaments and governments no longer retain the sovereignty to regulate and legislate as they please. Yet others see the benefits of the competitive discipline that interjurisdictional competition imposes on legislators and administrators. They are aware of the fact that parliamentarians, once elected, rarely do the voters' bidding. Instead, they regulate and redistribute in favour of well-organised interest groups. The latter will in turn help their party financially or 'helpful' officials financially and otherwise at the next election, or show personal gratitude to 'supportive' politicians after their retirement from politics.

People who are sceptical of collective action therefore see globalisation not only as a welcome constraint on political agents, but also as a tool of empowerment for small firms, individual citizens and freely formed citizen associations. Above all, they observe that the discipline of international competition induces the makers and enforcers of rules to provide better quality institutions.

**Graph 1**
**Economic Liberties and Prosperity**




*Source:* J. Gwartney and R. Lawson 2000.

The opening of national jurisdictions to free trade, investment and payments creates positive feedbacks into the quality of a nation's institutions. In the first instance, trade and mobile resources favour jurisdictions with freedom-enhancing and trust-inspiring institutions. The economy then flourishes, whereas others with poor institutions lag behind. Such differences in economic growth—as well as the revenues and resources to maintain political power—signal to those holding power that they ought to adjust the institutions accordingly.

Economic historian Eric Jones described this interaction in the context of post-Medieval Europe, showing how interstate rivalry and openness were the reasons why more secure individual liberties, private property rights, the rule of law and ultimately constitutional government developed. We shall therefore call the feedback from openness to institutional evolution the 'Eric Jones effect'. It is behind the data reported in Graph 1 opposite.

In Australia, the role and *modus operandi* of institutions and government rely on time-tested (British) concepts. Australia's stable democracy has developed rules of overarching constitutional quality, which facilitate orderly and peaceful adjustments in lower-level rules. In the 19th century, the colonial societies down under displayed great creativity in shaping innovative and progressive institutions. These institutions underpinned fundamental economic freedom and left much scope for entrepreneurial initiative, laying the foundations for the much-admired self-confidence of Australians. As a result, the population and its wealth grew rapidly.

In the wake of Federation, a more interventionist and prescriptive rule set was established, called by some the 'Australian Settlement'[3] (Kelly 1992: 1-16). It had to be abandoned from the 1950s onwards, albeit grudgingly, reluctantly and in a piecemeal fashion. A more timely and cohesive reform of the underlying economic constitution could have avoided much pain. But the protectionism and artificial security of the 'Settlement' prevented most Australians, and certainly the politicians and interest groups with a stake in the past, from perceiving the full import of the changes that were occurring around them after World War II.

Advanced globalisation is now raising new and fundamental questions as to whether the present rules of the game are appropriate. Can Australians prosper with the current mix of reformed conditions and leftovers from the post-Federation settlement? Can we succeed on the global scene with the present

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[3] The 'Settlement' covered a number of elements. By central wage fixing and protecting a growing array of domestic industries, the government ensured that working people—and White immigrants—earned adequate incomes. The philosophy of governance was based on paternalistic benevolence and protection of citizens from the consequences of mishaps. In international affairs, the Australian federation relied on imperial benevolence and British protection and excluded non-White immigration. This 'Settlement' was the result of seemingly automatic growth during most of the 19th century, the unsettling shock of the land crisis of 1888, and the nationalist-statist spirit of the times. The new interventionist order no doubt served stability and the personal security of many, but in the longer run it ossified the economic and social structures of this young country, retarded economic development and inflicted unnecessary material hardship.

size and functions of the state? We know for sure that those communities and nations that develop the fundamental rule systems to support and attract innovators and competitors on the international stage prosper. They become places of social optimism and fulfillment. Those who grudgingly drag their feet and allow entrenched interest groups to delay institutional rejuvenation will fall behind and turn their fears into self-fulfilling prophesies.

This forecast can be given substance by comparing how institutions and changing circumstances interacted in the 1990s in the Anglo-Saxon countries, continental Europe and Japan (see table 1 opposite). The aging societies of continental Europe and Japan clung to their economic constitutions of the past. They relied fairly heavily on centralised and *dirigiste* coordination, and tried to ensure security in the face of opening trade and technology frontiers by protecting politically well-connected groups. Over the past 15 years, the Japanese government has tried to overcome economic stagnation with one programme of massive Keynesian demand stimulation after the other, to little avail. Nowhere have Keynesian policies of fiscal and monetary stimulation been tried more than in Japan since 1987. Yet the only outcome has been mounting public debt.

By contrast, deregulation and the enforcement of simple rules spurred on the Anglo-Saxon economies. Companies were allowed to go broke; conditions for start-ups improved. Foreign trade and investment were liberalised. Union cartels were broken, if necessary by government intervention. Capital productivity and economic growth responded spontaneously. These reforms have set off a virtuous circle: The public supports the reforms and ensuing competition, which in turn prevents political agents from tinkering with the capitalist rule system and thereby hindering future growth.

Table 1 on the facing page shows some of the international ratings of economic freedom and institutional quality as well as the levels and rates of growth in various countries. Even such a cursory glance indicates that the quality of government, openness to international trade and investment, and ratings of economic freedom correlate positively with material living standards. The US and the UK economies are among the most open and free and the business environment there enjoys high ratings. Economic growth was higher than in the less free and open economies of Japan and Germany, for example[4].

The challenges of global competition face Australians (and New Zealanders) more immediately because we live in affluent, mature 'frontline states'. We are also located in the most dynamic time zone on earth. It is here that most new

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[4] The table also shows that Australia and New Zealand are credited with decent government, but poor openness. Australia's economic freedom leaves, according to international surveys, something to be desired (the main reasons in all such international surveys being poor government and unfree labour market). Australia and New Zealand are considerably poorer than the big lead economies in OECD, and this was one factor which has allowed the two countries to catch up a little during the 1990s.

## Table 1
## Institutions and Growth

| | Quality of Government (rank out of 43) | Openness (rank out of 43) | Business Environment (rank out of 47) | Economic Freedom Index (out of 161) | Level of per cap income (US$ PPP US=100) | Growth GDP in living standards (1990-99, %) |
|---|---|---|---|---|---|---|
| United States | 15 | 1 | 3 | 1.90 | 100 | 2.1 |
| United Kingdom | 19 | 4 | 2 | 1.95 | 71 | 1.8 |
| Germany | 31 | 7 | 11 | 2.30 | 73 | 1.0 |
| Japan | 23 | 21 | 24 | 2.05 | 84 | 1.0 |
| *For comparison:* | | | | | | |
| Australia | 8 | 28 | 12 | 2.10 | 67 | 2.5 |
| New Zealand | 9 | 33 | 15 | 1.75 | 54 | 2.0 |

*Source*: *The Economist* 1999, *World in Figures* (2000 edition), London.

industrial competitors and most new buyers are emerging. And we cannot rely on a big domestic market to give us the illusion of self-sufficient security, as may still be possible for Europeans and North Americans.

### *Historic Parallels*

The subject of this essay—economic freedom and how to support it institutionally—has a relevant historical perspective. A long view of social and economic history suggests that after periods of slow economic growth, political entrepreneurs emerge who win support for liberal reforms and adjustments to new circumstances. On the other hand, periods of fast growth are the harbingers of institutional backsliding, with organised pressure groups and political activists campaigning for rules that constrain individual initiative and innovation, thus hindering economic growth.

This is made clear by a comparison between Australia and the world at the beginning of this century and that of the last. Some striking parallels emerge:

- A hundred years ago and after a not-yet forgotten downturn in underlying economic growth, the start of the century was marked by renewed economic acceleration. The world economy was benefiting from strong integration gains, and fundamental innovations in the chemical, electrical and motor vehicle industries. There was a new optimism and hedonistic enjoyment of material progress and innovations during what became known as the belle époque or 'Edwardian era'. The Australian economy was emerging from the land crash of 1888, in particular in Premier Reid's free-trading New South Wales. It was driven forward by rapid gains from innovation and economic integration as colonial trade restrictions fell (the 'Federation boom'). Investors in Australia and around the world benefited from stable money, based on the gold standard.

One hundred years ago, there was much political controversy over the benefits of economic openness and competition in markets. Powerbrokers were inclined to play nationalistic or imperialistic political games that paved the way for the cataclysm of World War I and all that followed. In Australia, basic political institutions were put in place during the Deakin era that made it an interventionist-redistributive state and fairly closed economy for most of the 20th century. In contrast to the openness and economic freedom in the Colonies during the 19th century, the Deakin-era 'Australian Settlement' instituted rules that resulted in relatively slow economic growth.

- The early 2000s have also been marked by a vigorous worldwide economic upturn. It has, however, been underway a little longer than its predecessor 100 years ago. The world economy is again benefiting from rapid reductions in transport and communication costs and enormous cuts in information-processing costs, as well as promising inventions in biotechnology (gene manipulation), energy saving (for example, the fuel cell) and materials science (for example, nanotechnology). Segments of the world population seem to be caught in an optimistic *belle époque* spirit again, not least in the free-trading open Anglo-Saxon economies. The popular enjoyment of new products and forms of entertainment is reminiscent of the early 1900s.

  The Australian economy has been swept up by the current wave of globalisation, by the gains from trade with emerging East Asia and the rest of the world, and by the benefits of the communication revolution. The stifling 'tyranny of distance' is no more. Sydney has become one of the major hubs in global networks of trade, traffic, finance, innovation, the arts, and design and fashion (Andersson-Andersson 2000). Investors and entrepreneurs in Australia and the major economies around the world are once again benefiting from stable money. This has enabled them to plan new ventures without getting sidetracked by ultimately destructive speculation about inflation. But, once again, growing international investment flows and competition, not to mention the subjection of political action to the verdict of capital markets, are resented in some circles and are being actively opposed.

Some politicians in the year 2000 treat us to triumphalist statements that the Australian economy has not enjoyed such a long expansion of demand since the late 1960s. That is true: increasing demand is now, as it did then, meeting with fairly elastic and growing supply, so that cyclical upswings last, cyclical recessions are mild, and price pressures are relatively low. Consequently, much new demand is translated into the growth of output without inflation. Yet, it is during such periods of easy growth that economic structures and social attitudes become rigid. In the late 1960s, no-one predicted the economic debacles of the 1970s and hardly anyone was preparing for the contingencies of flagging economic growth.

All this points to an economic theory which says long-run growth of a nation's potential to supply goods and services is subject to generation-long 'Kondratieff cycles'. Two or three decades of accelerated growth tend to occur after institutions have been reformed and major technical innovation has been implemented by dynamic entrepreneurs who launch new industries. After about a generation, the very success and ease of economic growth permit obstacles to further growth to emerge. Some are material, but many are man-made. These then produce one or two decades of slowdown and widespread disappointment, as observed during the 1970s and early 1980s (see Chapter 1).

One purpose of this essay is therefore to ask: can we detect conditions that might transform the booming beginnings of the 2000s into a simile of the 1973-1982 experience by the end of the decade? If so, what can be done about it?

Economic growth can never be taken for granted. Admittedly, public policies can be conducted for some time without regard to cultivating the conditions for long-run economic growth. However, once the damage becomes evident, the consequences cannot be averted easily.

The nationalism born of the insouciance of the *belle époque*, for example, choked free international economic exchanges. This made the major monetary dislocations of the 1930s inevitable. When these caused enormous productivity losses, little could be done to undo the damage. The degree of international trade integration among the affluent countries reached in 1913 was not surpassed until the 1970s. Meantime, war and autarchy policies inflicted unnecessary losses and great suffering on two generations. The phase of international distrust and conflict lasting from 1914 to 1945 would not have been imaginable without the acts of economic nationalism—power politics without any regard to economic growth—and selfish protectionism at the start of the 20th century.

This is not to imply that we are now faced with risks to cosmopolitan cooperation and exchange akin to those looming after the first decade of the 20th century. But we have to be on guard against dangers for rational policymaking (Chapter 3). Environmentalism, new anarchical attacks on the global trading system, cultural pessimism, a new xenophobia, rampant welfare-statism and the attacks on rational analysis in economics and the law are all developments that can trigger long-term economic and political consequences that no-one intends or can foresee.

The same applies to the new nationalistic assertiveness in some of the fast-growing developing countries and in some sections of affluent societies. In several Asian countries entrenched elites are fomenting xenophobic or patriotic sentiment in order to protect their personal material positions from international competition. A combination of some of these sentiments and attitudes may yet again produce economic setbacks and force some communities to relearn the painful lessons of the 20th century.

At the very least, the historic perspective should alert us to the insight that cyclical waves rather than linear trends are the pattern of social and economic evolution. And we are well advised to reflect on what the great visionary of the merits of an individualist and free civilisation, Edmund Burke, had to say some 200 years ago:

> The science of constructing a commonwealth,. . . or reforming it, is . . . not to be taught *a priori*. Nor is it a short experience that can instruct us in that practical science, because the real effects of moral causes are not always immediate; but that which in the first instance is prejudicial may be excellent in its remoter operation. . . .The reverse also happens; and very plausible schemes, with very pleasing commencements, have often shameful and lamentable conclusions. (Burke 1986: 152)

## *Outline of this Essay*

With that in mind, I will review in Chapter 1 some of the salient developments during the quarter century from 1975 to 2000. I shall do so from the subjective standpoint of one who engaged in a little futurology in the late 1970s when co-authoring *Australia at the Crossroads—Our Choices to the Year 2000*. I shall focus on the notion that high quality economic institutions are essential for economic prowess, and much more. The analysis will draw on the concept of broad long-wave patterns of economic growth (or 'Kondratieff cycles'), showing that the Reagan and Thatcher reforms accelerated economic growth (as in the 1980s and 1990s) whereas institutional ossification slowed growth in the late 1960s/1970s.

The remaining chapters look to Australia's medium-term future, 2000 to 2025. Although most circumstances of daily life will not change greatly over the next 25 years (Chapter 2), we shall be on the lookout in Chapter 3 for changes in some major trends and for those political and economic constellations, that typically led to earlier slowdowns in growth. Are there harbingers, overseas and here, that foreshadow a renewed deceleration? In

Chapter 4 we shall ask whether there are policies that can prepare us now to cope with tendencies to rigidity and unnecessary constraints on freedom and prosperity. Long-term economic history has shown that individual communities and nations can weather global slowdowns if they cultivate free institutions and enterprising habits during times of plenty.

The ultimate intent of this essay is to make it plausible to readers that the creation of free, flexible and effective institutions can be viewed as a community's investment in valuable intangible assets, and that these instititutions are more important to our long-term well being than such hardware as roads, buildings or machinery.

# CHAPTER 1
# 1975-2000 in review

If Australia follows the Mercantilist Trend, we will not only see a continuing inability to cope with some aspects of economic welfare—such as high unemployment, particularly of the young, high inflation, slow growth in living standards, and a more unequal distribution of incomes—but also serious failures in meeting non-economic objectives to which Western societies aspire. . . . [The] alternative would concentrate on developing constructive responses to the trend breaks and challenges of the 1970s. This strategy is founded on welcoming and fostering innovation and the opening of the Australian society and economy to renewed competition. . . . [This] would amount to a new phase in the growing up of the Australian nation, a move from adolescence protected by the 'Mother State' to full maturity. . . .The assets we have inherited are considerable, and the self-reliance of young adulthood would lead to a confidence that is presently so badly lacking.

W. Kasper, R. Blandy, J. Freebairn, D. Hocking and Robert O'Neill (1980)
*Australia at the Crossroads: Our Choices to the Year 2000.*

## A. The Context

### *The Sad State of Australian Economics in the Late 1970s*

By the mid-1970s, it was obvious to many international observers that Australia's longstanding economic strategies were no longer tenable:

- The Whitlam government had tried demand expansion, as prescribed by the Keynesian textbook, to prevent a rise in unemployment during the downturn of 1974-75. Trusting in a stable trade-off between inflation and unemployment, the government created inflation by a politically convenient mix of wage increases, massive fiscal spending, easy money and devaluation. But there was no trade-off. Australians suffered record inflation (in 1974 and 1975 consumer prices rose by more than 17% p.a.) as well as unprecedented and long lasting unemployment. Economists mumbled about 'supply-side shocks' and 'stagflation'. In its first real test, Keynesian policy failed resoundingly to reduce unemployment, not only here but also around the world.
- The productive apparatus of Australia's inward-looking and protected economy displayed considerable rigidity because it was tied down by centrally regulated wages and working conditions, administered capital markets, foreign investment and exchange controls, high and distorting external tariffs, and much collective ownership of the means of production.

The economy responded to cyclical downturns in demand with job destruction. It could not cope constructively with structural changes. This became clear when the Whitlam government abruptly cut tariffs by 25%. Ham-fisted quota protection was needed to stop job losses.

- Obvious competitive advantages in Australian agriculture, mining, selected manufacturing industries and advanced services could not be exploited fully because of a web of rigid regulations often created by lobby groups. Many economists, trained in short-term demand-side macroeconomics, could not understand the economy-wide benefits of a more responsive micro supply apparatus. Thus, only very few economists advocated an opening of the economy, the deregulation of factor markets for labour and capital, and the liberalisation of many administered domestic markets for goods and services. Few saw that a focus on microeconomic reform was needed to cultivate a responsive supply side.

I had come to this country from different economic traditions, having worked with the German Council of Economic Advisers and the Kiel Institute of World Economics on supply growth and industrial structural change. I had also worked in East Asia where the mobilisation of labour, capital and knowledge for supply growth was all the rage. Like other outsiders, I was struck by the poor long-term productivity growth in this country. Australia was well endowed, politically stable and young, and it was located near the newly dynamic East Asian region. It should have been growing by 5% a year or more. In reality, it was not even managing a growth of real per-capita incomes of 1% during the second half of the 1970s.

Despite sluggish productivity and poor output growth, the growth problem hardly figured in academic courses or professional publications. Further afield, there was much 'lucky country complacency'. Only a few Australians identified tariffs and interventionism as the root cause of a spreading economic malaise. By the late 1970s, academics such as Trevor Swan, Colin Clark, Heinz Arndt, Max Corden and Colin Simkin were pointing out that tariffs and other market interventions were responsible for the harmful structural rigidity ultimately hurting Australian citizens.

But the political elite did not recognise the problem, let alone accept the remedies. Parliamentarians, officials and lobby groups remained ignorant of the fact that economic growth—like any other organic evolutionary growth process—requires constant and systematic adaptation, and that proliferating interventions ossify economic structures. Few realised that producers have to adjust existing structures and relationships to changing demands, new supply scarcities, fluctuating prices and new technical opportunities, and that the political protection of existing industrial and union jobs causes unemployment. Few policymakers—let alone the press—understood that improvements could be achieved only by freeing up markets.

Arguably, the most effective voice preaching the merits of markets and economic freedom was that of the 'Modest Member of Parliament', later 'Modest Farmer', Bert Kelly. Still a newcomer to Australia and feeling intellectually rather lonely among the economists at the Australian National University, I soon came to appreciate the humane and commonsense manner in which Bert presented complex economic problems and obvious solutions (Kelly 1981). Bert kept exposing the errors of the prevailing inward-looking mentality by pointing to the growing costs of the closed economy.

To my mind, standard macroeconomic growth theory could not explain Australia's poor track record: the economy was exceptionally well supplied with virtually all production factors considered essential for economic prowess. Capital, labour, technical knowledge and natural resources were abundant. Indeed, there were no obvious macroeconomic supply limits to growth if one took Australia's access to world factor markets and immigration into account.

Australia's long-term growth problem became clearer when one looked at structural microeconomic rigidities and an evident lack of entrepreneurial interest in exploiting new opportunities. This was the consequence of a pervasive politicisation of economic life. Once it was recognised that economic growth had a microeconomic dimension, it was obvious that poor growth was caused by 'tariffs on demand'—often granted as soon as an industry came close to even a whiff of international competitive pressure—as well as the regulation of international capital flows and labour markets, and the preferences given to well-connected and privileged interest groups.

In the 1970s, there was not much genuine innovation and outsider competition. New obstacles to structural adjustment were emerging in the form of the oil crisis, stagflation, balance-of-payment imbalances, a growing proclivity to strike, and popular fears of rising unemployment. The Whitlam government aggravated the situation through inflation and debt making. Nor did the Fraser government do anything to make the supply apparatus more responsive and elastic. It only fought persistent inflation through demand-side policies, in particular stolid and unimaginative monetary restraint.

### *The Long-Term Benefits of Free Markets*

In order to highlight the need for a more flexible supply-side and to show what was at stake over the longer term, I depicted plausible long-term scenarios with widely divergent growth paths to the year 2000, depending on the extent of microeconomic reform[5]. The use of long-term growth scenarios dramatised what theoreticians called 'third-factor growth': different systems of economic

[5] W. Kasper, 'Australia's Options', *Australian Financial Review*, 7 December 1977, pp. 2-3 and 41, and W. Kasper and T.G. Parry (eds), 1978. The book had the title *Growth, Trade and Structural Change in an Open Australian Economy*. Because of the term 'structural change' in the title, the book was initially classified by one of the ANU libraries under Civil Engineering. Such was the state of Australian economics at the time!

institutions allow enterprising people to find, test and use knowledge to differing degrees, so that the same amount of work effort and saving sacrifice produces greatly differing results in terms of national product. At the time, Australians were saving relatively large amounts and working rather long hours, but attained poor output growth[6]. Simulating some plausible long-term scenarios seemed the politest way of saying to Australians that many of economic policies looked rather dumb!

The only official reports that tied protectionism and regulation to poor growth in the 1970s were those of the Industry Assistance Commission. Treasury officials who had served overseas were also critical of the closed economy, but only in private. Australian academics were not very convincing when they argued for free trade, because they analysed the problem according to static neoclassical theories, using patently unrealistic and hence unconvincing notions of production, specialisation and exchange.

The most important argument against tariff protection is that it hinders competition and learning, and with it the evolutionary capacity of an economy to exploit knowledge. By assuming that all production knowledge and all consumer preferences were already known, the essential knowledge discovery argument for free trade was assumed away! This was the case with the government-sponsored econometric IMPACT model, which was closed to unforeseen discoveries. By its very conception, this static and simplistic model was ill suited to analysing major structural adjustments and the complex and open-ended phenomenon of growth.

The development of different growth scenarios was based on an understanding of the important role of economic competition. In open and competitive markets, suppliers rival with other suppliers and buyers with other buyers. On both sides of the market, people invest assets and skills so that they are able to strike an advantageous deal with people on the other side of the market. In other words, they incur transaction costs. These costs are of course unwelcome, and the outcomes of these competitive efforts are risky. But if the rules force the majority of the community to bear the transaction costs of competing by searching for and testing useful knowledge, the economy will grow (Kasper-Streit 1998, ch: 8; Kasper 1998: 76-95).

Some people will occasionally be unlucky and incur losses despite their best efforts. Exploring and using new knowledge is, after all, a risky business. Others will try to shirk the obligation to compete. However, if everyone acts entrepreneurially—i.e. uses their assets in knowledge exploration—the chances that most will succeed are enhanced. Prosperity then follows and growth

6 As a consequence, I was invited to do some work for the Crawford Inquiry into Structural Change, but was to discover that no-one on that inquiry shared my predilection for free markets. Indeed, they recommended in 1979 that structural adjustments should be held up by interventions until unemployment had again fallen below 5%. I was sure that without structural adjustment such a low unemployment rate could never be attained again. Alas, I proved to be right.

becomes self-reinforcing. Conversely, the more political interventions exempt some groups from competing, the more everyone's chances of success are diminished, and the less the economy will grow.

Even with hindsight, this positive and normative understanding of competition, rent-seeking and economic progress still seems highly relevant, both to the past and the future.

### *The Crossroads Study*

In late 1978, Shell Australia invited me to join a small team to debate these and related issues. The 'Crossroads Study' (Kasper et al. 1980) analysed past trends and identified major changes and trend breaks. Alternative futures to the year 2000 were examined (a) under a status quo setting of policies, and (b) with comprehensive liberalisation.

This exercise in futurology was loosely underpinned by the theory of long waves of economic growth (Kondratieff cycles), which owed much to the writings of Joseph Schumpeter. While Schumpeterian theories fit poorly into the prevailing orthodoxy of equilibrium economics, they offer relevant and constructive insights into entrepreneurship, competition, innovation, and political rent-seeking.

Long-wave theory shows that economic evolution is not a simple and linear process, but a complex interaction of social, demographic, technical, political and economic factors. Growth proceeds in generation-long accelerations: young relatively unregulated industries join existing production structures, followed by ten to twenty years of deceleration, when defensive social and political forces hold up the transfer of new ideas into innovations. The American economist Mancur Olson, who had just been to Australia, highlighted the interaction of political cartels and lobby groups in slowing economic growth, although he did not place his theories in a long-wave context. Nor did he allow for economic crises triggering overdue institutional innovations (Olson 1982).

A plausible hypothesis in the late 1970s was that rising social and industrial tensions and stagflation were typical symptoms of a Kondratieff slowdown, similar to previous episodes such as Australia's land crash of 1888 and the depression of the 1930s. In the Crossroads study, the key challenge for Australian policy was to catch quickly the next upswing of long-term supply. At the time, we saw a new growth wave approaching, driven by internationalisation and technological changes, in particular data processing and communications, energy saving, new materials and biotechnology. We were hoping that Australia would be among those who caught the growth wave early (Kasper et al. 1980: 95-170).

### *From the Viewpoint of 2000: How to Prepare for a Slowdown after the Present 'Globalisation Wave'?*

Australia has come a long way since the closed economy settings of the Menzies to Fraser era. The country is now a much more open, adaptable, individualistic and self-assured nation. Alas, the transformation came about more slowly and less completely than was hoped in the Crossroads study. That it occurred at all was probably due mainly to powerful trendsetting shifts in the international economy, instructive policy successes elsewhere (Reagan, Thatcher, East Asian Tigers) and some of the technological changes we had predicted.

The conservative and inward-looking stance of the Fraser years prevented Australians from catching the incipient upswing early. Thanks to the reforms of the early Hawke-Keating years, however, growing numbers of Australians were able to ride the upward trend in supply growth during the 1980s. They did so much more successfully and spontaneously than people in some more hidebound polities, such as Europe and Japan. There are some concerns that the upturn has not carried everyone forward in equal measure, but this rarely happens. As a consequence, there are regional and social pockets of people who have been left behind. However, this is not a reason not to welcome widely beneficial competition, structural change and innovation.

If one subscribes to notion that long-term economic and institutional development proceeds in waves, several key questions can be posed:

- Earlier Kondratieff downswings invariably surprised and disappointed a generation used to 20 or 30 years of seemingly automatic growth and rising stock markets, interrupted only by weak short-lived recessions (see Insert on Kondratieff Cycles, pp. 7-11). Can we expect a new downwave in or after the first decade of the millennium? Are there early warning signs? Or is such a mechanistic reading of the long-wave theory inappropriate because the infotech revolution has changed economic life for good?
- If a Kondratieff downturn is to be expected, what are the forces that create it and can they be attenuated? What can Australians do to buck a global downtrend and protect themselves in times of international adversity?
- In any event, has the reform agenda of the late 1970s been completed? And are there new items that should be put on the agenda of reformers in the opening decade of the new century?

This kind of thinking about our economic past and future does not imply an 'iron law of history', which would make a future deceleration of economic growth inevitable. But history cautions us to be on the alert while the going is good, as is currently the case. Periods of easy economic growth are typically times when social-economic contradictions build up, producing subsequent crises and disappointments. Although history never quite repeats itself, ignoring certain broad patterns of historic interaction is a surefire way to ensure that past pain will revisit us. Put differently, just as the conservative, complacent and protective Menzies era laid the basis for the economic pain of the Whitlam-Fraser years, so will the fundamental settings of the coming decade influence the economic fates of the 2010s and 2020s.

### *Kondratieff Cycles—A Thumbnail Sketch*

In the late 19th and early 20th century, a Russian statistician, Nikolai Kondratieff, looked into the terminal crisis of capitalism that Karl Marx had predicted. Kondratieff found that Marxian crises were not terminal after all, but were followed by phases of rejuvenation. In reality, capitalist economies went through long waves of accelerating and decelerating growth. Later, the Austrian-American economist Joseph Schumpeter (1939) called these long waves 'Kondratieff cycles'.*

Although no long-wave cycle replicates its predecessor, some broad, underlying patterns of development emerge from the history that Lord Chesterfield once considered 'only a confused heap of facts' (see Table 2; Freeman 1982, especially the article by Glismann et al., and Kasper et al. 1980: 8-14). These broad patterns do not resemble the waves that physicists observe on cathode tubes, but they nevertheless can serve to identify more or less probable developments in the medium-term future. At the very least, they should warn us against extrapolating the recent past in linear ways and remind us that the maxim 'what goes up must come down' is a more appropriate way to think about medium-term economic evolution.

The growth acceleration predicted for 1980 to 2000 on the basis of this theory in the Crossroads study fitted the pattern. Accelerations are created by low and stable real interest rates, low prices and secure supplies of raw materials, and a lessened degree of industrial relations conflict. This makes it easy for investors to plan ahead and anticipate strong profitability. At the same time, past economic difficulties trigger political reforms to make the institutions more market-friendly. All this

* Kondratieff (born 1892) challenged Lenin in intellectual debate about the critical issue in Marxian theory whether a crisis of capitalism had to be terminal. In the late 1920s, he made the fatal mistake of resuming the argument with Stalin. He vanished. Only after the crisis of Soviet state capitalism had proven to be terminal, was it discovered that Kondratieff, declared 'mentally ill', perished miserably in a Siberian camp, aged 38.

encourages entrepreneurs to risk implementing new and promising technologies, sometimes even new industries. Innovating entrepreneurs in one industry then frequently benefit from the development of new technologies elsewhere (Schumpeter [1961] speaks of the 'swarming of entrepreneurial activity').

Thus, the current economic growth wave depends not only on the development of new computer chips and other items of hardware, but a burgeoning software industry, the communications revolution of the Internet, and numerous entrepreneurs in entertainment, finance, logistics and marketing who exploit new opportunities. Typically, industries expand into areas that are not yet regulated. During 20 to 30 years of accelerating growth in the supply potential, people experience many positive surprises. The booms of the short-run demand cycle are long and strong. Share and other asset prices rise to great heights. Recessions are short-lived and mild.**

As the Kondratieff upswing progresses, the integrated international trading system spreads to new industrial countries. Thus, the acceleration of the mid-19th century turned France, Germany and the United States into 'new industrial countries' (Table 2 opposite). They then challenged Britain's political and military pre-eminence. The following upwave made Japan and Russia/Soviet Union into new industrial countries that subsequently challenged the international 'pecking order'. The upwave of the 1950s to 1970s led to the rise of the East Asian new industrial countries.

Typically, subsequent down phases do not greatly affect the new industrial countries. Their relatively new production apparatus makes it superfluous for them to engage in the 'creative destruction' of old superseded industries. Thus, the Soviet Union continued to enjoy economic growth during the 1930s. This had nothing to do with a superior growth capacity of socialism—as we learnt in the 1970s-1980s when the USSR had become an old industrial country and suffered a typical Marxian crisis of (state) capitalism. Lacking the capitalist market economy's capacity to self-rejuvenate, the socialist system collapsed.

After a generation of accelerated growth, contradictions and obstacles gradually build up in fast-growing economies. These lead to slowdowns lasting maybe one or two decades, that is periods of widespread economic disappointment.

Bottlenecks of labour and raw material emerge. These lead to slowdowns which last a decade or two (example the 1970s/early 1980s).

** The familiar three to five year business cycle in demand must not be confused with the long-term waves of supply growth (Kondratieff cycles), which last 40 to 50 years.

## Table 2
## Long Waves of Economic Growth: Broad Historic Patterns

| Timing | Leading innovations | Lead industries | New industrial countries |
|---|---|---|---|
| Industrial revolution | Stationary steam engine | Iron industry (UK) | England |
| | Mechanical weaving | Cotton textiles (UK) | — |
| Upswing: 1787-1815 | Rolling of cast iron | Food exports (US) | NW Europe |
| Slowdown: 1815-1842 | Deep ploughing/mech. sowing | | — |
| | Crop rotation | First railways | NW of USA |
| | Modern banks, stock company | | — |
| 'Bourgeois Kondratieff' | Mobile steam engine (ships, rail) | Iron and steel industries | USA |
| | Improved blast furnaces | Railways | France |
| Upswing: 1842-1878 | Open-hearth steel (Bessemer) | Mechanical engineering | Germany |
| Slowdown: 1878-1897 | New iron casting techniques | | — |
| | Sewing machine/agricultural implements/circular saw | | — |
| | Industrial norms and standards | | — |
| | Gold standard | | — |
| | Foreign investment | | — |
| 'Neo-Mercantilist Kondratieff' | Electric light and motors | Electrical industries | Russia |
| | Telegraph, telephone | Chemical industry | Japan |
| | Chemical acids/bases | Machine tools | Italy |
| Upswing: 1897-1920 | Synthetic fertilizers | Urban mass transport | — |
| Slowdown: 1920-1950 | Internal combustion engine | Shipping | Australia |
| | Harvesters | Automobiles | Canada |
| | High speed steel cutting | | (France, US) |
| | Underground rail | Consumer durables | (US) |
| | Urban sewerage, lighting | Aviation | — |
| | General franchise, commercial law | | — |
| 'Northern-Hemisphere Integration Kondratieff' | Cars & aircraft in mass transport | Auto industry | Mexico |
| | Aerospace, jet, helicopters | Aircraft | Brazil |
| | Plastics, synthetics | Petrochemicals | India |
| Upswing: 1950-1965 | Automation | Electronics, TV | Coastal China, Taiwan |
| Slowdown: 1965-1980 | Containers, pipelines | Health, education | South Korea |
| | Industrial conglomerates | International finance | Hong Kong, Singapore |
| | | Tourism, entertainment | Hong Kong, Singapore |
| 'Global Infotech Kondratieff' | Computer hard and software | Computers & telecom | Malaysia, Thailand |
| | Networking of computers | E-commerce, infotainment | Inland China |
| | Telecom, radio spectrum, space | GM agriculture, medicine | More of India |
| Upswing: 1980-2005? | Biotechnology (gene modific.) | International finance | Java |
| Slowdown: 2005?-? | Energy saving | Fuel cells | ??? |
| | Nanotechnology | | — |
| | Deregulation, privatisation | | — |

*Sources*: Schumpeter 1939; Kasper et al. 1980: 10-11, and author's own updates.

Capital becomes scarce, raising real interest costs (Kindleberger 1989). Distributional conflicts in the urban-industrial sector further reduce profitability—and with it the readiness of entrepreneurs to take up promising new technologies, as Karl Marx had described under the rubric of 'class warfare'. Optimistic expectations of innovators are disappointed and imitators wipe out the pioneer profits of the original innovators. Innovation slows down as businesses shift to defensive strategies to secure market share. Public opinion and the agents of collective action, who seem to assume economic growth is limitless and automatic, then turn from the production to the consumption and redistribution of wealth. Politicians side with established interest groups against new outside competitors with protective, redistributive and anti-competitive interventions. This further limits profitability (as it did during the Whitlam-Fraser era).

As growth stalls, the prevalent social mood (*Zeitgeist*) shifts further from can-do optimism to securing and defending existing positions. Morbid social comments become bestsellers: Robert Malthus' prediction of terminal overpopulation, Karl Marx' prediction of the end of capitalism, Spengler's *Decline of the West* (during the 1930s), and *the Club of Rome* (during the 1970s). In subsequent Kondratieff upturns, such analyses lose popularity. Thus, the *Club of Rome* is in the process of being dissolved in 2000.

As a Kondratieff upswing matures, protective and reactive attitudes tend to make it easy for 'political entrepreneurs' to implement programmes and rules which hamper the chances of new entrepreneurs and which favour established interests. There is a shift from risking experiments to security. Figuratively speaking, more and more roundabouts and speed bumps are built into the system by political operators and lobbyists. No wonder the traffic slows down!

Mancur Olson aptly described this process in the wake of the 1950s/1960s upwave (Olson 1982). The shifts in institutions and their enforcement do much to increase the obstacles to innovation and limit the opportunities for entrepreneurs who want to pioneer new technologies and new markets. Only when the Kondratieff downturn has had a sobering effect will readiness to reform institutions return again. The Thatcher and Reagan reforms and the worldwide deregulation and privatisation wave of recent decades are typical children of preceding Kondratieff slowdowns.

Seen through the eyes of the economic theorist, phases of decelerating growth present themselves as periods in which the elasticity of the supply system decreases, so that a given demand expansion results in little real growth and much inflation. Phases of accelerating growth, by contrast, are typified by more elastic supply, i.e. more real growth and less inflation.

But this is only a proximate explanation of the Kondratieff phenomenon. The underlying explanation, which should be kept in mind to guide public policy, turns to long cycles in institutional evolution: Competition- and innovation-friendly rules facilitate subsequent growth accelerations. Institutional degeneration and the protection of established interest groups make for economic sclerosis and a slowdown.

Unfortunately, the recognition lags are so long and often irregular that growth waves are very hard to avoid.

## B. 1975-2000: Impressions of History

*The International Scene*

Seen from a long-term historic and global perspective, the last quarter of the 20th century was a period of re-accelerating growth following the oil crises of the 1970s and early 1980s. It was also a time of pervasive and intensifying conflict between increasing openness (globalisation) and the wish of many to avoid competition with outsiders. This kind of conflict is nothing new, but the speed of adjustment to new outside competitors has arguably reached a new intensity. This adjustment burden impacts above all on those whose human and physical capital is invested in old industries, as these come under competitive pressure from fast-learning new industrial countries, specifically in East Asia. Another major part of the adjustment burden comes from the infotech revolution, which has made many services—for example, finance, accounting, insurance and design—internationally tradable for the first time in history. Volatile international movements of short-term capital and growing direct international investment also heat up the competition, as savers diversify their holdings among different jurisdictions. These processes are being driven by the drop in communications costs and the greater ease of decentralised communication.

Reactions to these technical changes differ, as they always do. Many have grasped the new opportunities which globalisation offers. Others focus mainly on the threat to familiar lifestyles and ways of doing things. Yet others, not least the politicians and bureaucrats, feel outraged that democratically elected governments are increasingly subjected to the daily verdict of international investors and multinationals. Many ordinary voters and small business operators, however, feel empowered by the new competition among jurisdictions. For the world as a whole, the opportunities have obviously outweighed the costs. Otherwise we would not have registered a growth in the real value of world production per capita by more than one-third since 1975.

Globalisation has benefited the income potential of many who operate locally and who have acquired new skills. Lower transport costs and better and cheaper communications have allowed great gains in specialisation and advances in innovations across a broad range of activities, reflected in economic growth. This has benefited not only those who are directly involved in international exchange, but also those who provide local goods and services—the plumbers, beauticians, repairers, providers of personal health and entertainment services and so on. Many workers who used to be employed in protected inefficient industries have found new jobs in the rapidly growing service sector. The gains from opening the economy over the past quarter century, through globalisation and deliberate policy choices, have thus been widespread. Trade shares in production and demand rose, with at least two million Australian jobs (about a quarter of all employment) now depend directly on foreign trade.

Australian gains from globalisation were also increased by the wiping out of the 'tyranny of distance' and by the shift of the centre of gravity from the (North) Atlantic back to the (North) Pacific, namely closer to our time zone. This has had the predicted consequence that events in the outside world now affect Australians more immediately than they used to.

### *The Demise of Totalitarian Socialism: Sea Change in Global Politics*

What was not predicted, and arguably was not predictable, was the epochal change in global politics and security after the demise of the Soviet empire. It was apparent to astute observers that the crude economic coordination system of state ownership and central planning could not cope with the demands of an increasingly complex and dynamic modern economy. The Soviets were able to send up sputniks, but ordinary coordination tasks such as supplying consumers with fresh vegetables eluded them! As clear-thinking free-market economists such as von Mises and Hayek had predicted all along, this fundamental problem triggered the rapid unravelling of the Soviet Union and its empire. The result was the geopolitical surprise of the last quarter century. Like all such surprises, it made the future less simple and secure. The old certainties of the big bloc balance of deterrence gave way to greater diffusion and less clear-cut political associations. The relief from the fear of major nuclear war and confrontation in central Europe or Korea was traded for regional conflicts, including conflicts over eternal issues such as race and religion (East Africa, the Balkans, Melanesia-Pacific), unsettled border disputes (such as Kashmir), and central control (such as in Indonesia and to some extent in China).

From the Australian point of view, the international security position has not necessarily improved despite the lessening of the threat from totalitarian socialism. The American alliance has become less 'load-bearing', at least in lesser regional conflicts, and the opportunity for a degree of free-riding in defence has diminished with the end of the cold war. The American stance on Australia's East Timor involvement in 1999-2000—sympathy but very limited material support—is an indicator of things to come.

The other epochal change occurred in the People's Republic of China. No one could have predicted in 1975 that xenophobic inward-looking Communist China would convert to a partially open economy, where government is claiming a smaller share of national output than in most European economies. No one could have anticipated that China would be the site for the biggest privatisation in history, giving 600 million peasants control of the land they till. Segments of the state industrial sector are now left to whither on the vine. Ambitious young people make careers in business, often networking around the world, and shun the privileges of Communist Party membership. The effects of the abandonment of socialism in all but name in China on world economic growth, trade and investment have been tremendous. Urban coastal China is rapidly developing an educated and sophisticated bourgeoisie and will be quite a different entity from what one might have expected two or three decades ago.

So far, the Chinese economy has propelled pent-up demand and opportunities into easy technical imitation and catch-up, despite its deficient economic, civic and political institutions. Once fast-growing supply saturates demand, these institutional deficiencies will create serious problems—a crisis to dwarf the events in East Asia in 1997-1999 is imaginable. Whether the end of this easy growth will trigger a politically assertive response from China's new middle class is still unclear. But political and social change in China will lead to contestation. This must be considered as one of the important imponderables of the next quarter century (Chapter 3).

The economic setbacks in several major East Asian countries after 1997 have highlighted their institutional deficiencies. It was relatively easy to copy the knowledge and structures for rapid growth in agriculture, mining and manufacturing and to build modern infrastructures, as long as imported blueprints could be imitated and land and labour costs stayed low. At the same time, progress in building skill capital in technology and management has been impressive. But these material conditions of economic growth must sooner or later be matched by improved 'software of development': ethical and legislated institutions that create trust, suppress discrimination and cronyism, and keep the transaction costs of doing business and innovating low (Kasper 1994).

The development of an 'institutional infrastructure' appropriate to a modern economy and mass society normally takes time and is fraught with accidents. As the global economy is still going through a vigorous Kondratieff upswing, many of the new East Asian industrial countries emerged rapidly from the setbacks of the late 1990s. But their apparent ease of recovery could prevent the thorough and necessary recasting of the political and economic rules. A postponement the thorough and necessary recasting of the political and economic rules. A postponement of institutional reform in East Asia would make the next Kondratieff deceleration a time of living dangerously, in particular for those Australians whose fates have become more closely tied to the stability and the prosperity of the region.

Economic, social and institutional problems are acute in neighbouring Indonesia. Its return to fast growth, not to mention its very national cohesion, is threatened by corrupt institutions. Excessive centralism in the 'Javanese empire', the corrupting 'dual function' of the military (in defence as well as in political and industrial affairs), an uneven commitment to the open international trading order, barriers to international competition that benefit crony capitalists, and insufficient checks and balances on government power are all cause for concern. Reform of Indonesia's institutions is a daunting task, but one in which Australians have a direct stake. If the reforms go wrong and entrenched power groups revolt, Australia's external security will be directly challenged. Yet Australians can do little but watch with sympathy. They must not pretend that they can do more.

### *Security*

Over the past 25 years the threat of direct military aggression has steadily declined. To protect our freedom of sovereign choice in the future, the equipment and organisation of Australia's military defences had to be changed significantly. Now it appears conventional military conflict may be going out of fashion. Where centrally coordinated military conflicts occur, technology may lead to 'wars without fighting'—high tech bombardment from afar or a great height, and operators on a computer screen rather than frontline soldiers who risk their lives. However, non-conventional and more diffuse conflicts have been on the rise. Terrorist and guerrilla attacks, insurgencies, militias, and organised crime networks are often motivated by religious and ethnic extremism or economic and social disintegration. Over the past quarter century, these security threats have cost more human lives than conventional combat. And it is likely that these threats will reach Australian shores.

The growing flow of illegal immigration indicates one limit to national sovereignty. Many of these immigrants have considerable financial resources, a good education and the means to reach Australia. It is likely that they are only the early harbinger of greater migration. The more our traditional welfare state acts to attract internationally mobile people, the more adjustment strains will be placed on it. Illegal immigration could also become a strain on social cohesion. Some groups argue for ready admission and generous material help to new arrivals. Others agitate for exclusion. A related issue is the illegal importation of drugs. Of course, more porous borders are a worldwide phenomenon, but the cultural and administrative strains of coping are bigger in Australia than in North America, and maybe even Europe, where there has been a longer experience of illegal border crossings.

Another area where the power of national governments for sovereign action has been diminished is in the growing challenge from internationally networked advocacy NGOs[7]. They now exert influence over policy, often by conducting anarchic and violent campaigns. Many participants do not seem open to rational argument and are committed to single issues rather than the complicated trade-offs and compromises upon which a prospering modern community rests. These Single Issue Promoters (SIPs) thrive in an atmosphere where fundamental values are not widely and expressly shared and where the understanding of how government and economy function is generally poor. They benefit from an climate in which political correctness counts for much and rational open debate for naught.

Many global single-issue campaigns are financed, partly or wholly, by foreign governments and international organisations, such as the European Union, UN bodies and other supranational organisations lacking electoral legitimacy. In return for subsidies and even quasi-diplomatic status, they offer non-elected supranational proponents of collective action, such as the European Union and UN, an audience and a degree of pseudo-legitimacy, typically demanding actions these bodies want to promote (Rabkin 1999).

Yet the SIPs habitually overlook the problems that their sponsors are causing. For example, heavy subsidies have contributed to over-fertilisation and the spoiling of Europe's water systems, but the EU's common agricultural policy has never been attacked by 'green' advocacy groups as environmentally harmful. Nor has agitation against 'Frankenstein food' (genetically modified food) been recognised as a ploy to strengthen and prolong the wasteful and ecologically harmful European agricultural policy. Likewise, agitation on 'greenhouse' gases and attacks on free trade promise to hamstring Europe's competitors who supply coal and manufactures, such as Australia and developing countries. Anyone doubting the client relations of many SIPs with the EU should nominate just one issue on which Greenpeace and other advocacy groups have gone against the interests and policies of the European Union. We shall return to this issue in Chapter 5.

### *Partial Partisan Reforms under Hawke-Keating*

After the economic debacles of the Whitlam era, the conservative-*dirigiste* Fraser government persisted in protective obstinacy. This prolonged the

[7] The term 'non-government organisation' (NGO) has become an inappropriate misnomer. Moreover, a distinction has to be made between advocacy groups and action groups who implement benevolent programmes, often with the support of government finance. To avoid confusion, we shall refer to the international advocacy groups as Single Issue Promoters (SIPs).

economic slowdown. The consequences of Fraser's retro-economics, however, were overturned in the 1980s by selectively reformist Labor governments. The Hawke administration embraced economic reforms in a number of areas, some of which had been contemplated but not acted upon by its conservative predecessor.

The reforms were directed at the capital market in the first instance, which was not part of Labor's traditional constituency. Domestic banking, investment and financial services were deregulated, and international flows of money and investments were liberalised. The exchange rate was set free. Australian savers were now able to move their financial assets freely to countries that looked promising, and borrowers could raise loans overseas. The process was sometimes costly, but ultimately valuable lessons were learnt. Australia's previously hidebound financial and capital markets matured into world-class players. Lessons were learnt by the regulators, as many entrepreneurs tested the limits of ethical and formal rules, with some falling foul of debtors. Bankruptcies by Australian entrepreneurs in the 1980s diminished the international creditworthiness of Australian borrowers as a whole. However, as capital markets learned to live with greater freedom and responsibility, an innate flexibility and resilience developed in capital markets. It now facilitates new enterprise and can absorb outside shocks, such as the impact of the Asian financial upsets of 1997-98.

In product markets, much was done to reduce tariffs in the least disruptive way possible. Tariffs were pared back, by and large, across the board and in preannounced and gradual steps. This policy helped to control inflationary pressures. The government strove to give some of the most heavily tariff-favoured industries additional assistance in the hope of preserving jobs ('Button plans'). On the whole, active industry policy interventionism was costly and unsuccessful in maintaining senescent factories. But it may have bought off influential industrial players with taxpayers' money, made the trade liberalisation more feasible and helped politically. Other domestic product market restrictions and state-sponsored marketing boards for Australian agricultural produce were also scaled back, but many remained.

The tariff cuts had the predicted effects: import prices came down. This created many unforeseen business opportunities in activities that depended on low input costs of traded goods. For example, at least three quarters of everything in Australian hardware stores is now 'made in China', since buyers voted for these goods with their dollars. Australians can now buy tools of better quality than those the old domestic import-substitution industry used to churn out.

This in turn improved our international cost competitiveness. Tariff cuts gave us better-quality, petrol-saving cars and trucks. Families with children enjoyed a sizeable drop in the prices of children's apparel. Australians have possibly forgotten how much the variety and quality of consumer goods has improved over the past two decades, not only because more foreign products were added to the basket, but also because local producers responded to the international competitive challenge by innovating. Australians may remember the 'import substitution cars' of the 1960s and 1970s with the nostalgia of selective hindsight, but they should not forget that the average small car cost about $28 000 in today's money, before tariff-reduction pressures triggered a rationalisation of the Australian car industry.

### *Economic Rationalism*

The term 'economic rationalism' has become an all-purpose invective in Australia.

At one level, attacks on economically rational policies seem quite silly, just as it would make no sense to attack a rational engineering design which ensures that a bridge stands up! Private and collective actions that are economically rational are intended to achieve outcomes that are valued by sufficient numbers of citizens to justify the sacrifice of scarce means for that specific purpose. Economic policies are rationally designed if they give effect to what most of us want. Communities that consistently act with economic irrationality soon violate other fundamental aspirations, such as security, justice, peace and a sustainable natural environment.

At another level, the criticism seems justified. It is directed at simplistic assessments of costs and benefits that are presumed to be known, but that in reality cannot be—not by Treasury, the Australian Competition and Consumer Commission, or the Productivity Commission! A narrow end-means rationality—known resources being used to 'maximise' known objectives—should not be applied to complex policy issues. Virtually any policy intervention has unexpected and often prejudicial side effects that cannot be captured by simplistic textbook models that assume that 'other things remain equal' (Kasper 1998: 34-36).

The narrow economic rationalism based on static models should certainly not be applied to issues of long-term growth where the discovery of new means and new resources is the core issue. All too easily, the 'rational' analysis excludes entrepreneurial activities aimed at discovering new means and new objectives. Economists lose popular credibility when they fail to recognise that entrepreneurs do not rationally maximise returns to known resources. Their business is to find and test additional resources and yet unknown wants. Economists need to acknowledge openly that the prevailing economic orthodoxy is built on a narrow end-means rationality. This makes it easy to build abstract models, but makes economists sound unrealistic to the average person and policymaker.

Despite the generally beneficial effects of deregulation and its associated privatisations, there was, of course, opposition. Intellectual collectivists criticised 'economic rationalism' (see box on previous page) by belittling material ains and stressing higher social goals such as a more equal distribution of wealth and income, 'green' issues and Aboriginal reconciliation. They argued that attainment of these goals was harmed by policies aimed at unlocking productivity and choice. The intellectual collectivists were in league with established interest groups, which invariably reflect the power structures of the past. Reforms were opposed by some industry lobbies, such as car manufacturers, business people with good political connections as well as regional coalitions of organised labour, industry and the political leaders of backward areas. The losers made themselves heard in the media, while the winners in the powerhouses of the new era, such as the wider Sydney region, the Queensland coast, and Western Australia, were too busy competing and producing. Opportunistic politicians catered to the demands of outspoken interest groups.

Tariff cuts were frequently blamed for developments, although the same thing happened elsewhere without tariff cuts. For example, the widening gap between the incomes of unskilled workers and the new knowledge workers, who grasped the opportunities of the new Kondratieff upswing, is a worldwide phenomenon. In Australia, however, it was blamed on tariff cuts. But this is not a matter of the old Marxist mantra of the 'rich getting richer and the poor getting poorer'. Rather, it is the consequence of some 250 million new industrial workers, mainly in Asia, joining the global competition in manufactures. Australian workers now have to compete with lower wages, improved skills and increasingly modern capital equipment. However, workers in old industrial countries like Australia have often been hamstrung and unable to compete due to inflexible workplace regulations, union ties, poor management, aging capital stocks and increasingly high wages and taxes. These obstacles hinder attempts by workers to move up the 'skill escalator', the only sustainable basis for rising living standards.

Despite some gains, market liberalisation under Labor remained partial and uneven. As a result, important segments of the economy remained trapped in the high-cost legacy of past protectionism. Had market deregulation been more evenly spread across the board, Australian manufacturers such as the motor industry, whose prices came down, would have experienced less of a cost and profit squeeze. More jobs would have been preserved even in these industries. Numerous Australian product and service markets were—and still are—far from free, that is open to all and subject only to essential health, safety and environmental constraints. Many services, such as the book trade, education, insurance and transport remain sheltered from genuine competition. As a result, the costs of transacting business in Australia did not fall as much as they would have had less effort gone into maintaining political alliances, for example with the unions and regulators.

Another set of political problems arose because deregulation and the disciplines of global competition have not fully reached regional Australia. Vast distances and high transport costs have so far prevented the spirit of the new global era from spreading to all the nooks and crannies of rural Australia. Many State government bodies and local councils are still overstaffed with people who do not realise that all government administrations are now competing internationally. Often they deliver poor services. Many local suppliers behave in the traditional monopoly mode, demanding high prices for poor quality and unreliable service. This uneven adjustment is causing unnecessary cost pressures. For example, world-market suppliers in agriculture, who still have to cope with protectionist restrictions in most overseas markets, also have to put up with costly local regulations and inefficient local monopoly suppliers. There are also disadvantages to producing in the hinterland, but technical change has also brought new advantages. It would seem that one way to enhance rural living conditions would be to spread the cultural change that has swept the world-market oriented centres of the country to more remote areas, including local government (Chapter 4).

Macroeconomic policy during the 1980s and 1990s provided a more stable and more predictable framework for individual economic pursuits. This was made easier by the gradual winding back of the worldwide, oil-fired inflation of the 1970s. It subsided when deregulation, tariffs cuts and unemployment made supply systems more flexible again, and when independent central banks in key economies implemented stricter policies. In addition, many product markets in Australia became more competitive, so that it became less easy for suppliers to simply pass on cost increases. Many firms had to abandon previously customary, quasi-monopolistic mark-up behaviour. Monetary stability also benefited from the floating of the currency, which strengthened the steadying hand of the Reserve Bank of Australia. The dollar could now be protected from imported inflation, and this focussed attention on who was to be held accountable for the stability of the Australian currency.

### *Sacred Cows*

Important areas were exempted from the creation of a new and more liberal economic order. Successive ALP governments (1982-1996) treated organised labour and the centralised industrial relations policy largely as sacrosanct. Collective bargaining and the partial central administration of wages and salaries were favoured over freely negotiated individual work contracts. The practice of collective but non-union bargaining by work teams, which spread in many overseas economies, was not allowed to make much of an impact in Australia. Instead, politicians and top union leaders assumed that a social contract—the Accord—between government, organised labour and employers would constrain aggregate wage increases, settle all arising disputes and accommodate all the ongoing changes in the diverse and complex labour markets throughout the country.

Fundamental economic theory and international experience with centralised wage fixing should have told policymakers that the undertaking of such an 'Accord' was far beyond the cognitive capacities and effective political or judicial control of any centralised body. A national economy is not an organisation where top-down commands are obeyed and enforced, but an incredibly complex, diffuse and evolving organism where much coordination occurs spontaneously. Predictably, the 'Accord' rigidified employment structures and work practices, and the retention of the centralised industrial relations model served to retard labour productivity and job creation. These rigidities, introduced into the supply system by the 'Accord', became a handicap as the diversity and speed of economic change grew.

Public welfare provision was another sacred cow that was more or less kept off the reform agenda. This created incentives for many not to act responsibly and hampered the reform of budget policy. Labor governments also increased transfers and subsidies to organised groups whose support government considered important, i.e. unions, green groups and ethnic communities.

Some State governments, who had been given greater fiscal freedom and could now borrow directly in international capital markets, could not resist the temptation to raise debt and spend up big. At a time when private Australian borrowers were also driving up international debts, the public sector added to the growing debt burden. As a result, the ratio of total external debts to gross domestic product approached the range where indebtedness had triggered financial crises in previous slowdowns of growth. This progression into debt was eventually halted by political intervention during the 'banana republic' crisis. Fortunately, the consequences of existing debt burdens did not become acute, because the global Kondratieff upswing made existing debt volumes more tolerable.

It is understandable that the ALP governments in the 1980s and early 1990s treated the public sector at all three levels of government as largely exempt from the discipline of globalisation. Public sector operators are not directly exposed to daily international competition, unlike farmers, miners and, increasingly, manufacturers. Officials therefore fail to recognise that the rules of the game have fundamentally changed and that they too have to compete now. The much-quoted 'primacy of politics over economic life' has come to an end, because the owners of capital and high skills can now move out of restrictive or poorly run jurisdictions.

The 'dollar votes' of capital markets are now demanding a fundamental psychological change in the public sector, from ruling to providing support services for internationally competing producers. This new reality is uncomfortable for some, but this is the future fate of Australian government administrations. Politicians and bureaucrats who accept the necessary functional shift in administrative style and adapt willingly can help us reap great material gain from the global division of labour and innovation. This will eventually translate into political gains for them. Communities that wish to fight the trend should take their cue from Cuba and North Korea.

It should be noted that some State governments engaged in substantial reforms during the 1980s to cut transaction costs and turn their States into more attractive locations for internationally mobile producers. Even Victoria—traditionally the epicentre of Australian protectionism and political 'correction' of market outcomes—switched from a defensive to a reformist policy stance once the Newell Highway to Queensland had become a one-way road for mobile citizens! Several other States and Territories persist with outdated mindsets and anti-reformist recalcitrance, since they are bailed out by fiscal transfers from the Commonwealth and economically more successful or fiscally more responsible States. The Federal-State financial transfer system, which was set up in the bygone era of the egalitarian 'Australian Settlement', remains unreformed and keeps rewarding poor performance. This undermines the discovery power of a genuinely competitive and decentralised federal system (Kasper 1995, 1996; Walker 1999; Hayne 2000).

After 1988, 'reform fatigue' set in. In other words, the institutional reforms that had been easy for Labor governments had been done and Labor's client groups began to resist reforms closer to their interests. As a consequence, Australians had to live with the openness of product and capital markets on the one hand and traditional regulatory regimes in labour markets and an unreformed public sector and socialised welfare regime on the other. Such inconsistent orders prove unsustainable over the longer term. Either regulations have to be refined or extended to shore up remaining 'islands of interventionism', or the government has to withdraw from all areas of the economy.

### *The Howard Government Widens the Ambit of Reform—Somewhat*

In the mid-1990s Australians voted for the Liberal-National coalition, who promised further reforms in previously sacrosanct areas. The Howard government upheld, by and large, the reformed regime in capital and product markets, made attempts to reform labour markets and addressed imbalances in the public sector, both with respect to debt and the tax regime. In a timely response to more dynamic and changeable financial markets, the government gave the Reserve Bank a greater degree of independence to set policies. This enabled the Bank to focus on the only objective that the producers of money can nowadays pursue, namely the maintenance of stable assets value. The Australian government has, however, failed to go as far as New Zealand in freeing the central bank from day-to-day political interference and in signalling this to world markets by a formally legislated new 'constitution' of central bank policy. This probably does not matter much at a time of growth, but it may prove a weakness in periods of international monetary turmoil.

Another reform of the Howard government was the attempt to enhance the transparency and accountability of the Commonwealth government. It introduced to government an accounting system that resembles what the legislator demands of business corporations. Governments must now account not only for cash flows, but for contracted receipts and expenditures. They must also document all their assets and liabilities ('accrual accounting'). When an official Commission of Audit handed the Treasurer and Minister of Finance an independent valuation report of Commonwealth assets and liabilities, it was revealed to what extent past Australian governments had been in the business not of value adding, but of value destruction. The Federal government was broke. Over the years, it had accumulated losses. In 1996, liabilities exceeded assets by no less than $73.4 billion (compared to $188 billion in government assets, National Commission of Audit 1996: xxii). Surprisingly, little has been made in public of this fundamental and important fact. And although a *Charter of Budget Honesty* was passed subsequently by the Federal parliament, it is rarely quoted in parliamentary debates. Perhaps budgetary honesty suits neither the government nor the opposition. It certainly does not seem to interest elected representatives of the people or the press, which is making little of this essential information about the nation's collective liabilities and assets. Perhaps accounting for the nation's collective wealth is not exciting enough, as that wealth belongs to no-one in particular.

There was also a shift in public enterprise management, which began in the Hawke-Keating era. Many government-owned enterprises at Commonwealth and State levels were corporatised, i.e. withdrawn from immediate day-to-day political intervention, and subjected to benchmarking on international best practice. Considerable government-owned assets were privatised, even for example in Defence provision, where there used to be enormous inefficiencies and lack of accountability. The self-sufficiency lobby was kept off-guard by successive moves to more responsible management. In the 1990s alone, Australian governments of various political hues sold off some $95bn of collective property (or $13,500 per household, see Walker & Walker 2000: 8, 20-23). The fact that this country appears to be one of the world's privatisation leaders relative to the national product is, of course, the consequence of a previously high degree of socialised ownership of the means of production.

Welfare reform was conducted in a piecemeal fashion by successive Australian parliaments, although it seems that not all administrative tightening decreed by Canberra has been followed through by effective implementation on the ground. It is less easy to live on welfare now than 20 years ago, but the rising trend in social welfare transfers has not been halted despite economic growth and job creation. Whereas some $500 annually (in 1997-98 dollars) was transferred from every Australian resident by coercive government measures in the mid-1960s, this figure tripled in the Whitlam era. It has since been creeping up inexorably to about $2,500 by the end of the century (Sullivan et al. 1999: 126). The redistribution of incomes from those who earn them in markets to those who depend on tax-funded handouts is therefore making the market economy increasingly dysfunctional.

Another consequence of proliferating welfare redistribution has been the flat trend of public infrastructure investments, the shift to the private provision of infrastructures and a relative decline in defence spending. In the future, welfare will again have to become a personal concern if economic freedom is not to be endangered by growing confiscations. As the Australian population ages, there have been some moves towards greater accumulation of self-funded superannuation. But by making saving compulsory, the Labor government obviated the need to address the underlying reasons for poor savings performance, such as the availability of cradle-to-grave social security, the socialisation of the costs of medical care and education, and the progressive socialisation of many other of life's normal risks.

The beneficial effect of private saving was undermined further by endless and vexatious rule changes inflicted on citizens saving privately for retirement or taking our private health insurance. These endless legislative alterations emanate from perfectionist administrators and rent-seeking parliamentarians, but they hamper long-term planning by citizens as well as private saving. This suggests that some may not wish to promote the material independence of citizens from the government.

In the late 1990s and early 2000s, the discussion of tax reform dominated political and public attention almost to the exclusion of other equally important issues. The underlying reason for widespread discontent with tax burdens is that successive governments relied heavily on personal income taxes to fund the explosion in public welfare. The unavoidable corollary of proliferating transfer programmes was that average Australian families have to pay for parliament's 'generosity'. Lower and middle-income households, which traditionally carried low personal taxes, were pushed progressively towards the top marginal tax bracket. Whereas it had taken an annual income 20 times the average wage in 1950 to fall into the top tax bracket, it took an income of only 1.4 times the average wage in 1998 (Sullivan et al. 1999: 130).

One technique by which governments typically transfer incomes from private citizens to their treasuries is the combination of inflation and progressive income taxation. In Australia, this technique was undercut by the comprehensive indexation of the tax system by the Whitlam government. This made it harder for the government to profiteer from inflation. More recently, the Howard government has partially stepped back from this position by reducing capital gains taxes rates at the same time as indexation was abolished. This is not a concern as long as the atmosphere of low inflation prevails. But if and when inflation picks up, government will win from this form of 'cold socialisation', i.e. of tax increases without parliamentary scrutiny.

The burden of the redistributive 'churning' of taxes and subsidies, by which some 19% of the national income is taken from and then redistributed to 'the battlers', rests inevitably on the shoulders of middle Australia. There are too few top income earners and they are too internationally mobile to carry the welfare burden. Neither will the shuffling from income taxes to GST disguise the fundamental truth that the brunt of welfare redistribution will always have to be borne by the bulk of Australian families.

The second Howard government was returned to office by the voters after announcing shifts in the tax structure from the traditional heavy reliance on personal and corporate income taxes to a general across-the-board tax on spending on goods and services (GST, at an initial rate of 10% in goods and service purchases by end-users). At the same time, the government made a pledge to simplify the archaic and distorting plethora of existing direct taxes and promised cuts in Australia's high personal income taxes. This followed from earlier legislated promises of cuts in some tax rates by the Keating government, most of which had of course not been kept. Australian governments can now enjoy a much broader tax base, and one that can be raised easily by parliaments, as the tax-rate creep in the European VAT regimes shows.

The introduction of the GST was also partly motivated by globalisation. High-income earners and corporations can move between tax regimes and jurisdictions, which means that national parliaments cannot impose excessive direct tax rates and compliance costs on them. Parliaments loath to reduce public expenditures and forced by high interest payments, taxpayer revolts and international debt monitors to curb their borrowing therefore have to increase the direct taxation of resident citizens, local services and the owners of land and other immobile resources. We do not yet know whether growing e-commerce and e-money will in future frustrate high-spending/broad-taxing strategies and whether lean and competitive government is the only sustainable response to globalisation (Chapter 4).

The Howard government attempted to make the liberal economic order more consistent across the various areas of the economy and hence more tenable in the longer term. However, for a government that had been in opposition for a decade and a half, the Howard government showed little principled commitment to comprehensive reform and a great readiness to compromise with the soft-populist Democrats in the Senate. Cabinet ministers demonstrated by their very actions that they did not believe in the fundamental liberal values they proclaimed in public speeches. Labour market liberalisation fell far short of the requirements of a globally competitive economy. Advisors failed to understand globalisation and, imbued with the collectivist spirit of the industrial relations tradition, produced the new and unnecessarily complicated 1996 *Workplace Relations Act* of 300 pages (no less!). It retained numerous holdovers from traditional central wage fixing[8]. Individual contracts made little progress, leaving most workers in big enterprises under union bargaining and administered wage fixing, despite the fact that only 20% of the workforce in private industry now choose to belong to a union.

The 'reform' set up numerous hostages to the deeply entrenched industrial relations industry, instead of simply applying the common law to labour contracts. Unsurprisingly, the Act did not stand the test on the waterfront. Another test it failed was the aborted attempt by BHP, long a protected monopoly in steel and hence a long-time supporter of quasi-judicial wage fixing, to shift its internationally competing mining operations to an individual contract basis in early 2000. These signal failures have inflicted widespread and long-lasting damage on employer confidence and job creation. Poor labour market institutions therefore continue to hamper productivity gains and wage increases. In international comparisons, industrial relations and labour management invariably show up amongst Australia's most pronounced competitive weaknesses.

The Liberal/National Party government showed little commitment to a consistent liberal economic strategy when it readily capitulated to car makers and motor industry unions who demanded—and got—a halt in preannounced tariff cuts for cars. Overdue plans for reforming the ailing 'unitary tertiary education system', which has more in common with Soviet planning than global competition for new knowledge, were dropped opportunistically in late 1999. Welfare reform was never pushed with much conviction in parliament. It seems that the reform commitment of the 'Dries' twenty years ago is now but a faint memory and that accommodation with the *status quo* is the real political priority. When economic growth is easy, politicians make opportunistic choices to secure existing positions and shirk difficult reforms. Unfortunately, such behaviour is the stuff from which the next Kondratieff downturn is made.

Taking all this together, Australia has entered the new millennium equipped with a somewhat more resilient set of economic institutions, but one which falls far short of what is needed for sustaining prosperity and full employment in the face of adversity. The weaknesses in our 'economic constitution' may not weigh all that heavily now, as we are surfing the current global growth wave. But they will prove a costly liability when global growth slows down again, as was the case in the late 1880s, 1930s and 1970s.

[8] The *Act* violates an important principle of institutional design in that it tries to match the complex reality of labour markets with complex rules. We know that the cognitive limitations of the human mind require simple, easy-to-grasp and easy-to-remember rules if people are to obey them. Complex rules are not only ineffectual, but also the source of unnecessary and costly transaction costs of mediation and litigation in markets (Epstein 1998).

### *The Domestic Consequences of Institutional Changes*

In concluding this synopsis of 25 years of Australian economic history, it seems useful to summarise the consequences of the institutional reforms of the 1980s and 1990s:

- Economic growth has not been overwhelming over the past quarter century, but nor has it been disastrous (gross domestic product rose by 1.8% p.a. after adjustment for inflation and population growth)[9]. Over this period, the growth trend accelerated slightly, reflecting Australia's belated participation in the new Kondratieff upturn. The growth acceleration also reflects the earlier 'deaths' of once-protected production capacities and the more recent and rising 'birth rate' of new capacities to supply world-competitive output. As of the late 1990s, Australia stands at about 19th place among nations in the ranking of real per-capita incomes valued at purchasing power, the most reliable measuring rod for such comparisons (*The Economist* 1999: 40). Over the past quarter century Australian living standards have been overtaken by some of the more advanced Asian countries, Singapore, Hong Kong, and Japan, and have barely managed to keep their position relative to the mature industrial countries of Europe. Growth fell far short of what had been assessed *ex ante* as the growth potential, had consistent market-oriented reforms been implemented (3.8% p.a., Kasper et al. 1980: 221).
- Tariff cuts and other deregulation in product markets helped to lower many prices, kept general inflation and hence interest rates low. It also made activities reliant on cheaper inputs internationally competitive. As tariffs were placed predominantly on consumer goods, the cuts eliminated the long-standing, politically-sanctioned exploitation of consumers.
- The Australian economy gradually became more internationally oriented. The abnormally low ratios of exports and imports to total economic activity up to the 1970s have risen. They are now closer to what can be expected of a country of Australia's size and income level. The growing international orientation has also been reflected in substantially rising foreign investments and a dramatic rise in net foreign indebtedness. Whereas net foreign debt stood at 10% of gross domestic product around 1975, Australia's net foreign liabilities are now around 60%, with private indebtedness now fuelling most of the increase (Sullivan et al. 1999: 121). Whether this reflects a greater international creditworthiness of Australians or a potentially dangerous debt addiction cannot be assessed *a priori*. But the debt is high

[9] This modest growth outcome was used by J. Quiggin, when he reviewed the *Crossroads* analysis as 'the first systematic program of microeconomic reform . . . presented in Australia' (Quiggin 1996: 1), to dismiss the notion that comprehensive liberalisation will enhance economic growth. He overlooked that the reforms were delayed and never implemented comprehensively, and he published before the end-of-century growth push materialised.

by historic standards, and we should note that major economic crises occurred in Australia after debt exposure had risen to such levels, for example in the 1880s and 1920s (see Chapter 3). It is also worth recording that over the past quarter century the Australian dollar has been a soft currency. Despite the gradual tightening of domestic monetary policy, the AUS$ has been in decline, losing on annual average about 3.4% of its value in terms of US$ over the quarter century. If this trend were to continue, then more than $A4.00 will have to be paid for $US1.00 in 2025.

- Liberalisation and deregulation removed obstacles to innovation. They also inflicted 'creative destruction' on many old-style jobs in 'rust belt' industries and regions. When institutional systems are changed, the 'death rate' of jobs and enterprises, which rely on outdated institutions, always rises. But what matters for long-term prosperity is the 'birth rate' of new enterprises, jobs and production capacities. This is most evident in the greater Sydney region, where the number of jobs over the past decade has been growing by a vigorous 10% p.a., most in new service-sector jobs and many in world-market oriented activities (Kasper in Andersson-Andersson 2000).
- The range of sophisticated products and services available to Australian consumers and producers has grown enormously. Long gone are the days when the only cheese available was cheddar, the only distinction between two poor airline services was the colour of the plane's tail, and builders had to rely on one or two local monopolistic suppliers. Deregulation has eroded the traditional 'supplier bias' in many markets, thus empowering the buyers.
- Deregulation and growing international competition are also forcing Australians, when they are in producer mode, to work harder and to compete. They now have to incur higher costs of exploring new markets and products, risk innovations of products and processes, and control the costs of transacting business by more reliable and leaner methods of management. The shift from the 'good old days' for producers (industrialists and workers alike) in government-protected market niches has been translated into 'good new days' for consumers. In some industries and regions, where the willingness to adjust has been missing or profit conditions were totally out of sync with world markets, the adjustment has meant job and income losses. Other areas and people benefited greatly, leading to a certain millennial euphoria in the economic heartland of Australia.
- No degree of public redistribution policy could undo the effects of changing competitive conditions and factor scarcities. Low-skilled workers in Australia now face strong international competition. They must learn to grasp the new opportunities and embrace progress. Those enemies of progress who are now preaching resistance or promising political protection for self-

seeking political ends will only protract the transitional lop-sidedness of income distribution and prolong the adjustment problems of the 'battlers' (Postrel 1998).

- The opening up of the Australian economy and heightened competitiveness has led to an innovation push. Australians are rapidly adopting the information and communications revolution. At the same time, however, there has also been a dramatic rise in business failures. Whereas some 200-250 bankruptcies per 1 million of the population occurred in peacetime during most of the 20th century, the number of bankruptcies has now more than quadrupled (Sullivan et al. 1999: 133).

The changes in Australian society place the future distribution between private and public action in the limelight. Globalisation and technological progress are forcing a re-examination of the relative roles of economic freedom and collective coercion. International competition and technological developments make it easier for individuals to escape local coercion. As a result, there are rising pressures to re-examine the role and function of government and to think about alternative voluntary arrangements through which individuals can best pursue their own purposes. A re-examination seems timely now, as we can enjoy the luxury of reforming where necessary while the economic tide is high. If we do, we will create the resilient institutions needed to sustain Australian prosperity through a deceleration of global growth.

# CHAPTER 2
# Continuing Trends

Time travels in divers paces with divers persons.
I'll tell you who time ambles withal, who time trots withal,
who time gallops withal, and who he stands still withal'

William Shakespeare, *As You Like It*, III, ca. 1600.

### *World Economic Growth*

The 20th century marked an extraordinary transition in the history of humanity. After sustained economic growth had taken hold in a small number of industrial countries around the north Atlantic in the 19th century and first half of the 20th, the second half of the 20th century witnessed the spread of cumulative improvements in productivity and living standards around the world. In many places, mass poverty was overcome for the first time, although poorly educated people and groups of migrants from the hinterland continue to live in poverty in many parts of the world.

In earlier eras, many of those who are now living in penury would not have survived into adulthood. Last century, economic growth enabled the world population to grow by an unprecedented 1.3% p.a., or about three-and-a-half-fold over the past 100 years. The remarkable aspect of this increase in population growth is that—with the notable exceptions of countries ravaged by war or socialism—people now live longer, healthier, cleaner, and culturally richer lives than ever before. The second half of the 20th century far surpassed the Victorian era in achieving what most of us would consider progress.

A central motor of material progress has been the improved division of labour among nations and the accelerated pace of innovation which international competition compels. After the cataclysm of World War II, the General Agreement on Tariffs and Trade, the World Bank, the International Monetary Fund, the Organisation for Economic Cooperation and Development and similar institutions laid down a few basic rules for the international economy that mitigated against discrimination and power abuses by opportunistic national governments. This has been the fundamental force driving the unprecedented growth of the global economy over the past 50 years. Another essential element has been technological progress, which has helped to lower transport and communications costs (see Table 3 on the next page).

## Table 3
## The Drop in Transport and Communication Costs

*(a) The Secular Decline in Transport and Communication Costs*
*(percentage changes p.a., in constant 1990 US-$)*

| | 1930-1950 | 1950-2000 |
|---|---|---|
| Average cost of freight and port handling (per ton) in international trade | –2.8 % | –0.5 % |
| Average air revenue per passenger mile | –4.0 % | –2.7 % |
| Cost of London-New York 'phone call (3 mins) | –7.3 % | –8.5 % |

*Source*: Data from G. Hufbauer 1991, updated by author's own estimates.

*(b) The Recent Plummeting of*
*the Costs of Transmitting Information*

| | Index of US-$ cost of transmitting 1 million bits of information over 1 km 1975 = 100.0 | Bandwidth (mill bits/sec) in optical fibre transmission |
|---|---|---|
| 1975 | 100.0 | 45 |
| 1985 | 9.8 | 400 |
| 1995 | 0.1 | 10,000 |
| 2000 (projected) | 0.06 | 40,000 |

*Source*: J. Bond 1997.

Over the last quarter century, per capita incomes worldwide grew by 1.3% annually, somewhat more slowly than in the preceding quarter century from 1950 to 1975. This reflects the Kondratieff slowdown of the 1970s. Remarkably, the East Asians (excluding Japan, now nearly 2 billion people) averaged an annual growth rate of no less than 3.8% from 1975 to 2000 (achieving a phenomenal 2.5-fold increase in their living standards; Madison 2000). Some have tried to denigrate this singular historic achievement as something that benefited only the multinationals. However, never in the history of mankind have so many learnt useful skills and integrated themselves into the international economy. Never have so many experienced such a substantial reduction in poverty. The number of industrial workers who compete directly in international markets has probably doubled. Naturally, the hardworking newcomers pose a major competitive challenge to the less well-trained and less well-managed workers in the old industrial countries.

The weight of the global economy has shifted to the Pacific region. For the last two decades more trade has been crossing the (north) Pacific than the Atlantic, and 11 of the world's 15 biggest megalopolises in 2015 are expected to lie in East and South Asia (compared to 6 out of 15 in 1950, Andersson-Andersson 2000). At the start of the 21st century, some 15% of global production is being generated by the relatively young populations in East Asia, many of whom are, on the whole, increasingly better governed. Their pursuit of material progress is not hampered by social welfarism and pervasive redistribution policies. In the north American economy, where productivity grew overall by nearly half during the last quarter of the 20th century, the centre of gravity kept shifting to the Pacific coast and away from the old centres on the Atlantic. The economic weight of the Pacific region is bound to rise further, as more and more societies on its shores attain middle-class standard and set world innovation trends. In particular, the triangle of North America, China and Japan will become the focal point of the global economy and hence of international politics. Harmony or discord among these three very uneven societies and polities will determine much of the fate of humanity.

The dynamism of the wider Pacific region owes much to the readiness of the USA to admit the rising volume of imports from the new industrial countries of East and Southeast Asia. The liberal interpretation of the GATT rules on trade (outside agricultural produce) by America owes much to a combination of prosperity at home and strategic-military considerations. Rather than prop up non-communist regimes during the cold war by aid, the Americans did much to give the new industries of the countries at the fringe of China access to US markets and to encourage their outward-looking industrialisation. The free trade policy that underpinned the *Pax Americana* imposed considerable adjustment demands on Americans, as workers, consumers, savers and investors. This was tolerated while the cold war lasted and growth was strong. Since then the opponents of free trade have become more vocal. It is a critical issue for the future whether the free traders keep winning, or whether protectionists or people who promote an exclusive alliance of the Americas will win. Other affluent regions and countries—Japan, Europe, and Australia—have admitted the new competitors from Asia more grudgingly, but have gradually become more liberal, mainly in their own self-interest. Their multinational companies often import products and components made by new subsidiaries in low-cost locations.

The economically dynamic parts of the world are at times distracted by what happens in the least developed countries where growth has all too often lagged behind (1975-2000: 1.1% p.a.); in some parts of Africa it has even declined.

Vast differences in social and political institutions have of course produced great differentials in economic growth rates and living standards, as we saw in the Introduction (Graph 1). This has nothing to do with 'social injustice', as moralisers tend to believe, and cannot be remedied by the mere transfer of funds, as the aid lobbies suggest. To improve living standards these countries must abandon the nationalist-socialist dogma that collective action can solve most economic problems and instead place trust in the competitive engagement of their citizens. In practice, that means deregulation and privatisation.

The assertion that the world's poor are getting poorer and the rich richer is a propaganda lie. Although many fellow human beings in countries at war and under socialism have experienced a decline in material well being, the overall picture of the recent past is encouraging. The Chinese, Indians, Bangladeshis and Thais have all, on average, raised their material condition by above world-average real growth in the 1990s. Indeed, over half the world population enjoyed growth rates above 3% p.a. during the 1990s, which goes to show that the present Kondratieff upwave is not confined to the 'rich countries' club' (Gittins 2000: 19). The 1990s have been the most remarkable growth period yet for many of the most populous nations.

Economic progress has of course not been uniform. From an Australian perspective, the slow growth and economic and political instability in the 'archipelago boomerang' from Sumatra to the South Pacific island states is a matter of serious concern. Our most important trading routes run through these regions. Yet we can do little to enhance the institutions and the growth capacity of these communities. Instead, we may have to learn to accept that our aspirations for freedom, economic welfare, security and justice are not necessarily shared in neighbouring countries, at least not among the politically powerful elites there.

Overall, there is no compelling reason for not anticipating a continued improvement in the material state of humanity (Simon 1995; Moore 2000). Of course, we have to remain wary of the downside risks. Over the next quarter century, the global rise in living standards could exceed the record of the past quarter. This is possible even if a Kondratieff slowdown materialises, because modernisation has now a certain momentum.

Should the pace of growth ease after the present American-led upwave, structural-institutional crises can be expected both in the old and the by-now-aging new industrial countries. In the 'graduating new industrial countries' of East Asia, most citizens and policymakers are taking fast growth for granted. After all, these economies kept growing through their first Kondratieff slowdown in the 1970s. They did not have to engage in 'creative destruction' of mature manufacturing industries—there were none. Redistributive pressure groups were not yet entrenched. However, in the next worldwide slowdown, East Asian economies are likely to be affected. Political and institutional infrastructures will by then be in dire need of reform if they are not to become growth handicaps. Much will then depend on overarching constitutional rules that facilitate adjustment. What happened in Asia in the late 1990s should serve as a warning. So far, many Asian polities have failed to develop the institutional and political infrastructures needed for prosperity beyond the stage when easy productivity gains from imitation are possible and local costs are low.

During Kondratieff downwaves and early upturns, international pecking orders tend to be challenged. Successful new industrial countries demand a place in international politics that reflects their newly found economic prowess. This was the case when newly industrialised Germany and Japan challenged Anglo-Saxon supremacy in the late 19th century, or when the Soviet Union took on American supremacy in the late 1940s and 1950s. Regimes in China and elsewhere in East Asia can be expected to behave similarly. Much will then depend on the willingness and capability of the more mature industrial countries to accommodate the aspirations of the ascendant countries, not to mention their defence postures. For a small, slow-growing and somewhat isolated member of the 'rich man's club' such as Australia, the political challenge from an ascendant Asia could spell 'years of living dangerously'.

The major risk during a Kondratieff deceleration is renewed mercantilism. If popular resistance in the rich countries promotes a demolition of the free world trade order and if free investment flows are hampered, this could become a crystallising point for international conflict. World history of the late 19th and early 20th centuries should serve as a warning.

Another risk to the world economy will emerge if the growth of debt by major borrowers is allowed to spin out of control. As economies grow fast, borrowers, investors and governments tend to incur rising debt. This suits those savers who wish to invest their funds profitably. Once the stock of outstanding credit exceeds certain proportions of the income flow, asset-liability structures become sources of instability and magnifiers of downturns when profits begin to disappoint.

As the affluent populations in the mature industrial countries age, secure and profitable investments will become essential to their material security: when private savings decline (as they have in the affluent West) and governments keep borrowing for unproductive political purposes, the living standards of aging populations are exposed to major risks. The main challenge then is to ensure a high rate of return on capital investments, a task that is much harder to achieve during Kondratieff downturns. It is therefore essential for the sake of growing capital productivity to maintain an open economy. Unfortunately, aging Australians do not realise that it is impossible to aspire to secure retirement savings and to ask for protectionism at the same time.

The major task for the early 2000s is therefore to lay the basis for high worldwide capital productivity. In the next chapter, we shall examine possible obstacles to rising capital productivity in the Australian context, but similar trends can also be anticipated globally.

### *Security*

The power stalemate between the US and the Soviet Union had long imposed a predictable but costly and uncomfortable order on international politics. The risk of nuclear conflagration contributed to a *Pax Americana-cum-Sovietica*, which suppressed many a regional conflict. The peace dividend reaped after 1989 included a withdrawal of the big powers from areas of lesser interest to them, such as the South Pacific. Even regions of greater strategic relevance, such as Southeast Asia, felt a lessening of US commitment. This became evident in the East Timor crisis of 1999, when the American government let the Australian allies shoulder the cost of intervention, as well as the blame if things went wrong. From Europe to the West Pacific, allies now have to invest more effort in the alliance with the 'world's only superpower left standing', apart from becoming more self-reliant in defence and security.

By a similar logic, an economically and socially weakened Russia allowed the Soviet Empire to dissolve, leaving many of the new states to their own destinies. The Russian population itself experienced a decline in living standards in excess of one third, that is a far greater decline than that experienced in the West during the Great Depression of the 1930s. Russian life expectancies, health standards and internal security have declined dramatically, demonstrating that these blessings of civilisation cannot be taken for granted. The reason for the decay since 1989 has been that the old socialist order was not replaced by the spontaneous formation of new and reliable internal or external institutions. Chaos, lawlessness and apathy took over instead. The Russian decay should serve to demonstrate the fundamental importance of 'institutional capital' for the attainment and preservation of widely shared values such as freedom, security, justice, peace, and economic welfare.

Australia's future security will be greatly influenced by the degree to which we manage to cultivate the American alliance as well as by the economic and political fate of China. It is possible that China's fast transforming economy will trigger demands for freedom that the old political system is not prepared to concede, and that the contradictions of China's mixed economy will produce economic crises which could then lead to political turmoil. This eventuality would directly challenge Australia's security. While this is not the most probable scenario, it seems sufficiently likely to invite analysis of the consequences and possible ways of handling them. A similar incapability of institutional systems to modernise in other Asian countries could also cause severe international problems for Australia. It is therefore in our national interest that the problems of institutional change in Asia are understood properly. Alas, there is little we can do directly to promote necessary institutional modernisation.

A greater self-responsibility among distant allies and more leeway to experiment and commit blunders have led to growing regional conflicts and breakdowns of order in many parts of the world. Of particular relevance to Australia have been two developments, which are likely to shape trends in the next quarter century. First, although the—for many unexpected—Asian economic setbacks of the late 1990s were followed by a fairly strong and prompt recovery in the early 2000s in most countries, there will be a great need to implement and enforce proper political and economic institutions. Second, there will be the recurrent conflicts in the fractious societies of the island arc from Indonesia through East Timor to Fiji, making our wider neighbourhood less comfortable.

Although universalist-globalist sentiment among some Australian elites will urge governments to intervene overseas, official collective action can achieve little. These countries have been independent for a generation or two. They will have to discover their own paths to institutional change and modernity (Kasper 1994). Australians may be able to lend a little help with transplanting and adjusting institutions and organisations that have stood the test of time, for example law enforcement, finance, accounting, logistics, administration, education and skill training. But such aid will have to be invited. In many instances we will have to watch as mistakes are made, and only hope that our northern neighbours can learn from them. At the individual level, openness and trade can assist in the modernisation of the societies to our north. But—like America at the global level—we will have to accept that we will be blamed for being affluent and open and therefore an affront to traditional power groups in the neighbourhood.

Security will also come under increasing threat from sub-national, non-government origins. International crime, drugs, people smuggling, cyberattacks on computer networks, and extortion will play an increasing role. It is likely that Australians, once protected by the tyranny of distance, will lose a degree of innocence. They will also have to invest greater government resources to cope with these threats. For example, it is conceivable that some weak South Pacific microstate might become a home base for such international security threats or a way station for illegal mass migration.

Policymakers will have to steer between instincts towards neo-isolationism and the desire to act as the regional policeman. In practice, neither extreme will do. But costly experiments and lessons lie ahead. Investments in the intellectual and material resources to cope with non-traditional offshore threats to Australian security and freedom will not be made easily in our open democracy. It will take far-sighted leadership to argue against the immediate election-to-election concerns that drive much policymaking.

### *Resources and Technology*

After the oil and food shortages in the 1970s and early 1980s economic growth resumed worldwide. Free markets and higher prices for petroleum and other energy products triggered impressive spontaneous efforts to raise the energy efficiency of cars, industry and electricity generation and, indeed, induced people all around the world to economise on energy use. At the same time, new non-OPEC sources of oil and gas and alternative power supplies were tapped.

This is how free markets cope with shortages. The experience of the past 25 years certainly gives cause for optimism about the power of human creativity and coordination in markets. The danger lies in governments or monopolies hampering open competition and creating market failures. The Whitlam government reacted to the oil crisis of 1973 by fixing the prices of locally produced crude oil at pre-crisis levels, that is at about one quarter of world-price levels. This politically opportunistic policy delayed appropriate responses in this country by several years. Higher petrol prices are never welcome, but no-one wants rationing either, as we discovered in the late 1970s. Politicians should have learnt from that experience that price fixing is dangerous to their chances of re-election.

Markets of course do not work instantaneously. It is possible, indeed likely, that temporary shortages will be part of the next slowdown in supply growth. It takes time to adopt new technology, to turn over the capital stock, adjust habits and skills and digest the income losses from specific resource shortages. Unlike most affluent countries, Australia sits on a unique and varied endowment of natural resources. We have a better chance of profiting from another resource crisis than most, but we need the social structures to expand supplies rapidly if the opportunity arises.

Another possible resource constraint on future economic growth is the availability of clean air, water and other environmental inputs, as well as the capacity to absorb waste from production and consumption. Growth in Australia might be hampered by local environmental problems and the costs of more environmental care, but on the whole there is little reason why this should be a major obstacle to continuing growth. Environmental dangers are real, but they must not be allowed to dominate overall policymaking to the extent that a self-appointed Green elite dictates their preferences to all. More importantly, single-issue policies invariably neglect all other objectives and therefore lead, sooner or later, to hectic and costly corrections. The only approach to environmental policy is to embed environmental security in an integral and balanced set of general and fundamental policy objectives and to assess the costs and benefits as best we can.

Many cases of 'market failure' in environmental conservation are alleged in the literature. However, this is often due not to the untrammeled play of market forces, but stifled or non-existent markets. For instance, there is a growing and serious problem of salinity in rivers and farmlands in several parts of Australia. Water for consumption and irrigation is becoming scarce because water is not properly priced. Regulators who wish to tackle such problems by direct intervention presume that they have all the necessary knowledge of alternative means to meet the demand. But do they? It is infinitely more appropriate to allow the development of a proper market for water, that is a free price mechanism that balances conflicting demands with available water flows. As in the oil shortage of the late 1970s, competition would mobilise enormous creativity and a decentralised search for economies in water usage. Steps in that direction have been taken in parts of Australia, including the trade in water rights which allows the bidder with the ideas for the most valuable uses of that water to win a higher share. The system does not work perfectly, but experience tells us that it will work better than the alternative of central administrative control and politicking. This is advocated by those who were accustomed to free water and who now wish to shirk paying scarcity prices.

Another case where markets could help in tackling resource scarcity is the global greenhouse problem. Increases in carbon dioxide and allied emissions are changing the atmosphere. It is, however, not yet proven that this will lead to harmful global warming (see box below). Although activists, including those in national and UN bodies seeking greater influence and power, try to suggest otherwise, the jury is still out. Global climate models are based on dubious assumptions. So now it is being argued that the scientific evidence does not matter, as environmental and ecological policy should be governed by a 'precautionary motive'. This is another way of saying 'we cannot prove a thing, but you'd better do as we tell you!'. If this approach were applied to all public policy, or individual behaviour, it would be a surefire way to reduce freedom, economic growth and security. Whenever unproven fears and superstitions govern collective action, there are dangers ahead (Chapter 3).

### *Global Warming Raises Political Temperature*

*Barry Maley*

. . . It . . . looks as though the global warming issue and Australia's position on the Kyoto treaty will be one of the critical political and economic issues for the coming year.

Australia's economic future would be adversely affected if we were to reduce significantly our use of hydrocarbons for energy production, or methane emissions by grazing animals. However, if we do not reduce hydrocarbon use and emissions, the European Union may impose trade sanctions on us. So the international and domestic politics of global warming and greenhouse gas emissions are delicate. Moreover, emerging scientific facts may prove pivotal in determining the economic and political outcomes, both domestically and internationally.

Global warming is not new. The fossil records, evidence from tree rings, ice cores and ocean sediments, and other indirect measures of earth temperatures, reveal significant variations over tens of thousands of years. Temperature fluctuations quite independent of human activity are normal.

The immediate question for the world is whether the recent climatic record reveals significant temperature changes. Within the last 50 years we have experienced major increases in the release into the atmosphere of the so-called greenhouse gases which some climatologists and environmentalists have argued are causing global warming and raising the possibility of catastrophic climatic changes. The climatic models accepted as a basis for the Kyoto treaty predicted that measurements would show that atmospheric temperatures have risen over the last twenty years. This prediction allows a crucial test for the global warming hypothesis. If the prediction is not fulfilled the hypothesis must be discarded, and with it the case for emission controls under the Kyoto protocols collapses.

As Australian scientist John Daly points out, the record of these surface temperatures from 1880 to 2000 shows a sustained warming of 0.6 degrees Celsius, a cooling of 0.2 degrees from 1940 to 1975, followed by a warming of 0.4 degrees from 1975 to the present.

It is the latter portion of the warming phase that is of particular interest, especially when compared with the measurements of atmospheric temperature over the same period.

These atmospheric measurements were made by satellites using highly sophisticated and accurate measuring devices. There is confirmation of the accuracy of the satellite records from quite independent recordings by a different method. Helium balloons are sent aloft using radiosondes, as they are called, to measure exactly the same part of the atmosphere measured by satellites. These measures proved to be highly consistent with each other.

The results from both sets of atmospheric measurements showed a trend at odds with that shown by the surface measurements. Atmospheric temperatures showed a warming of less than 0.1 C, due to the El Nino of 1997-98. Prior to then the satellites were showing a slight global cooling, which persisted in the Southern Hemisphere, with the Northern Hemisphere showing only the slight warming over the 21 year period.

How, then, can we reconcile a surface warming of 0.4 C over the 21 years with this atmospheric record of virtually no change? To add to the puzzle, the surface records taken in North America, Australia, and Western Europe are in close agreement with the atmospheric recordings.

The answer seems to be that in these countries the records have been better collected and maintained than elsewhere, especially in those countries racked by warfare and upheaval, where the records showed rising surface temperature. Further evidence has been adduced to throw doubt upon the reliability of the surface measures in various locations, especially the local distortions caused by heat-producing activities in urban and airport areas. A significant proportion of the surface measurements are therefore suspect, while the atmospheric measurements are above suspicion and reliable.

The upshot is that the climatic model predictions, which formed the basis of the Kyoto recommendations, have been invalidated. This is the conclusion reached in January this year by an expert panel of scientific specialists in temperature measurements commissioned by the United States Academy of Sciences. The best data and eminent scientific opinion find no real evidence of global warming caused by greenhouse gas emissions. With so much of economic and social importance at stake, it would be the height of scientific, economic and political irrationality for Australia to ratify the Kyoto treaty or to take any steps to reduce emissions."

*Source: Courier Mail*, 5 July 2000: 17.

Technical progress is the result of human creativity, and it has helped humanity overcome most problems, as long as markets signalled these problems through price movements. In the 'Crossroads study', it was predicted that the upswing of the 1980s and 1990s would be driven by the infotech revolution, the marriage of computing to communications, biotechnology (namely the promise of gene modification in food and fibre production, medicine and waste disposal), energy saving and new materials.

Before we deal with the impact of the Internet, it should be noted that other technologies have begun to grow rapidly. Gene modification, cloning and related scientific procedures have become controversial. However, if the history of humanity is any guide, Luddite resistance will not hold up the progress of ideas. In the case of gene-modified (GM) food, the big scare radiates from Europe where governments intervene in food markets, suffer from the consequent budget costs of surplus production and therefore have absolutely no interest in GM-driven improvements in productivity. In other parts of the world—such as the land-scarce, over-fertilised, and heavily populated countries of Asia—gene modification is a blessing. The question is whether Australian growers will enter the fray in supplying the growing Asian demand or leave the field to possibly less scrupulous competitors in South America and elsewhere? The mature and protectionist countries will, of course, exert political pressures on Australia by funding and manipulating domestic activist groups. However, since Australia does not export many foodstuffs to the protected Common Market of Europe, European policy pressures should not carry much weight in our political choices.

It should also be noted that new materials are being developed. This has a scattered though often unnoticed impact on economic growth. Thus, synthetic microfibres have created problems and opportunities for wool growers, new building materials are influencing how we construct houses and bridges, and nanotechnology can be expected to have a major impact in the next few decades.

### *The Internet—Unique or Just Another Core Innovation?*

Over the past 25 years, the infotech revolution has had the most visible and pervasive impact. Numerous follow-on opportunities have been created for other innovators and start-up businesses, but there was also a need for adjustments in the way society and markets are organised, people cooperate and communities are ruled. Some observers are arguing that the infotech revolution is bringing about more pervasive changes than any other emergent innovation before; they also predict that it will add so much drive to competition and innovation that a future slowdown is improbable. We find this implausible and would not commit to the conclusion that the long-wave cycle is dead. Rather, it seems appropriate to think about the net in terms of historic precedents no more and no less fundamental and revolutionary than book printing, steam and combustion engines, and electricity. They certainly stimulated growth accelerations, but these growth waves subsided again.

The Internet has a number of unique and revolutionary features (Engel 1999). It is global and decentralised. Distance plays no role, though familiarity with the world language, English, certainly does. Over 100 million net subscribers (estimated as of early 2000) can now communicate text, sound, still and moving pictures. As new peripherals and new forms of business organisation are being developed, the competition with established information sources and communications carriers will intensify. Except for a few technical protocols enforced by central net coordinators, the net is self-organising. There is no central authority or hierarchy, and the entry barriers and entry costs for new access providers and new individual customers are low, making this a very democratic medium for the individual player and the small club.

The net liberates individuals, enhancing their freedom of information and association. Packet switching in a single message ensures that bits of the message are transmitted over different paths, so that messages cannot be intercepted. Net access can be wireless, linking people via satellites or mobile phones outside national territories. This worries national governments who want to censor message content, such as Singapore, the Peoples Republic of China, Iran and Saudi Arabia, or who want to monopolise information exchange with the rest of the world, such as Burma and North Korea. The Internet will also enhance the transparency of governance. Secret deals and corrupt actions can be easily leaked over the net, even anonymously by whistle blowers.

Older communications technology led to the mass media, but this could be influenced by the few suppliers with concentrated interests in the market ('supplier bias'). Now, people network directly and buyers can organise themselves to counter influential seller groups. This makes it possible to shift the balance more in the direction of the buyers and small new suppliers who previously could not cope with high fixed entry costs.

The net is also timeless, not only allowing Australians to communicate during their waking hours with people in far-away time zones, but also helping to overcome human amnesia. Messages written but then erased from the originator's computer can probably be found somewhere on the net by using search engines.

It has therefore become much harder for governments to regulate the exchange of information and the formation of private international associations. On the one hand, this is making certain types of collective action, regulation and central direction near-impossible, thus promoting the pluralist society. On the other hand, it is also possible that collective control will be made more comprehensive with the help of the net. Statistical and other information can be gathered and exploited by government agents, and demands on citizens to comply with government prescriptions may well increase thanks to the Internet.

However, on balance, the Internet empowers the individual and the small operator. Decentralised information networking already weakens the monopolistic sway of big government, big industry, unions, churches, political parties and nations. These traditional power groups will probably use popular concerns about crime, computer viruses, pornography, intellectual property rights, or anything else to justify ways of censoring, licensing and regulating the free flow of ideas. Nonetheless, it is likely that the ambit of national policies, which work by coercive means, will shrink. To be successful, policies will have to appeal to voluntary compliance. Many traditional institutions of governance will have to be reshaped and the entire philosophy of collective action recast. The style of governance will have to become less autocratic and those who govern will have to be competitive and focussed on equal partnerships, rather than dependent on hierarchical command and control.

The net has already had pervasive effects on how we produce, exchange and consume. It is possible that the spread of e-commerce will lead to a thinning out of retail areas in cities and towns. This will free up space in CBDs for more apartment living, restaurants and diverse services, provided regulations on space usage and opening hours allow such adaptations. The growing B2B commerce, i.e. the electronic trade in industrial components and intermediate goods, will affect the intensity of competition. Some fear that competition will be reduced as monopsonists (single buyers) exert more power over suppliers. Others see opportunities for competitive bidding and auctions, which will ultimately reduce transaction costs.

To date, the spread of computing and the net has not brought the measured gains that promoters have been promising (*The Economist*, 17 June 2000: 94). This could be because the quality improvements due to net use cannot be properly measured as output growth. The costly and frequent changes in hardware and software negate the full payoff from investments in computerising. Computer use has led to expensive staff typing their own work, replacing much cheaper typists. The net also facilitates much private on-the-job entertainment and other private activity, diverting staff from productive tasks. Moreover, the 'network culture' has given rise to information overload, inattentiveness and short-termism, since everything can be easily changed and corrected. What really matters is the sifting, absorption and integration of information into a stock of productive knowledge. It is not yet clear whether the emerging 'e-culture' promotes or reduces the growth of useful knowledge.

A further cost problem in reaping the fruit of the information technology revolution could be taxation in the form of national auctions of spectrum slots for 'third generation' mobile phones, mobile email and other broad spectrum uses. Britain and Germany set the scene in 2000 first by limiting the number of licenses and then auctioning off the spectrum to the highest bidders, despite the fact that there is no technical necessity for limiting supply. Only expected rents for licenses drive up the revenue. It would not be the first time in human history that fiscal greed has killed the innovation goose that lays golden eggs.

## Social and Political Impacts of Networking

Centralised control and rigid hierarchies are being eroded by the dynamism of the 'e-system'. Attempts by government regulators and ministers to give preference to one communications technology over another, or one 'e-operator' over the other, as the Australian government did in 1999 with regard to picture transmission (high-definition television), seem foolhardy and condemned to failure. Citizens will find ways to bypass such old-fashioned and preferential deals.

The broader lesson to be drawn from this is that the new technology has only begun to produce changes in the mindset of citizens and policymakers, with problematic consequences for social cohesion and governability. No community can function without a reasonably reliable set of shared rules (institutions) and common values. Isolationist individualism and anarchy are ineffectual. People coordinate their actions to achieve their individual ends, either through internal rules (which evolve from experience and tend to be enforced spontaneously), or external rules (which are designed and imposed on society by political authorities).[10] Many of the institutions upon which our civilisation and wealth are built are now being challenged by the spreading social and psychological impact of the Internet. The majority agreements necessary to steer collective action will be harder to achieve in the future.

Bulletin boards and quickly organised networks already enable private associations to share information and to make their common voice heard. Experience to date shows that such spontaneous cooperation is more easily brought about to oppose public policies and big enterprises than to thrash out problem solutions. The net has made it much easier to organise a local protest movement, to mass-produce and channel protest letters to politicians and business executives, to mobilise ad hoc opposition to national legislatures via worldwide advocacy NGO networks steered by activists and policymakers in other countries.

A typical case was the massive public opposition to the rather legal-technical attempt to standardise foreign investment rules among OECD and other countries through a 'Multilateral Agreement on Investment' (MAI). Standard protest letters, some of them drafted by overseas activists, inundated national parliaments and induced governments keen on passing the agreement to stipulate so many exceptions to the general rules that the MAI was no longer worth the effort. The net has also been essential to organising the new opposition to the World Trade Organisation. So far, however, it has proven much harder to use fleeting Internet contacts to develop constructive solutions to collective or industrial problems.

One concerning feature of the net is that the information posted on it is often not critically evaluated and scrutinised. The formal institutions of critical review, which have been developed in the print media, do not (yet?) exist on the Internet. The advantage is that no-one is censored and every voice can contribute. But the danger is that time-tested bodies of knowledge are ignored and that pseudo science, lies and intentional distortions are spread to an audience that has not learn to assess information critically and that is inclined to anarchic action. An information-rich society can therefore become knowledge-poor. Information only becomes productive if it is assimilated into bodies of knowledge. But the flood of information and present trends in education make the gradual, careful and deliberate building and testing of bodies of knowledge harder. In the face of information overload, critical analytical capacities and knowledge will be at a premuim. Future generations of net users will have to

[10] Internal institutions may be moral standards, work and trading practices, customs or professional standards. External institutions are imposed on the community from above by legislation and regulation. For the modern theory of institutional economics, see Kasper-Streit 1998, chapters 4 and 5.

learn how to distinguish between dreams and reality, 'funk science' and proven paradigms—just as people had to learn to handle the printed word sceptically after the advent of book printing and to filter out lies and propaganda once radio messages reached everyone.

### Population and Immigration

A major trend change since the 1960s has been the continuing decline in population growth in affluent countries.

Australia's population growth rate has followed this downward trend. A hundred years ago, the natural increase in the population—births over deaths—was around 3%. Now it is 1.3% p.a., thus contributing only half of the total population increase (Sullivan et al. 1999: 4). The 'pill' has lowered the natural rate of population growth. Birth control now seems deeply embedded in social attitudes in all affluent societies. For Australia this means that without immigration this fairly empty, resource-rich continent would be home to a shrinking and aging portion of the world's population. Admittedly, large parts of Australia are barely habitable, but even the remainder would become underpopulated by prevailing world standards.

The remaining source of population growth for Australia is government controlled immigration. As a consequence, the share of the Australian population born overseas now exceeds 20%. Immigrants now come from more diverse origins, with Anglo-Saxon countries supplying only 36% and with New Zealand being the biggest single source. East Asians now constitute about a quarter of immigrants, and people of Mideastern and African background 15%. Immigration—legal as well as illegal—will remain a major issue in Australian policy.

It would be risky to stop immigration. It is not imaginable over the long run that a shrinking share of the world's population could inhabit this vast and relatively empty continent. And it is even less imaginable that the Australian population could shrink in absolute numbers, as would be the case without immigration. As of 2000, the natural growth rate falls far short of the 'replacement rate' of 2.1 %. In any event, it is likely that policy will only affect the profile and composition of immigration, not the long-term intake.

To date, Australians have enjoyed remarkable success in absorbing immigrants from varied cultural backgrounds. The British tradition of law and civic tolerance, and a background of economic growth and labour shortages, especially in the outback, have served Australia well. Immigrants have come from many different lands and cultures, and few groups have been able to congregate in exclusivist-reactive closed circles. Until Prime Ministers Fraser and Hawke turned ethnic identity into a political issue, assimilation and integration proceeded at the personal level—across the garden fence, in the workplace, in new restaurants, and increasingly through intermarriage. It is remarkable that the rate of intermarriage between Anglo-Saxon and non-Anglo-Saxon partners now exceeds 50%.

Worldwide experience suggests that market interaction is the recipe for ethnic harmony. But increasing politicisation, combined with second-generation reactions against integration, could endanger the record. It is true that communities live by shared rules, and that large numbers of immigrants can overburden the community's capacity to maintain the rules. This is why a steady flow governed by Australian choices should be allowed. A bigger flow of immigrants could no doubt be 'digested' if policy were to revert to a goal of cautious assimilation, if opportunistic political subsidies which discriminate on racial-ethnic grounds were discontinued, and if the protagonists of immigration policy appealed more directly to the material gains the incumbents derive from immigration of productive people.

In contrast to the largely harmonious integration of immigrants from around the world, the issue of finding a constructive and peaceful *modus vivendi* with Aborigines has eluded the Australian community. The number of those who designate themselves as Aborigines or Torres Strait Islanders has risen dramatically in the 25 years since the 1971 census, namely by an average annual rate of no less than 5.2% p.a.

At first glance, this growth seems to indicate outstanding success. But the 2% of the Australian population recorded as of full or part-indigenous descent, have a life expectancy and health standards that fall woefully short of the attainments of the other 98% of Australians, though present-day Aboriginal life expectancy is far higher than it was 200 years ago. The dramatic increase in numbers has much to do with record keeping, increasing intermarriage and the growing availability of substantial subsidies to people of Aboriginal descent (Sullivan et al. 2000: 5). The definition of 'Aboriginal' includes many persons of predominantly non-Aboriginal descent, who might with equal or greater genetic justification designate themselves as non-Aborigines.

Only a small minority of indigenous Australians now live within social and institutional frameworks that give their communities cohesion and order. Many are integrated into the wider community, but many also find themselves in an institutional no-man's land, neither fully belonging to the Australian community at large, nor a living in a functioning traditional community. This naturally causes disorientation and friction, in particular if organised interest groups, activists and massive government funding push the issue in the direction of group politics and away from person-to-person solutions.

The task of finding shared rules upon which to base friendly interaction will not be easy. Australian Aboriginals lived in a paleolithic culture until recently, that is a culture that had not discovered and cultivated private property rights.

Nor had they developed many of the other institutions needed to prosper in the dynamic modern world. The life of the ancestors of Aborigines was shaped by small bands rather than bigger more anonymous social units. Aboriginal institutions and traditional knowledge were eminently suited for the task of survival in nature. But they are unequal to the task of coping with life among six billion people who trade and interact globally. Policies that naively gloss over these deep differences, that try to engineer outcomes irrespective of individual behaviour (for example in health) and that are driven by self-seeking racialist activists, will only antagonise the majority of Australians. Claims to some sort of apartheid and land rights based on models imported from other countries in reality benefit urban activists and self-appointed representatives rather than Aboriginal communities. They are bound to lead to conflict rather than solutions. A new approach based on fundamental human rights and individual, family and clan identities is worth exploring.

One of the most profound consequences of Australian population trends is the aging of the population. In this respect, Australia's population follows international trends, but it is still much younger on average than the mature populations of Europe and Japan. Nonetheless, Australian life expectancies are among the highest in the world. If one takes the World Health Organisation data on life expectancy without disabilities, Australians' self-reliant life expectancy of 73 years is exceeded only marginally by the Japanese (*The Economist* 10 June 2000: 96). This is a remarkable achievement. Moreover, the trend in statistical life expectancy is rising (Sullivan et al. 1999: 29-30). Infant mortality has dropped during the 20th century to an almost unimaginable degree, from nearly 12/100 live births to 0.6, and maternal death at child birth, which was once the scourge of families throughout the ages, has dwindled to infinitesimal.

Australians now enjoy more leisure than ever before. Rising productivity growth can be used to increase incomes, but it can also be used to enhance leisure. On average and despite popular complaints about the increasingly competitive 'rat race', Australians are now spending some three hours daily on passive leisure. Expenditures on entertainment, participation in sports, and cultural pursuits have gone up dramatically. A novel form of entertainment now is infotainment over the net, especially among school children.

Material progress during the past quarter century has not solved all the major problems in our communities. Medical visits and costs have increased, as has the incidence of some infectious diseases, such as hepatitis-C, the number of drug overdoses, and the prescriptions of anti-depressant medication. It is also of concern that crime has been rising, with reported serious crimes going from some 1.6% of the population in 1972/73 to 3.7% in 1997 (Sullivan et al.

1999: 81) and drug-related offences going from 0.09% p.a. to 4% in the late 1990s (Sullivan et al. 1999: 82). The rate of imprisonment has also risen quite steeply since the 1970s—from 0.06% of the population to 0.14% in the late 1990s—despite the fact that fewer offenders are kept in prison for violent crimes, than was the case previously.

These ills are not unavoidable corollaries of economic advances or globalisation. To the contrary, higher productivity and living standards provide individuals and communities with the material resources to tackle these ills and to think about more effective private and collective solutions.

Economic growth has provided the means for an improvement in education, with rising numbers of families sending their children to private schools (Sullivan et al. 1999: 63). More teachers are being employed per 100 students. If class sizes have not declined apace, this is due to the growing tendency to impose administrative overheads on education. In 2000, the expenditure per school student is at an all-time high, and the maths skills of Australian students exceed international averages, though they do not come close to the achievements of world leaders in education. Participation in university education has been driven up since the mid-1970s, from some 130 000 tertiary students to over 300 000. Whether this expansion—let alone official goals of raising tertiary education participation to 100% of young people—makes economic sense is debatable and it is arguable that a shift to a more practical education for some would be more advantageous.

### *Social Trends and Socialised Welfare*

The trends reported in this chapter have had pervasive impacts on private life and the community. Very important change has occurred at the family level. The share of those who marry has been declining considerably since the mid-1970s as people marry later in life and more live together informally (Sullivan et al. 1999: 13-16). This is reflected in a steep rise in ex-nuptial births (Sullivan et al. 1999: 20). The divorce rate nearly doubled after the reforms in divorce law in the 1970s (Sullivan et al. 1999: 24). The increasing number of children growing up in households that do not conform to the standard pattern of the nuclear family and the rise in taxpayer funded sole-parent households can probably not be directly attributed to economic changes. It is nevertheless impossible not to see the growing instability of the family as totally independent of the accelerated changes in the economy and the subsidies with which successive Australian parliaments have favoured non-traditional families. One can observe a statistical association between family instability and social ills, such as youth criminality and youth suicide, which is hard to understand. It deserves careful analysis (Buckingham 2000).

Simply throwing taxpayers' funds at such social problems does not solve them. Indeed, the evidence is mounting that the welfare state has failed on moral, fiscal, economic and social grounds. Socialised welfare has contributed to producing and prolonging intergenerational poverty in families and has produced moral hazard, that is induced many people to make choices that harm them in the long run and lock them into poverty traps. It is in urgent need of fundamental reform (Kasper 1998: 106-109).

Other important changes have occurred in the workplace, which is central to the well being and social interaction of most. The number of Australians in employment went up by an annual average 1.8% over the past quarter century, nearly twice as fast as the average employment growth in all rich countries taken together. Behind the aggregate jobs growth lies a fairly dramatic change in the structure of employment. The primary and secondary sectors lost employment share. However, the tertiary sector, which produces tailor-made personalised outputs, expanded employment dramatically.

In the process, job opportunities for women improved, and there was a considerable increase in female participation in work. By contrast, men's participation rates dropped considerably, from 78% of working-age men in the late 1970s to about 73% as of 2000, reflecting a trend to earlier retirement, lesser work incentives and difficulties for many previously employed in protected activities in finding adequate new work. Changing preferences and technologies, the changing character of work and rigidities in traditional employment structures have also contributed to the rise in part-time employment. Australia now has one of the highest percentages of part-time workers among OECD countries (over a quarter of the workforce are working less than 30 hours per week); 70% of them are women.

The rate of unemployment has remained high by historic standards, after it was ratcheted up by the policies of the Whitlam government. In each recession, unemployment rose dramatically, most notably after the wage explosions of the mid-1970s and 1980-81. But the following upswings did not lead to much of a drop in unemployment. Long-term joblessness became the fate of many Australians and a cause of poverty and social dislocation, despite social welfare handouts to the unemployed. Unemployment has been turned into a problem that the government ought to solve.

Government spokesmen habitually perpetuate the myth that governments are responsible for creating jobs, although in reality it is the employers who create jobs. Much would be gained if job creation were understood as a private concern and unemployment as a sign of overregulated and therefore grossly dysfunctional labour markets. Neither those who seek jobs nor those who create them are presently investing the necessary transaction costs of market search and skill learning. Market imbalances cannot be effectively signalled and eliminated because wages and salaries are not allowed to be flexible.

There are numerous regulatory obstacles to improving labour productivity and hence job creation. It is safe to assert that the highly desirable state of full employment will only be attained when the regulators and wage fixers get out of the workplace, and when it is popularly acknowledged that governments are unable to create employment.

The Howard government has taken some steps in the direction of stressing that central government alone cannot get rid of unemployment and that the unemployed must take responsibility by engaging in active job search. The dissolution of the monopoly Commonwealth Employment Service (CES) and the part-privatisation of job-search services, which now have incentives to reduce the transaction costs of matching supplies and demands, point in this direction. Administrative efforts to get able-bodied recipients of unemployment handouts to perform collectively organised work as directed by government go in the same direction, although such efforts suffer from high organisation costs and low 'worker' motivation. The Federal government's experiments with 'mutual obligation' (Abbott 2000) can at best seen as a paternalistic stop-gap measure and a first step towards denationalising the unemployment problem (in Chapter 4 we shall make a case for going much further and devolving unemployment to local government).

Economic structural change has led to a relative shrinkage of the traditional economy, in which standardisation and mass production, work routines and narrow skill specification predominate. At the same time, there has been a rapid expansion in the new service economy. What matters here is the competition of small independent teams and the ability to tailor-make every service to the customers' specifications. As a consequence, fewer and fewer workers are prepared to organise themselves in unions; rather, many interact as equals with their employers.

Class divisions, which have their roots in agriculture with landowners and landless peasants, never prevailed in Australia. Traditional manufacturing and attendant social attitudes have little room in trade, finance, design, legal and tourism services. As a consequence, Australia's traditionally high rate of unionisation has declined naturally to 20% of the private-sector workforce (Sullivan et al. 1999: 135). It is higher in the public sector (52%), as government workers can exert their monopoly power more easily—they do not have to produce for competitive markets because they are securely funded from taxation. This enables managers and workers to perpetuate the old-fashioned antagonism inherent in the outdated 'us and them' approach to working.

It is certain that Australia's population will age further. The experience of labour scarcity dominated the lives of many generations of Australians. It did much to empower working people and give ordinary citizens a feeling of security and confidence. Alas, it has not been a familiar life experience for Australians since the 1960s. However, the future decline in the growth of the working-age population and a trend to earlier retirement may contribute to future labour shortages. This would create pressures to raise productivity. The sooner it is realised that productivity growth is central to our future well-being and the sooner this is addressed by reforms to remove policy-made obstacles to productivity, the easier it will be for ordinary Australians to enjoy better job security. A thorough reform of welfare programmes that have been allowed to proliferate since the 1970s, and that have since acquired lobbies that agitate for their retention, will be crucial. Without far-sighted and principled reforms of socialised welfare, the Australian community will not be able to manage the challenges of an aging society. At the same time, there is much merit in the Australian tradition of offering volunteer help to fellow citizens through the organisations of civil society. It will be important to cultivate voluntary organisations that are truly independent of the welfare state. In recent years they have increasingly become professional service providers who rely mainly on government finance.

One of the dominant trends of the past 25 years has been the growing fiscal transfers to support a large part of the population (Sullivan et al. 1999: 126). This is based on a deep and admirable commitment to fairness, but welfare transfers have increased enormously since the 1960s. Political parties and a growing welfare lobby have exploited the widely held commitment to equity. It is unthinkingly accepted by many that the advocates of redistribution occupy the moral high ground on fairness. When the pernicious effects of easy welfare on the poor and less motivated are examined, the association between *dirigisme* and moral claims to fairness can be readily dismissed. Such scepticism is easily denigrated as politically incorrect. But it needs to be acknowledged that the welfare state as we know it has been a failure. It has promoted pressure groups, discrimination and injustice, has endangered freedom, and is promoting widespread contempt for government. Present arrangements are not sustainable in the face of population change on moral, social or fiscal grounds. Welfare reform will therefore be one of the major challenges for policymakers. The outcome will determine in no small measure how the next generation weathers the coming economic slowdown.

One final social trend that is hard to document needs to be mentioned. In recent years, public opinion has moved in the direction of less reliance on government, both in Australia and overseas. Fewer and fewer independent observers now see the alleviation of unemployment—one of the major causes of poverty— as the sole responsibility of government. No longer is the search cost in the labour market nationalised through a monolithic Commonwealth Employment Service. It is now expected that those who claim unemployment payments make a search effort. The new intermediaries in the jobs market offer subsidised services, but unemployed persons have to invest their own time and money to find a job. It is essential to drive home the point that the responsibility of finding a job is ultimately with the person who wants one! Indiscriminate handouts of income support, simply on the basis of current income and existing lack of wealth (as far as the authorities can find out) now meet with popular disapproval. They are being gradually pared back, for example in work-for-the-dole schemes.

Care will have to be taken that a further rational slimming of the welfare state will exempt old-age pensions and the like. Lifelong taxpayers can with good justification consider old-age care as a quid pro quo for taxes contributed over a lifetime. Reformers will therefore have to change the pension system with very long lead times in mind. For those with half or more of their working lives ahead of them, the expectation of an automatic government pension needs to be eliminated if individually funded superannuation schemes are to become the dominant form of old-age provision and if the national savings rate is to rise again. For those in retirement or close to it, simple and easily understood criteria have to be developed that distinguish between subsidies to the able-bodied and transfers to those who are old now. Simple criteria will also have to be found to single out that small minority whose physical or mental disabilities are such as to genuinely prevent them from earning an income.

Government welfare and health services are often mass produced and offered with indifference to the needs of the specific case and time. Centralised and hierarchical administrations are poorly structured to do otherwise. But there is a need to reorganise the delivery of assistance to the truly helpless and to make welfare and health care more humane (Chapter 4).

Given fiercer international cost competition—particularly with the countries of East Asia where welfare has remained a private and a family matter—the Australian social welfare system will only survive intact if it focuses on absolute poverty and helplessness, and is again supplemented by voluntary private effort.

# CHAPTER 3
# Possible Challenges

I believe there are more instances of the abridgement of the freedom of the people by gradual and silent encroachments of those in power than by violent and sudden usurpation.

James Madison, Speech in the Virginia Convention, 16 June 1788.

When trying to guess the shape of the economic future over the next 25 years, one should begin by trying to identify what obstacles there will be to flexible adaptations to expected social, political, technical and economic changes and hence to rising prosperity. If past history is any guide, a deceleration in the pace of global economic growth is on the cards. In the past, such slowdowns in economic growth have typically been the result of a cumulation of adverse circumstances, namely:

- heightened international security concerns;
- new mercantilistic designs against free international trade and payments;
- shifts in domestic preferences from economic growth to protecting past socioeconomic and political positions;
- intensifying distribution conflicts between business, labour and governments;
- shortages and price rises for food and other raw materials that the urban-industrial centres rely on and;
- rises in real interest rates, coupled with financial instability.

In this Chapter, we will discuss the likelihood of these changes over the next decade or two, mainly in Australia. Of necessity, this is a speculative exercise. The future can never be 'proven', it can only be made plausible. However, without such speculation, collective and private action would be akin to driving by looking only in the rear-vision mirror—a most accident-prone mode of behaviour!

## *The International Dimension: Prosperity, Conflict and Security*

During the long cold war era, smaller countries were able to free-ride to some extent on the military defence effort of the big powers, as we saw in the previous chapter. Since the 'fall of the wall' most nations have reaped a peace dividend and cut back on defence expenditures. This has contributed to more balanced budgets and, in minor ways, has helped long-term growth. If, however, new threats of serious conflict emerge, more defence spending will be necessary. For Australia, with its small population and vast real estate, this will mean very capital- and skill-intensive defence, probably amid emerging skill shortages.

Threats to Australian security might emerge from various sources: civil conflict and internal turmoil in the 'archipelago boomerang' to our north, or turmoil in China, Vietnam and South Asia where demographic, technical, social and economic conditions are changing dramatically and where the inherited institutions seem inadequate. Huge differences in productivity and living standards around the globe are another potential for conflict. As noted, mere transfers of aid would do little to reduce the problem. Yet Australians have a considerable interest in mitigating the tensions arising from unequal productivities and incomes in the world.

Within the southwest Pacific region, Australia looms not only as a major power, but constitutes an affront to traditional social and political hierarchies. On occasions prickly relations with the Malaysian leadership, for example, indicate that our rich, free and open nation serves as an inspiration to many younger Asians and a beacon of greater freedom. This can easily be perceived as imperialist and provocative. The US generally plays this bogeyman role, but populist leaders in the region may sometimes find it more convenient and less risky to set up Australia as an external scarecrow. Calm and mature reactions to such assaults on the part of the Australian government, media and public may suffice to avert acute conflict, but our security may require that we match our position with a credible military defence.

The internal pressures on land and resources in the fast-growing countries of Asia will be considerable. Free trade in resources and resource intensive products will therefore be essential to accommodate the demands of growing urbanisation and economic growth in Asia. Admittedly, the nature of economic growth is shifting further and further from high resource intensity to services, so that shortages of land and natural resources will be less of a problem. Genetic modification, for example, may soon increase crop yields faster than the population. Nevertheless, energy and mere space will be at a premium. Shortages of these essentials may well drive up cost levels in Asia and impede the future growth of exports and living standards.

In my opinion, however, inadequate institutions are likely to constitute the principal risks to ongoing growth in Asia. The early phases of industrialisation are always driven by easy imitation and advantages in labour and other local production costs. To the extent that industrialisation is successful in raising wage and other incomes, domestic cost levels go up. At the same time, the potential for easy technical imitation is eventually exhausted, and productivity grows more slowly. As a result, unit cost levels tend to rise after two or three decades of industrialisation. Moreover, industrialising societies develop a more complex division of labour so that they also become more exposed to the consequences of high transaction costs and poor institutions. Unfortunately, institutions are not transformed easily; social traditions and established political interests stand in the way.

When institutions are out of sync with technical and industrial conditions, international competitiveness suffers. Economic crises occur which are reminiscent of the 'crises of capitalism' that Karl Marx observed when the new industrialised country Britain experienced its first Kondratieff slowdown in the 1830s and early 1840s. Capital flight frequently accentuates such crises. This is why new industrial countries, when they mature after a generation of fast progress, are frequently places of social tension. First generation structures and networks need to undergo 'creative destruction'. The 'Eric Jones effect' (see p. xix) has to be allowed to work. For the ruling elites that is a novel experience, and the overarching institutions that could smooth the path for creative institutional adaptations, such as a genuine participatory democracy and a trust-inspiring constitution, frequently do not exist.

Part of this constellation became evident during the East Asian economic setbacks in the late 1990s. In 25 years' time, that experience may well look like a forewarning. The problem of a 'Marxian crisis' of East Asian capitalism may not become acute for some time, but it will if the Chinese economy, which is presently coordinated on the basis of poor institutions, reaches saturation point. Australians would be well advised to monitor the institutional and economic evolution in Asia critically by keeping some sceptical distance from Asian boosterism, so typical of new industrial countries in their second generation of success.

Australian security may be challenged from within when the bounce goes out of economic growth. Mob violence has erupted throughout history in the overcrowded centres of the world. International communications could inspire imitators in Australia when the underlying economic and social conditions are fragile. Australia has been and in all probability will continue to be a peaceful country. But internal peace may have to be bought at a higher cost, if terrorism, ethnic conflict or crime ignite latent tensions in the community. It is a matter for concern that the rate of unemployment at the height of the growth wave still lingers around 7%, whereas the previous growth wave had reduced unemployment to 1-2% in the late 1960s. Joblessness could contribute to an erosion of internal security, one of our greatest collective assets.

### *New Enemies of Free Trade and Investment*

The living standards of most people on earth would not have grown as much without steady global progress towards free trade and free flows of capital since World War II. Trade and foreign investment did not just generate more income, it also spread useful new ideas and practices to far-away places. This message is not generally understood, whereas the burdens of international competition are often loudly resented. As already noted, the open economy challenges established interest groups and political power—little wonder that many political agents do not welcome free trade and free investment flows.

The shortsighted self-interest of politically influential advocacy groups has in the 1990s given rise to a new coalition against globalisation. Opposition comes from the old enemies of free trade, who were restrained over recent decades, and new enemies of the open economy. Old enemies include the industry groups who invest in lobbying to reserve the domestic market for themselves and to obtain political protection against outside suppliers of goods and services. Such lobbying by a few suppliers is rarely counteracted by the many buyers, because buyers are hard to organise and each of them bears only a small burden from intervention. Industry lobbies are often joined by labour organisations representing mature manufacturing industries in old industrial countries that are migrating to new locations.

Their new allies are single-issue Green advocacy groups who see international competitiveness as an obstacle to their aspirations and who care naught about the complex, multi-issue pursuit of economic growth. Social welfare lobbies, art establishments and others who have come to rely on big government also resent international pressures to cut government expenditures and social welfare transfers. The social welfare lobbies claim that free trade impoverishes the poor and fails to promote equality on earth. As we saw in the previous chapter, this allegation is not matched by the facts. In addition, churches and civil associations wedded to traditional values and identities sometimes resent the provocative influence of internationalism and foreign pressures to change morals and values (note the nervous reactions to 'Hollywood culture').

A coalition of political forces and groups in favour of free trade and openness to international investment flows is always tenuous. The cause has not been helped by drawn-out and complicated trade bargaining and mutual concessions. This has given trade negotiators a career and political importance, but has led to lopsided results. A case in point are the compromises with major importers of agricultural products, despite the valiant efforts of the Australia-led 'Cairns group', an international coalition of food exporting countries. The practice of limited market access and heavy subsidisation of agriculture in Europe, Japan and the USA makes many Australian agriculturalists wonder whether it is worthwhile supporting the logical principle of free trade. When confronted with the realities of international trade, it is easy to fall into the logical trap of mutualism in international trade concessions. A case can be made for unilateral trade, however. The Australian experience has shown that trade barriers hurt citizens and that trade liberalisation confers lasting benefits throughout the community.

Anti-free trade coalitions can also grow because people are comfortable with traditional institutions. They resent globalisation when it acts as an anonymous force necessitating institutional change. In addition, intellectual elites—many academics, the media, policy advisors and consultants—tend to believe that the government can engineer desirable outcomes rather than relying on the spontaneous order of an open system. Intellectuals have a greater role and higher status in society when affairs are guided by the government (Hayek 1949). It is therefore relatively easy to forge xenophobic collectivist coalitions for 'fair trade', which in reality means unfree trade. 'Fair trade' is now becoming a euphemism for protectionism, but history has shown time and again that interference with free trade and payments has a habit of growing.

Populist political careers can be made in this climate. When some bystanders applauded the demonstrators against the World Trade Organisation at Seattle in 1999, or against the OECD when it tried to standardise international investment rules, few raised their voices in defence of a free international trade and investment. However, the long-term costs of the deconstruction of the free economic order would be devastating, as the experience with international disintegration in the first half of 20th century has taught us. Australians depend on global trade and foreign investment for their prosperity and their security. They should take a keen interest in fostering and preserving an open, free and non-discriminatory economic order.

Pursuing the free trade ideal has become more complicated since the rise of vocal, populist and often anarchic 'non-government' organisations that we have dubbed Single Issue Promoters (SIPs). These self-appointed, unelected enemies of free trade have gained a pseudo-legitimacy at international meetings, because international organisations, such as the World Bank or OECD, have invited them to the table as if they were elected government representatives. In opposing free markets and voluntary exchanges, the SIPs save protectionist parliamentarians and bureaucrats the trouble and political exposure of doing so themselves (Rabkin 1999). The assaults on the free international economic order may not matter much now. But a poor public understanding and weak political commitment to the open economy will become a serious liability when the economic tide turns. It is then that political leaders will need the feedback from the open economy most urgently to recognise what is going wrong. New obstacles to free international economic relations would undermine the 'Eric Jones effect' because they impede the mechanisms that overcome the notoriously poor cognitive capacities of collection action enthusiasts.

Damage to the existing world order is potentially more immediate with regard to international institutions and organisations. After World War II, the International Monetary Fund, the World Bank, the OECD and the GATT were entrusted with cultivating universal and simple rules that constrain nationalist protectionist opportunism. In recent years, international bureaucracies have become more and more sidetracked from the priority of ensuring free trade and investment by novel political causes, such as 'social justice', environmental protection and labour standards. These have the potential to undermine the commitment to free international exchanges. The World Bank, the International Monetary Fund, the OECD and many UN bodies have grown into overstaffed mega organisations with limited missions. Principally out of bureaucratic self-interest, they have widened their mission from ensuring freedom from trade and investment restrictions to pursuing more and more specific outcomes. They organise successive, emotional single-issue world summits—for example on the environment or on 'labour rights'. These summits erode the commitment to free trade and undermine the foundations of the international division of labour.

### *Is the Nation State Obsolete?*

The rise of globally networked SIPs is part of a wider challenge to the nation state. As national borders have become more permeable, the government's capacity to control national affairs has eroded. Often this is welcomed by ordinary citizens, as competition among power holders promotes a freer and more innovative society. However, when power is eroded by anarchists beyond a certain point, order decays and everyone suffers.

The UN and its branch organisations such as the International Labour Organisation have also tried to emasculate national sovereignty in a growing number of areas. This began with legitimate constraints on nationalistic and opportunistic politicians in order to prohibit internationally harmful action by some members of the international community and included actions to protect liberty, life and limb. Thus, the GATT prohibited harmful trade protectionism, and the international criminal court dealt with gross abuses of fundamental human liberties. But there is a growing tendency to surrender national sovereignty to international organisations under covenants and treaties that engineer specific outcomes, rather than suppressing abuses.

For example, the aging welfare states of the West are now using UN mechanisms to inflict welfare cost handicaps on their competitors by prescribing specific policies and establishing positive claims on sovereign governments and electorates. These UN policies are interpreted and administered in non-transparent ways by unelected international bureaucracies lacking local knowledge. Worthwhile causes can, of course, always be found to build up bigger and bigger international organisations—a UN intervention force to stop bloodshed in Africa, a climate convention to address carbon dioxide output before its consequences are proven, or UN policies on child-rearing or work. Such policies are driven by elites who cannot obtain broad public support in their home countries, and may be totally alien to a community's time-tested traditions.

To pacify vocal domestic interest groups, the Commonwealth government surrenders its sovereignty and relies on illegitimate uses of external affairs power encouraged by some dubious High Court judgements. It emphasises incompatible single issues in politics and downgrades the focus on shared values and sensible compromises. It also constrains our ability to react promptly in future contingencies. Many of these international conventions are not in our collective interest, but give international leverage to SIPs who have lost the political argument at home. The growing supranational activism by a range of SIPs is therefore a threat to our freedom and sovereignty.

Moreover, small and somewhat isolated nations such as Australia tend to lose out in international political majorities. The Australian government should therefore be wary of attending the growing number of international fora, and the Australian public should control the immature political instinct of wanting to belong to any international diplomatic club open to us.

The Australian parliament should apply a 'negative freedom test' when reviewing international treaty obligations, that is it should only approve those international constraints on our sovereignty that enhance negative liberties (freedom from interference). Positive claims on us and elitist prescriptions by international bodies only weaken our freedom. It is therefore time to claw back some of the national rights we used to have.

### *Environmental and Raw Material Limits to Growth?*

Previous Kondratieff downturns have typically been associated with temporary raw material shortages and unexpected increases in the input costs of the industrial-urban sector, resulting in reduced potential for profitable investment and innovation. Over the past two decades raw material prices have, on the whole, trended down (Moore 2000). However, the rapid oil price increases in 1999 and 2000 indicate that it is dangerous to rely on low energy prices as global demands keep growing. Political conflicts that affect world oil supplies could easily lead to a repetition of the 1974-75 and 1981-82 oil shocks and ensuing major recessions.

In the longer term, energy crises can again be overcome. Sufficient oil reserves are known and assessed. Most of the major Mideastern oil suppliers, who control two thirds of known oil reserves, are estimated to have between 65 and 100 years' present extraction in reserves (*The Economist* 15 July 1000: 102). The major oil reserves are controlled by so few governments that access at a sustainable price remains a problem. The major oil producers will, however, be loath to exploit their monopoly power to the full, because a global recession hurts them and because alternative sources of energy and energy-saving technologies are now known. But these come at a cost. Huge tar sand, deep natural gas and oil shale deposits have been assessed and the technology has been developed to exploit them. Several 'Saudi Arabias' could be added to global petroleum supplies. These projects will not be implemented as long as the long-term price of conventional oil and gas is expected to be low. But this knowledge introduces a ceiling to energy prices, which are critical to the prosperity of the urban-industrial core of the world economy.

Another potential risk to future growth stems from growing anti-nuclear sentiment. It is true that no major nuclear accident has occurred other than Chernobyl, which was due to incredible irresponsibility and socialist decay. But nuclear power has now become a cause célèbre for environmentalists in many leading countries. For example, Germany and Sweden are abandoning their nuclear power plants at immense cost to taxpayers and their economic growth potential. This will increase their import dependency and will make the global energy balance more precarious. If the anti-nuclear movement spreads—as it probably will if there is another major nuclear accident—this might precipitate another energy crisis, followed by the write-off of energy-dependent equipment and industries; in other words, there could be a re-run of the 1970s[11].

When looking ahead, one must also be aware of the growing demand for other raw materials and food by developing countries. In the wake of the present wave of economic growth such demand is likely to accelerate over the coming decade. A price explosion can therefore not be ruled out, should poor harvests reduce supplies or a military conflict erupt. Higher input prices could then cut into profitability and trigger—as they always have—a Kondratieff downturn.

With spreading urbanisation, industrialisation and overfertilisation, localised environmental bottlenecks can also be expected. If pollution becomes noxious, people who have the means will begin to invest some of their resources into remedying pollution problems. In rich societies, this is just a cost that has to be absorbed. In more fragile developing economies, such contingencies may well add to the instability of the economy and contribute to a downturn.

When confronted with resource problems, we must, however, not lose sight of an important lesson of the last quarter century: mercantilist fearmongers, even respectable science establishments, tend to exploit shortages for their own political reasons. It is salutary to compare the alarmist forecasts of the 'Club of Rome' and official reports, such as President Carter's media-celebrated Global 2000 report, with what forecasters that were more knowledgeable in the social sciences, such as Herman Kahn and Julian Simon predicted (Kahn et al. 1976; Moore 2000). Officials predicted that 'Life raft Earth' would by 2000 be overburdened: 'we are running out of resources . . . we are robbing future generations when we use these scarce, irreplaceable or non-renewable

11 It is worth noting that the mining of coal, which will have to replace nuclear energy, has been responsible for an estimated 20 000 deaths per annum in addition to those caused by the transport and burning of coal.

resources.' It was predicted that by the year 2000 the world would be insufferably polluted, less stable ecologically, and more vulnerable to disruption, with the world's people becoming poorer. The solution offered was more government control and regulation. Observers such as Kahn and Simon argued that economic freedom would unlock new resources and that the future was bright. But they were widely reviled for this (Paul Ehrlich, the spiritus rector of the Club of Rome, remarked that their analysis only proved that 'the world isn't running out of imbeciles' (Moore 2000).

As we have already seen, the economists were right and the science lobby was wrong. The oil price, adjusted for inflation, is not at US$ 80-100 a barrel, as the US government predicted in Global 2000. Instead it is around US$ 30, despite the shortage situation of 2000. The widespread catastrophes of starvation and the doubling of the food price index by the year 2000 predicted by the US government did not materialise. In reality, real food prices have fallen by about 50% since the poor harvests of 1975, and worldwide food production per capita is now about 25% higher than in 1975. Instead of the catastrophic population bomb that we were told to expect, we observe that fertility has dropped from 5 to 3 children per family in the third world (Moore 2000).

If temporary resource shortages arise again, it is to be hoped that the media and the wider public will have learnt a lesson from the gross divergence of economic forecasts and advocacy of economic freedom on the one hand, and the scientific-Malthusian extrapolations and advocacy of controls on the other. Judging by the way the 'precautionary motive' is being pushed by promoters of single environmental issues and the way that governments are being cajoled by activists and the media into signing the 'Kyoto protocol' and similar costly exercises in world government, this lesson has not been absorbed.

### *Capital, Debt and Financial Stability*

Another frequent contributor to Kondratieff downturns is the instability of capital and finance. Marx and Kondratieff wrote much of their respective stories around the instability of capital markets and swings in capital interest rates.

When production and income accelerate, entrepreneurs discover more and more projects that look profitable at the prevailing interest cost. Events often bear them out. At the same time, people find it easier to save out of rising incomes. Growing savings, supplies of capital and growing borrowing demand by investors build up higher and higher balances of monetary assets and liabilities. This process can be compared with the hoisting of sails on a yacht: in fair weather, more and more sails are set, propelling the vessel forward faster and faster. The expansion feeds back into investor optimism and asset prices rise, reinforcing the optimism. Warning signals, such as the odd drop in stock prices, do not dampen the upward trend in asset prices. Growing investor optimism eventually triggers high interest rates, which means high borrowing costs. Some investment projects then turn out to be disappointing. Nonetheless, asset price inflation goes on for a while and induces speculative overexpansion, until the economy is so top heavy with 'credit sails' that a minor disturbance can cause it to topple (Kindleberger 1989).

Against this background, the rapid rises in the foreign indebtedness of Australian business and, to a lesser extent, governments are a worry. Australia's foreign debt relative to the flow of production has risen steeply over the past two decades. High and rising international indebtedness preceded Australia's Kondratieff downturns in the 1880s/1890s and the 1930s. Next time around, it is possible that problems of excessive credit volumes will be more acute.

This is partly because all capital-rich, high-savings populations around the world are aging and are, in their pension years, calling in outstanding loans and partly because new aggressive borrowers among developing countries will be willing and able to crowd Australian borrowers out of the market for expensive credit. Even if the flow of international capital to Australia during the present period of Kondratieff acceleration reflects improving creditworthiness, international lenders are likely to reassess their Australian exposure and recall outstanding debts in times of growth deceleration. International capital outflows can then easily lead to currency depreciation and a protracted financial crisis. Private foreign indebtedness then has a tendency to become a collective concern.

Warning lights should be flashing because of the low rate of saving by Australian households (similar to the United States). In recent years, asset price rises have inspired feelings of affluence, stimulating consumption. Because the 'baby boomer generation'—the post-war and pre-pill generation born between 1945 and the early 1960s—grew up without the experience of penury and with the promise of material security in a growing welfare state, savings motives are weak. The unwillingness to make adequate sacrifices for a rainy day and old age is widespread and entrenched. From now on, this large age group will begin to retire, while the growth of the working-age population (18 to 64 years of age) subsides rapidly, as the following figures from a study by Treasury's RIM Unit show (cited after Institute of Public Affairs 2000, *Facts* 42:1, June: 5):

- In the 1980s and 1990s, the 18-64 year old population grew by 1.6% p.a., and the over 65-year olds by 2.6%.
- In the current decade, the 18-64 year old population will grow by 1%, and the over 65-year olds by 2%.
- In the 2010s and 2020s, the 18-64 year old population will grow by 0.3%, and the over 65-year olds by 2.9%.

Before long, the working age population will be growing by a fraction of 1% a year, whereas the aging baby boomers will demand more medical care and other old-age services. After 2010, private and public financial strains are therefore programmed to snowball. Aging baby boomers will discover that the promises of successive parliaments over the past quarter century will be hard to deliver. Retirement incomes are likely to buy less comfort than expected, even if there is rapid productivity growth from now on. The more likely outcome is that those who have failed to make private savings provisions for old age will be disappointed. The growing age-care burden will lead to intergenerational conflict. Politicians will find it hard to reconcile the aspirations of old voters with those of the young.

One promising way to deal with the problem of low household savings at its source is to improve on existing superannuation schemes and to protect superannuation savings from confiscation. Some countries now try to oblige all income earners to save a certain percentage for retirement; superannuation savers are given individual and fully portable super savings accounts that can be managed with low transaction costs. Unlike government- or union-run superannuation funds, which lock in savings and encourage manager opportunism, portable superfunds make savers responsible for the value of their savings and hence induce them to inform themselves about alternative investment performances. Fraud by opportunistic funds managers becomes less likely, and a generation of citizens of property is created.

A difficult issue arises with all compulsory superannuation savings: should these assets be made available as collateral for loans? If the answer is affirmative, then the positive effect on aggregate saving and investment is reduced and savers are induced to take risks with their retirement savings. If the answer is negative, people have more lifetime freedom to dispose of their assets and take risks, but then government-funded fallback positions, such as a pension scheme for the destitute, become less acceptable.

Low domestic household savings increase the risks of a foreign-debt crisis of the sort that accompanied Australian Kondratieff downturns in the 1880s and 1930s. Seen in this context, policies that discourage savings, such as the high (double) taxation of yields from savings and the uncertainties and high compliance costs that legislatures continually inflict on self-funded superannuants seem foolhardy. On the other hand, the likelihood of a credit crunch is now reduced by the public sector. It has eased its demands on capital markets, arresting the drop in aggregate gross savings rate in the Australian economy during the 1990s. Because inflation and nominal interest rates are currently low, the hoisting of more 'debt sails' may still look like a good idea to many optimistic entrepreneurs. If history is any guide, tight monetary policy and the timely defence of stable money can reduce the excess credit risk of a Kondratieff slowdown.

But will the central bank be able to retain monetary control? Problems could arise if future governments are again more interventionist. Unlike some other countries, the independence of the Reserve Bank of Australia is not cast in hard-to-change legislation. A modernised *Reserve Bank Act*, which at long last sheds the outdated Keynesian and closed economy vestiges of the 1940s, would build institutional trust in the Bank's independence and reinforce the commitment to price level stability as the only goal that monetary policy can credibly pursue nowadays.

Another danger to central bank independence looms from the emergence of 'e-money', i.e. the creation of widely accepted and liquid liabilities that are used as means of payment over the Internet and whose creation is not controlled by the monetary policies of any one nation (Mikkelsen 1997-1998). In minor ways, such developments are already occurring. In some Asian countries, for example, multinational e-commerce firms accept prepayment for CDs, books and other entertainment products. These balances are Internet-tradable, and third parties have begun to use them to settle debts in lieu of national cash. The money volume is thus 'backed' by music. This means of payment is spreading among the Chinese networks in East Asia. Just as the silver shops of old became banks, so could e-commerce firms become providers of liquidity. If this private e-money creates tax and regulatory advantages, monetary control will slip from the grasp of central banks. The process is bound to accelerate if central banks inflate the supply of government monopoly money.

So far, e-money does not compete with national currencies. These are early developments, mentioned here only because they could be the harbingers of Internet-based money, which erodes the taxing capacity of governments and the control capacity of central banks. E-money may at this stage seem like a fanciful pipe dream, but so did instantaneous worldwide communication, even across hermetic borders, a mere 25 years ago!

## Distribution Conflicts

National income is produced by the employment of labour, knowledge, capital, natural resources and other inputs. Over the longer run, these production factors tend to be rewarded according to their contribution to output growth. In the market economy, production and 'distribution' cannot be compartmentalised. Government interventions to redistribute incomes inevitably distort the incentives to produce and so make the market system dysfunctional. People then have to pay more if they want products or services in short supply, and certain goods and services are produced even though they are not really wanted. Government thus distorts, even destroys, the signalling mechanism which is absolutely essential for the functioning of a complex and ever-evolving economy. Of course, a modicum of redistribution may be acceptable for the sake of avoiding gross inequalities, but the more redistribution increases, the less well markets function. Ultimately, poor people suffer.

Since the liberal reforms of the 1980s and 1990s, redistribution has played a lesser role, particularly in the new—and hence as yet unregulated—flexible growth industries, such as the e-economy. Economic growth therefore tends to accelerate. After the growth process has been running strongly for a decade or two, new political interests and pressure groups come into existence and create distribution conflicts. The longer the good times roll, the more perceived risks of job losses dwindle and the more organised labour is inclined to expand its relative income position, often through resorting to strikes. In such conditions, legislators begin to take fast growth for granted and therefore switch from the tedious business of nurturing growth to electorally rewarding social issues and redistribution.

At the same time, governments become more ruthless and try to increase their 'take' from national income—whether a bigger government share adds to national productivity or not. When the Kondratieff wave is high, raw material suppliers, many of them abroad, join the distribution battle by trying to raise their incomes. The growing distribution conflicts then squeeze the profitability of industrial and other producers. Planned investments suddenly look unpromising. Consequently, economic growth slows down.

In this context, we should note that the claim by Australian governments on the national income on a per-capita basis has grown over the long run. After the Korean war, the public sector claimed about a quarter of GDP. This share was driven up dramatically in the Whitlam years. It was not reduced under the Fraser administration and was raised again in the Hawke years, until the famous 'Banana republic scare' of the late 1980s brought a temporary drop. The Howard-Costello years brought a slow but remarkable decline in the aggregate government claim on resources from 42 to 37% of GDP. We will argue later that even this share may in future be unsustainable. If the consequences of a coming Kondratieff slowdown are to be minimised, it is important that governments curb their tax claims and that parliaments ensure that government is lean and delivers only those services citizens really want. When the previous Kondratieff downturn began, the 'Whitlam push' for more public spending came at exactly the wrong time, thus worsening the deceleration of the economy.

An essential precaution against a possible slowdown would be to make labour markets more flexible and responsive to changes in the pace of growth. Australia's rigid industrial relations system aggravated distributional conflicts during the two Kondratieff downturns of the 20th century. Quasi-judicial arbitrators and union officials persisted with real wage increases, because they failed to recognise the onset of a supply-side downturn. Will the first Kondratieff downturn of the 21st century again be aggravated by a similar recognition lag and administrative inflexibilities, or will we by then have decentralised and responsive labour markets?

### Regional Problems and Redistribution

It is frequently asserted that globalisation has benefited the big centres, leaving rural Australia behind. Major economic transformations, such as the liberalisation and globalisation of the 1980s and 1990s, do not have an even impact across industries and regions. Fast learners and people with skills in demand by leading industries make gains. These industries then drive and steer structural changes towards new opportunities and new sources of demand. The growth in modern services, for instance, did not begin in rust-belt regions where entrepreneurial energies were habitually geared to lobbying rather than production. It began near the new industries where entrepreneurs were used to looking to the market for success. New export activities also began in this way.

A pick-up in growth thus came mainly in outward-looking areas, such as the Sydney region, greater Brisbane and Perth. More conservative places full of the once-protected import-substitution industries in the south of the continent were slower to make the necessary adjustments. Over the past two decades, travellers have been impressed by the existence of two Australias: the optimistic and confident East and West, and the pessimistic, pusillanimous South. Cyclical recessions were weaker and shorter in Sydney and Queensland, and more protracted in Adelaide and Hobart. This breeds different economic attitudes and differences in the confidence with which new ventures are approached. It also produces different public and official perceptions of the creative potential of the market process.

Globalisation and its economic consequences impacted on the States, some of which did much to improve competitive conditions by reshaping their budget policies and streamlining regulations. Queensland and Western Australia probably provided better economic freedom for enterprises and workers, but interjurisdictional competition between these States and States like Victoria spread the reformatory impulse to some of the over-regulated rust-belt locations. Privatisation in Victoria improved the quality of services, reduced prevalent strike risks, allowed the reduction of government debts and the improvement of credit ratings, and halted the outflow of talent and capital to freer States.

Regional divergencies, as well as differences in economic dynamism between the cities and 'the Bush', have been influenced by the willingness to learn and take entrepreneurial risks. Those inclined to resist and rely on government initiatives typically lost out. Long after the lessons of globalisation had been absorbed in Brisbane, Gladstone, Cairns, Darwin and Perth, they were still resisted and bemoaned in Launceston, Adelaide, outer Melbourne, and many parts of rural Australia (Sorensen 2000, Trebeck 2000).

Rural producers and miners exposed to harsh world market forces had to take prices and market conditions as given. Unfortunately, many of their input costs have been kept high by hidebound local suppliers and poorly run local governments. The socialist notion that people and communities should not be held responsible for their economic fates, regardless of how they react to challenges or whom they have voted into office, is no longer tenable. Yet, this leftover from the 'Australian Settlement' has rarely come under scrutiny. Existing regional distribution and inter-State fiscal redistributions are still uncritically supported by most. The notion is widespread that living conditions must be the same irrespective of place and irrespective of mental agility in coming to terms with change. The long tradition of intra-State and regional redistribution policies foments this attitude. With it come the very forces and attitudes that make for rich and poor regions. Regional communities must ultimately and primarily be responsible for local living conditions and local economic growth. Fiscal redistribution is a brake on regional prosperity. In social welfare policy outcome egalitarianism is increasingly understood as harmful. Mendicant States and regions that clamour for subsidies, and even act to qualify for greater subsidies, need to be weaned from this dependency habit if the ailing regions are to overcome their backwardness.

Regional prosperity can be created. Many rural centres prosper, despite the publicity implying that all of the 'Bush' is suffering as a result of policy reforms and globalisation. In some regional centres, local government and local enterprise have taken the initiative and turned the tide. The once-ailing abattoir town of Gladstone in Central Queensland is now a modern, world-market oriented centre with attractive amenities. Enterprising young innovators have turned the Barossa, the Hunter, the Riverina, the Darling Downs and the Margaret River region into success stories. The culprits for regional failures can often be found close to home. The blame lies with cumbersome, poorly administered regulations, power plays by local government inspectors and local cartels, and councils that seem to be run for the benefit of local trades and labour councils; the real-estate industry or local monopolies, or all three.

More fiscal redistribution and regional aid is not the answer, but rather a closer supervision of local administrations and fiscal devolution is needed (Chapter 4). Of course, some regions and centres are not favoured by the changing winds of economic development, and some will always be on the decline. But in many cases, the answer is more local responsibility, including institutional arrangements which drive home to the local electorate that tolerating corrupt or ineffective political leaders, poor local administrations and a closed small-town mentality can have dire consequences for them.

### *Disappointments in Business*

Kondratieff upswings are times of heightened expectations, many of which are self-fulfilling. However, as entrepreneurs tackle more and more promising projects, and as the most promising opportunities get exhausted, disappointments set in. A technology may reach its profit potential quickly. Other technologies may never yield the expected profits. In computerisation, for example, many users are now finding themselves on the treadmill of having to upgrade their software without ever enjoying good returns for their investments in computing. Eventually, they conclude that further spending is not rewarding and may slow down further computing investments. In markets where pioneers reaped massive profits, imitators tend to crowd in, often creating overcapacities.

In every historic Kondratieff cycle, the tide has also turned because of disappointments in organisational innovation. When the upswing is under way and capital is cheap and freely available, there is a tendency for takeovers and mergers. Karl Marx observed the tendency to concentrate in growing capitalist systems and was critical of the trend to monopolies. In the 1990s, we have again seen a move to company mergers; mature and new industries alike are being reorganised, this time often by border-crossing mega mergers.

Big corporations are not normally the drivers of genuine innovations, although they tend to engage in much useful information searching and adaptive innovation. It is the small firms and the outsiders who frequently set new trends. The proverbial garage in the computer industry and the small firms in the motor industry, such as Honda and BMW, launch the more pathbreaking innovations. Many of them become takeover targets when their management teams run out of steam, but newly merged companies find it often difficult to combine different business cultures and must cope with duplication, infighting and institutional conflicts. This is why mergers often fail—more than half are estimated to destroy shareholder wealth and fewer than one in six increase it. As *The Economist* recently put it: '[mergers] are, like second marriages, a triumph of hope over experience' (22 July 2000: 15).

### *Shortened Time Horizons and the Emerging Neo-Romanticism*

In the early 1980s, when the Australian economy was ailing after the downturn and oil crises of the 1970s and 1980s, some political leaders—such as the 'Dries' in the conservative camp and certain leaders in the ALP—as well as many officials, industrialists and citizens adopted a long-term view of the costs and benefits of policy reform. In the present climate of easy expansion, little of that is left. Collective action is again focussed more on shortsighted political redistribution and side issues. Federal politics and the media seem dominated by issues such as the gun buy-back scheme, Aboriginal reconciliation, the republic question, the petty redistribution consequences of tax reform, and East Timor. Major economic issues are given little attention. The Australian Labor Party, which once took a reformist lead after defeating the reactionary

Fraser administration, now seems bent on becoming interventionist and reactionary. It has committed itself to labour market regulations, whose transparent aim is to raise union membership, and to opposing the tax and welfare reforms that global competitiveness demands.

The voices calling for renewed protectionism and selective industry subsidies are again becoming louder. Important segments in the conservative coalition, especially in the National Party, advocate populist solutions and short-termist remedies, obviously unaware of their deleterious long-term side effects. More generally, the trend has been towards much outcome-specific legislative activism, often at the behest of a well-organised interest group. There is much 'kneejerk' and 'lowest common denominator' legislation. When some problem or scare makes headlines, activist politicians react by pushing through legislation to solve the problem, but they give little thought to long-term side effects. An example is sexual harassment legislation, in which well-meaning external institutions were grafted onto long-existing internal rules against harassment. The legislation, however, crowded out the traditional restraints of proper behaviour and mutual social control, inflicting high costs on policing compliance.

There is little interest in shaping simpler and more general rules that ordinary citizens can understand. Admittedly, the rules of macroeconomic policy have been improved, and microeconomic reforms have improved competition among States and public corporations. Nevertheless, contradictory and detailed legislation has proliferated. Hardly anyone in the Commonwealth parliament or the executive seems perturbed about the proliferation of legislated interventions in private life. Where ordinary people once solved their conflicts and problems by commonsense and with the help of private law, public law is taking over. During the 1990s alone, the Commonwealth parliament inflicted more than 40 000 pages of new legislation on the people whose interests they pretend to represent. This was more than the cumulative aggregate from 1901 to 1990 (Institute of Public Affairs 2000)! The beneficiaries are the lawyers, counsellors, administrators, arbitrators, commissioners, commissars and supervisors. But the trend hurts citizens. Politicians should not be surprised that citizens and businesspeople resent growing compliance costs and form-filling. Few people see the attraction in having to file four tax returns a year.

The political atmosphere has not become more favourable to productivity improvements by competitive private and collective action. Time and again in history, productivity growth has been hampered by populist and anti-rational trends, as are now becoming evident in Australia too. Aboriginal policies are based on recently fabricated 'traditions', such as South Australia's secret women's business. Costly burdens and restraints are imposed on industry and citizens on the basis of unproven ecological assumptions and fears. International fads that have no proven bearing on national conditions are being championed by SIPs. Yielding to mere instincts, gut feelings and neo-Romanticism by abandoning calm rationality and logical analysis of proven facts and being swayed by emotional pressure groups with selfish and narrow objectives is a surefire way to ensure poor economic and social outcomes for everyone. The oppositionism and spreading scepticism that many SIPs represent will make rational policy formulation and implementation more difficult.

Political support is needed for non-discrimination, equality before the law, and the abolition of much interventionist legislation and regulation. The moral advantages of this approach needs to be spelled out anew, forcefully and convincingly. Such policies need to be shown as effective in eradicating poverty and enhancing people's life opportunities. Governments, to be convincing and consistent, will have to abandon interventionism on behalf of their typical clients. On 'the Right', these are big industry and many long protected professions. On the 'Left', these are organised labour, the welfare lobbies and many public employees.

The crucial point about equality before the law and economic freedom cannot be made clearly unless the political grammar distinguishes between income distribution and 'relative poverty', on the one hand, and poverty measured in absolute terms on the other. There will always be some who have less income and wealth than others, in other words who are relatively poor. A dynamic economy inevitably favours one group or the other. If internet millionaires, successful industrial innovators and new-economy regions zoom ahead and enjoy high market rewards, this automatically leads to a notional 'deterioration' of relative income distribution. Such successes must not be allowed to evoke cries of 'the poor getting poorer while the rich are getting richer'. This whole approach is based on envy and is totally mistaken if one applies individual humane standards. As some get richer, others do not get poorer in absolute terms. Moreover, the newly rich spend their incomes on goods and services. This gives the less well-off new job opportunities, as is now reflected in the burgeoning number of well-paid service-sector jobs and small enterprises. Those who watch statistics of relative income distribution and advocate remedial action on that basis surely do not intend to diminish the life opportunities of the alert, the successful and the fortunate and reduce overall economic growth!

Politicians and publicists who exploit the politics of envy deserve to be castigated by public opinion. Governments should confine their efforts to fighting absolute poverty. Only then can political action solve social problems.

A further difficult intellectual change is needed. As tax resources available for redistribution dry up, boldness will be required to speak of 'behavioral poverty'. It will be necessary to identify types of harmful individual choices that are likely to result in penury, such as dropping out of school early, dishonesty, gambling, and drug taking. In the present climate of political correctness, it will take courageous community leaders to argue that such voluntary choices do not justify unconditional automatic compensation via handouts of tax money. Remedial action and personal effort should be demanded as a precondition for (time-limited) income subsidies.

It is extremely doubtful whether public administrators know enough to diagnose behavioral poverty, and whether the political will is there to enforce the appropriate rules to curb it. The needed change in policy would perhaps stand a better chance if welfare were devolved to local government level. In this way, the resources for welfare subsidies could be raised at least partly from local ratepayers. Or competing private charities who raise funds from tax-deductible donations could be entrusted with the task. Taxpayers could then be given 'charity vouchers' that they allocate through an agency for an approved purpose of their own choosing[12]. The information revolution makes such experiments feasible. Poverty alleviation could then shift from mindless indiscriminate handouts to a real leg-up to a better life.

Shorter time horizons and the focus on romantic and/or opportunistic political tactics have a further deleterious consequence: policy inconsistencies build up over time, preparing the ground for social conflict. Policymaking should be focussed on cultivating citizen- and enterprise-friendly ground rules, not on specific outcomes and redistribution. Policy design should start by asking where we want to be in 25 years, so that attention is paid to obstacles and contradictions as soon as they arise. Conflicts could then be averted before they come to a head, as they can often be resolved spontaneously and without political intervention. This demands political leaders who have the imagination and intellect to focus on the big picture and public servants who think long-term. Given the institutional set-up of the Australian polity, there is little incentive for such a far-sighted outlook. Citizens remain resigned and sceptical, if not cynical, and assume that politics will always have to be short-termist, reactive, interventionist and confrontationist.

As a result we now observe the development of costly long-term inconsistencies that bear the seeds of a repetition of the 1970s and a decay of the simple yet effective rule system of economic coordination. The government is making commitments to anti-growth groups, such as the Greens and social welfare groups, that will at some future time emaciate the economy. Resources for nature conservation and social welfare consequently become short. Many an organised interest group argues for positions that will lead to a backlash.

For example, a popular backlash against aggressive Aboriginal activism and the more radical Green positions has to be anticipated. Such backlashes, when they come, are rarely constructive, as the rise of xenophobia and extraparliamentary radicalism in Europe and elsewhere demonstrates. Inconsistencies are also being introduced through technological change. Many

[12] Hungarian income tax payers are given the right to direct 1% of their annual income tax to approved 'good causes', running from charities to arts funding.

in public life still behave as if the power and wisdom of government were unlimited, although the Internet is already reducing the its power. How often do 'spokespersons' demand problem solutions from governments when in reality only their own initiatives and small-group cooperation can remedy the problem?

The advantages of private over collective action and of civil society over politics are not readily accepted in this country. After a century of heavy reliance on government, the experience of life in a closed economy, the unremitting public education in schools and the media about the omnipotence of government, the turn to a more individualistic competitive ethos will not come easily.

## *Communitarianism, Social Contracts, Third Ways and Other Diversions*

Many observers have realised that big government, the nationalised welfare bureaucracy and other centralised devices to obtain targeted outcomes have failed. The aspiration to a 'Great Society'—to use the slogan from the Kennedy-Johnson era in the United States—or to the post-war Fabian, social democratic dream has proven unrealistic. Such schemes are now the pipedreams of an elite. The rising level of general education has made more and more ordinary people the world over sceptical of big government. Witness for example the popular response to the elite-promoted 'republic issue', the political promotion of GST fears in Australia or the 'millennium bug scare' worldwide. The popular media are full of food, safety, and environmental scares, many put out by self-serving interest groups. Politicians still seem to react to such stories, but ordinary citizens barely respond anymore. The population has reached its cognitive limits for the ever-changing issues and concerns promoted by the media and policy elites. This reaction is a clear sign of general 'overgovernance'.

Traditional social democrats and the many people who made collectivist solutions their life's career, are now severely challenged. Most social democrats did not want to join the collapse of totalitarian socialism after 1989. They kept clinging to innate reservations against individualist and rule-based solutions. They are trying to find a 'third way'. It is not always clear what the promoters of the 'third way' have in mind, but they seem to be drawing on longstanding European traditions of communitarianism and the concept of a 'social contract'. They now want to promote collective action and top-down coordination—coupled with as little coercion as possible—at the local community rather than national level (Latham 1997). Nevertheless, they frequently argue for public ownership and fail to tell us why outright private ownership and competitive supply are not preferable.

Compared to the grand design of an all-encompassing social democratic welfare state, this approach has much to recommend it. Many institutions work best when cultivated and shared at the local level, where information about specific circumstances is rich and where the incentives to act for the benefit of citizens are strongest. As the domain of collective action is shrunk and decentralised, local communities are bound to discover that action with external benefits for the neighbourhood also generates benefits that can be captured locally. Thus, a community that cultivates local public and private amenities—such as parks, clean streets, safe living conditions, cultural facilities, honesty, punctuality, spontaneous rule compliance, and the like—is bound to discover that this will, sooner or later, raise local real estate values and improve local business conditions. Many a region has prospered thanks to such local facilities and informal institutions (Ostrom 1990, Putnam 1994).

Shared intangible and tangible 'social capital' do not, however, need to be directed from the top down, nor is there always a need for tax subsidies. Living conditions in Australia could be greatly enhanced by more reliance on voluntarism and a vigorous civil society that owes the state nothing. Clubs, churches and other private associations can do much to promote these community assets. They are able to draw not only on the financial contributions from the members, but also on the members' dedication, skills and personal networks. Community recognition—at times even involving informal shaming of notorious free-riders—will often be a more effective reward than payment. Governments have crowded out many voluntary associations over the past generation. The welfare state has reduced voluntary charity. Government-funded 'recreation and education officers' have usurped the maintenance of tracks and parks from boy scouts and school groups. Local hospitals are now managed by far-away bureaucracies. The conditions of community life familiar to and appreciated by many Australians—in particular in rural communities—for most of the last 200 years have thus been usurped by distant bureaucracies.

What governments should do is ensure that services meet stipulated health, safety and environmental standards, and that no citizen is denied access by discrimination. For example, local clubs and associations of volunteers can be chartered to run schools, cultural centres, hospitals and employment exchanges. Care must be taken to prevent the creation of private monopolies, which would often be as objectionable economically and socially as public sector monopolies. This will require the enforcement of competitive standards by a supervisory arm of government. It will certainly require that office holders abstain from granting exclusive licenses or from intervening directly and in preferential ways. Experience has shown that voluntary groups are easily 'crowded out' by tax-funded activism.

Advocates of the 'third way' and communitarians tend to go beyond this. At least in this author's reading of the communitarian and 'third way' literature, one normally finds cautiously disguised elements of coercion and elitism as well as residuals of politically protected monopolisation. Many politicians who promote 'civil society' do not refer to the 'civil society' that John Locke (1632-1704) had in mind when he coined the phrase. He and the fathers of the US Constitution saw civil society as a community of self-motivated, free citizens whose will had to be respected by government. They saw civil society as a spontaneous non-political order. The current political fashion, by contrast, is to redefine civil society as an array of private associations and groupings who work under government direction and who are part of a 'third way' collective order. In such cases, coordination does not rely on autonomous competing clubs and associations, which members can join or leave. Instead, tax-financed public sector administrators are the ultimate arbiters of what collective problems are to be addressed. Private autonomy and decentralised decisionmaking are limited in favour of elite-driven solutions, preferably with the voluntary contributions of well-meaning people. In Britain, 'third way' rhetoric and sloganeering has now been recognised as a disguise for the elitist and centralised nature of the new 'socialism in communitarian clothes'.

Another code word for the new soft collectivism is the notion of 'stakeholders'. This is based on a vision of society as a purely political affair, where all interactions are negotiated by all concerned and where nothing is left to compliance with rules and the spontaneous interaction in markets. If, for example, 'stakeholders' were to determine the business of a corporation, there would be endless bargaining and politicking amongst stakeholder groups—the capital owners, the workers, the suppliers, the customers, and management. In practice, 'stakeholder' management relies on elites who do the bargaining and who will often have little incentive to reach an accord. Such companies are bound to lose out to competitors who are guided by simpler management models and can therefore respond more quickly to shifting market opportunities.

A related 'third way' concept is the notion that companies have to observe not only the capitalist bottom line of a profit, but also 'other bottom lines': environmental impact, labour standards, ethnic equality etc. The straightforward and time-tested model of management for profit within given institutional settings will, in the long run, lead to a better utilisation of knowledge and better coordination, i.e. to superior economic growth rates. Greater wealth can then, in turn, assist with the promotion of other objectives (see Conclusion). Beginning by imposing constraints with varying degrees of coercion and reliance on group bargaining puts the cart before the horse.

Collective negotiations and actions are often justified by the notion that all citizens in a community have concluded a 'social contract' with the ruler or ruling class. The idea originated with Jean Jacques Rousseau. It was conceived at a time when autocratic and hereditary rulers still existed or were at least a recent memory. Rousseau's concept of the 'social contract' has been used to promote collectivism and suppress the voluntary coordination of individuals by reliable and impersonal rules. The contractarian concept has not improved with age. The Swedish economist Knut Wicksell revived and modified the concept to explain the existence of the state. More recently, it has surfaced in important segments of the 'public choice' literature being used by otherwise liberal thinkers to limit the radical conclusions that flow from the logic of libertarians and individualists (Kasper-Streit 1998: 334-37).

Has there ever been such a thing as a 'social contract'? Can there be? Our children and grandchildren have certainly been born free. They have never signed a contract with anyone to shoulder future obligations, for example to pay the unfunded pensions of the baby boomers or even to obey a written or unwritten constitution that they have never sighted. A contract is typically a mutually binding but voluntary agreement between consenting parties. The concept of 'contractarianism' should not be allowed to hijack this meaning. Rather, a constitution that underpins the interactions of all members of the community should be understood as a collection of time-tested and high-level rules that give the community confidence and continuity (Hayek 1960; Ordeshook 1992). The acceptance of a constitution derives from the insight that free people accept certain obligations and constraints so that they can prosper. The Roman orator and jurist Cicero put it well when he said: 'we are the servants of the law, so that we can be free'.

### *Parliament and Administration: the Citizens' Agents or Their Masters?*

The British parliamentary tradition, on which Australian electoral democracy is based, emerged as a counterweight to powerful lords and rulers. Their aspirations and the taxes to fund them were constrained by assemblies of elected representatives who acted as the agents of growing numbers of taxpayers. Power was thus divided between the rulers and the people. The division of powers was enhanced further when the right to adjudicate in disputes became independent of the rulers and an independent judiciary evolved.

Since those early beginnings much has changed. With the creation of the Westminster system and the formation of organised political parties in the early 19th century, the executive power came into the hands of elected rulers who represented a majority party, or coalition of parties, in parliament. Members of the parliamentary majority were increasingly coerced to adhere to party discipline. Parliamentary majorities thus gained massive though temporary political power. As monarchs became constitutional figureheads, the classical division of power between the executive government and the parliamentary majority fell by the wayside.

In the British system of government, power is unduly concentrated in the hands of the elected parliamentary majority and government. If the majority of the day sets out to overturn the fundamental ground rules on which people rely to coordinate their daily activities, there are relatively few constitutional anchors to prevent this. In practice, fundamental decisions are made by slim majorities on a committee normally staffed by parliamentarians with a strong interest in the matter at hand. In reality this frequently means that the particular interest of an organised lobby group will determine the content of legislation. Party discipline will subsequently ensure that the legislation is adopted by the plenary session. Given the hectic schedule of present day parliaments, few will ask how new legislation affects the majority of citizens. The press gallery, which depends on the benevolence of the government, is likely to remain silent. Legislation is thus increasingly biased in the direction of organised interest groups. Long-term common interests are rarely taken into account.

Some Westminster-style democracies have bicameral systems that are meant to work as independent regionally-based or class-based counterweights. But in most circumstances the party system has made regional representation rather illusory. In Australia, the central government's powers are sometimes held in check by the States, but State independence has been eroded over time. The States willingly shed the opprobrium of having to raise taxes and thus become more and more dependent on Federally designed and collected taxes. The latest step in the process of abandoning State tax independence was taken with the formula-sharing of the Goods and Services Tax in 1999. Less assertive State policies are bound to follow. With the emasculation of State's rights, it is not surprising that many now argue for the elimination of this second level of government.

Other parliamentary traditions work with more formal written constitutions, watched over by strong-minded constitutional courts and independently elected presidents. Some regimes temper the powers of parliamentary majorities by popular and citizen-initiated referenda and other devices that make it less easy for the majority of the day to act opportunistically. These control devices reduce the likelihood that power will corrupt the parliament. This has become more likely as the public realises that is powerless to affect legislation. There is therefore normally little interest in incurring the costs of information about legislation and administration. Thus, the public remains in 'rational ignorance'.

So what began as a representation of the citizens against powerful rulers by assemblies that fought for individual liberties has in practice become an enemy of individual freedom and social flexibility. Every time the parliament sits, individual liberties and private property are arguably under threat.

In Australia, the emasculation of people's freedom by gradual and silent encroachments of which James Madison warned in 1788 (see quote at the head of this Chapter), has progressed a long way. Government often behave as if they were the masters. Meanwhile citizens are increasingly being treated as the servants of government and their powerful client groups. The perversion of the principal-agent relationship in Australia is expressed nowhere more clearly than in the self-serving legislation that forces us, the citizens, to attend elections. A truly free vote comprises the freedom not to bother about voting. The punitive coercion to attend the ballot signals to all citizens who the master is. In extreme cases, the role reversal is fought by the citizens, such as in the episode in the 1980s, when all major political parties favoured the introduction of identity cards, but popular resentment prevailed.

Democracy has thus degenerated due to government domination and interest-group politics in all mature democracies. The result is that parliaments, ministers and officials are now widely held in contempt. Much triumphalist propaganda is heard about the advances of democracy around the world. But progress in the substance of democracy, and the freedoms it is meant to protect, is not so clear.

The growing alienation of voters is serious, because the very stability of the political system depends on the acceptance and legitimacy of parliament and government in the eyes of the citizens. If unchecked, growing political alienation could become a major challenge to democratic life, in particular should a faltering economy strain social cohesion. A rejuvenation of Australian democracy, a hundred years after Federation, is therefore an important challenge. Such a priority task must not be tied to an issue of secondary importance, such as the republic. Constitutional reform needs to be debated with reference to widely shared values such as the freedom to pursue our own objectives, security of that freedom in the future, internal peace and harmony, justice in the sense that the same rules apply to like cases, and equity in the sense that we all deserve reasonably equal starting opportunities.

### *Can a Kondratieff Downturn Be Avoided?*

One question remains to be answered: can Australians sidestep a downturn in the global economy in the coming generation? Both Karl Marx and Joseph Schumpeter (1947), who thought profoundly about the connection between a capitalist democratic society and sustained prosperity, concluded that economic stagnation would eventually be terminal for the reasons discussed in this chapter.

They have been proven wrong time and time again. Social systems are capable of rejuvenation and can overcome the tendencies to entropy. Periods of institutional sclerosis and rigidity in the face of changing circumstances have, with painful time lags, been followed by institutional, organisational and economic innovation. If there is a history lesson in all of this, it is that economic downturns eventually trigger antidotes to overcome rigidification, political rent-creation, distribution conflicts and political power games. These antidotes have invariably been found where people enjoyed economic and other freedoms so that what we called the 'Eric Jones effect' (see p. xix) can work. Where people were able to transact business in free markets and where they could have the confidence that they would be able to keep the fruits of their efforts, economies have soon re-emerged with renewed growth accelerations. The more economic freedom citizens are able to enjoy, the faster and more pervasive the creative responses to the challenges to prosperity will be. This is why economic freedom needs to be cultivated and why governments must in future act as support organisations for competing citizens.

The history of Kondratieff waves makes it more likely that the early decades of the new century will witness a turnaround in the currently fast economic growth. Easy prosperity fosters institutional shifts that lead to political and economic sclerosis (Kindleberger 1989). But there is nothing mechanical or inevitable about this. We now have sufficient understanding of the big pattern of interaction between institutional evolution and economic growth to know that interventionism and lesser economic freedom impede growth, and vice versa. It would be genuine social and political progress if that understanding could induce timely reform to avoid rigidities cumulating into a decade-long crisis of capitalism until reforms are implemented.

A major task ahead for the Australian community—and a task that deserves the best political and jurisprudential efforts—will be to rejuvenate democracy and governance in ways that empower the citizens (Brennan & Hamlin 1997). We can only point to the problem; we cannot assess the likelihood of this important insight becoming a guiding influence over Australian public policy.

Taken on their own, none of the above challenges alone will cause a turnaround from fast to disappointing growth. It is their cumulative effect and mutual reinforcement that produce the trend breaks that surprise investors and that turn 'golden eras' such as the 1960s into 'decades of woe', such as the 1970s.

# CHAPTER 4
# Policies for Economic Freedom

'Freedom is that faculty which enlarges the usefulness of all other faculties'.

Immanuel Kant, *Lectures*, 1775

'.... there have existed, in every age and every country, two distinct orders of men — the lovers of freedom and the devoted advocates of power'.

Robert Y. Hayne, Speech to the US Senate, 21 January 1827

## A. Governance and Economic Freedom

### *Prepare While the Sun Shines*

Investing in freedom while the economy is flourishing is the best way to safeguard future prosperity. But here is the rub: when the economy is growing, few see the necessity and most dismiss warnings about what might follow. Thus, problems are not diagnosed in enough time and remedies to ameliorate the trauma and disappointments of an economic slowdown are only belatedly developed.

Figuratively speaking, there is a great temptation to act like the crickets do: to fiddle away all summer, denying that a winter might be approaching. The alternative strategy is the approach of the bees: to prepare for the cold while the sun shines. Switching from carefree cricket-like enjoyment of the current upwave to the more arduous attitudes of the bees will save the Australian community much pain later.

This will require a strategic reappraisal of the unwritten and written rules that make up Australia's political and economic constitution. It is a century since Federation. A debate about constitutional fundamentals has been begun, albeit as an add-on to the republic debate of the late 1990s, when a preamble was put to the people in a politician-initiated referendum. Observers have argued for reflection on the constitution, and for fitting it and the role of the highest authorities into the mould of an open information society. In a dynamic world where demographic, economic and political circumstances change, we need a set of reliable and explicit ground rules that inspire trust in the fundamental settings, but expedite adjustment of the more specific institutions. This is the very function of a good constitution. Developing one that meets these criteria now would stand the community in good stead in the 21st century.

Demands for a comprehensive overhaul and modernisation of the Federal constitution are unlikely to go away. The owners of internationally mobile knowledge and capital will in future not bother with complicated constitutional rules or wait for case-by-case decisions. The present constitution does not fit well with the requirements of the developing rivalry among jurisdictions. At present, we are living not only by the often excessively detailed written Constitution of 1901, but by numerous unwritten fundamental rules that go back to Magna Carta and beyond, as well as precepts of natural law and the shared traditions of Anglo-Saxon constitutional law (Walker 1993; Ratnapala 1993, 1999-2000). The system has, by and large, served Australians well. But greater international exposure, faster technical, social and economic change, and a recent tendency on the part of activist High Court judges to engineer and impose outcomes, rather than simply cultivating and applying the law, will sooner or later force us to revisit the constitutional question (Craven 1997).

Whatever the circumstances this will be a major exercise. If it is to be worthwhile, it must begin with the question of how the fundamental values to which all Australians aspire—such as security, freedom, justice, peace, equity and economic welfare—can best be attained. It must be based on a fresh discussion about the appropriate delineation of the border between protected private action and public collective action.

The purpose of this Chapter is to caution against complacency that all necessary reforms have been done and that the good times will keep rolling on. It also contributes a few ideas to a forward-looking, comprehensive review of the ground rules that Australian society shares, mainly from the viewpoint of economic welfare.

### *Individualism, Competition and Enterprise in the Open Economy*

Australia's belated but fairly successful adaptation to the new opportunities and requirements of a more open economy was made easier by an excellent resource endowment, ethnic diversity and relative youth as well as its location in the dynamic West Pacific region and its institutional traditions of tolerance, commonsense, political participation, compromise and social stability. Time-tested and shared rules of informal social conduct, coupled with the commitment to constitutional government and the rule of law, have been valuable assets during the immense economic transition of the past 25 years. Most of these conditions are so widely accepted that they are often taken for granted.

The reforms of the past 25 years have in important respects enhanced fundamental economic institutions, such as private property rights and the freedom of contract. In many respects, however, Australians still have to live with a rather defective set of economic liberties. The interventionist traditions of the first three-quarters of the century after Federation linger. They have conditioned the population to tolerate rather restrictive political limitations on their economic freedom, for example in their work places. As the economy becomes more sophisticated and the competition hots up, popular tolerance for political interventions will erode.

This has already happened in the agricultural and mining industries that once upon a time tolerated tariffs. They attacked the protectionists in industry and politics when faced with fiercer global competition in their industries in the 1970s. The new manufacturing and service industries that compete internationally are now demanding more comprehensive and reliable economic liberties. More and more Australians will want to use this country as a platform to compete internationally.

The open-ended and unpredictable evolution of economic opportunities and contingencies—most of them specific to time and place—requires prompt, decentralised and innovative responses by self-responsible individuals and teams. Ponderous and prescriptive collective action simply handicaps those out to catch fleeting opportunities in world markets. When the present economic tide turns, quick responses by free citizens and firms will be the best safeguard against a cumulative downturn. They alone are in a position to ensure what economists call elastic responses of supply and demand.

In Australia, as in most other parts of the world, a collectivist tide ran from the late 19th century to the 1970s. Government mushroomed as never before in human history. The after effects are still lingering, despite privatisation and deregulation. Moreover, collectivist controllers could reassert themselves when the going gets tough. Neither major political party in Australia now seems as committed to free market reform and openness as they were in the early 1980s, and many opinion leaders appear to consider the economic reform agenda as *passé*. But Australia's 'economic constitution' is not yet committed to the principle of individual freedom. The liberal regime in financial and product markets is not matched by similarly free sub-orders in labour markets. Many parts of the public sector are ill attuned to the competitive advantage of free and open global products, capital and knowledge. Constitutional consistency is essential to making Australia an attractive place for productive capital, technical knowledge, high organisational skills and enterprise. Only if this country is highly attractive to these internationally mobile production factors will the local owners of labour, skills and land thrive. Only then will government administrations be able to collect the revenue necessary to meet their essential tasks.

All great historic transitions cause confusion. Traditional labels and associations lose some of their meaning. Thus, the traditional identification of progressive reform with 'the Left', which began with the first French parliament at the beginning of the French revolution, and the conservative-reactionary defenders of existing institutions with 'the Right' has become meaningless, if not misleading. Nowadays, collectivists who want to undo privatisation and re-regulate markets are the reactionaries. Progressive policies aim at deregulation and the shoring up of individual liberty. They have to contend with reactionaries on the Right and the Left. To unscramble the terminology is therefore an important first step in introducing clear thinking into the public debate. And to unscramble the traditional political parties may be a second step. The empowerment of the individual through the information revolution, and the evolution of the workforce from a mass of poorly-skilled process workers into citizens with skills and individual aspirations indicates a progression from coercive collectivism to more self-responsibility and voluntary action. Those with an individualist vision and with a preference for civil society therefore deserve to be designated as the progressive forces.

Great transitions also raise transaction costs. About half of all costs of producing and distributing the national product are nowadays coordination costs, that is transaction costs in markets and coordination costs within businesses and other organisations. Moreover, the share of the 'transaction services sector' is rising rapidly. The costs of exploring and testing new opportunities, finding partners, and negotiating and credibly enforcing contracts are of particular importance in the new 'e-economy', the knowledge industries and internationally traded services. The international competitiveness of jobs located in Australia will therefore depend increasingly on low coordination costs. This in turn depends on simple and effective institutions. A comprehensive review of Australia's regulatory system therefore seems urgent. The sooner this massive task is tackled, the better.

A ruggedly individualistic and responsive Australian society will require much less toleration of discrimination and those privileges which elected legislatures habitually dish out to well-connected or vocal interest groups. The silent majority has long put up with such political schemes, because voters incur high costs to stay informed and feel impotent to change things. What some consider to be tolerance is in reality 'rational ignorance' and apathy. The long-term consequences of such popular attitudes to collective action are poor politics, a poorly run economy and growing encroachments on individual liberties. Individual citizens will need the courage to stand up to opinion-making interest groups and to oppose blatant group egotism.

Until recently, for example, elected parliaments perverted the free trade rule within the Commonwealth (Section 92 of the Constitution) by granting milk producers in less productive States protection from competition by producers in States with more favourable natural conditions and better management. Dairy farmers, naïve enough to believe that the governments' breaches of the internal free trade rule would last forever, bought milk quotas, which became expensive because the restriction of a free market generated high rents. The public and the media ought to have castigated such favouritism as an unconstitutional misdeed! When at long last in 2000 the internal trade in milk was liberalised, consumers and political leaders should have derided the selfish rearguard action of politicians who offered subsidies to milk producers.

Political opportunists who represent selfish interests of the lobbies should be exposed mercilessly, because they conspire to undermine the equality of all before the law. No judicial sophistry should be allowed to detract from a proper understanding of first-best principles. Despite deregulation, the main activity of Australian parliamentarians is still to allot privileges and interventions for an industry or interest group. The elected representatives of the people thus weaken private property rights, effective markets and principles of justice (Chapter 5). In future, such political meddling will inflict more immediate costs in terms of employment and growth.

The big question is who will reform politics and the law? Citizens have to rely on the legislature to rein in the opportunism of the legislators, and on the courts to constrain the courts' interference in free markets. This conundrum cannot simply be dismissed with talk of politics being the art of the possible or hopes that politics can go on manoeuvering through interest group conflicts. If rational analysis and insight fail to motivate reforms, traumatic events may well occur which turn today's unthinkable reforms into the next generation's political necessity.

Economic freedom is a difficult task for policymakers nowadays. Freedom always needs to be constrained through universal and credibly enforced institutions, lest liberty become license and conflicts multiply. Unfortunately, concepts such as 'enforcement', 'rule-bound behaviour', 'constraint', and 'self-responsibility' are not popular in the post-modernist, endlessly tolerant climate of the start of the 21st century. Many resent any form of constraint and they reject universally binding institutions.

Political leaders who want to be popular therefore often shy away from imposing binding institutions. Many crimes against property and other rule infringements are dismissed, and 'zero tolerance policies' are under popular political attack. Populist politicians often prefer to yield to claims, pretending there are no mutual obligations. This is, for example, becoming evident in the debate about unemployment payments and obligations of job seekers to undertake job searches or participate in work-for-the-dole schemes. Many politicians speak in terms of a right to the dole, and display public outrage about the unemployed's obligations to find work. Such a populist approach to policymaking promotes the rule of interest groups and leads to the decay of a free society. Indeed, populist illusions have been a frequent cause of the secular decline of societies, and episodes of social decline may serve a salutary substitute for direct experience.[13]

In the immediate future, powerful stimuli for consistent legislative and regulatory reform and institutional simplification are bound to come from without (Eric Jones effect). Investors and gifted people who leave this country and negative unsustainable trade balances would probably trigger recognition among the voting public and among politicians, judges and officials that Australia's institutional regime needs a thorough overhaul, that constitutional and law reforms are needed to simplify the rule system, and that society's internal institutions have to become more competition-friendly. If political entrepreneurs develop programmes for the next wave of reform and the public gives them support, much trauma—normally the most powerful stimulus for reform—can still be avoided.

In a competitive and just society, people with wealth are expected to reinvest their wealth—time and again—in the risky search for innovations. Without this obligation the capitalist market economy would not remain popularly acceptable. Nothing turns public opinion more against capitalism than rich citizens seeking political protection from competition. Politicians who indulge individual capitalists as well as industry and union lobbies by offering privileged protection from competition should be exposed.[14]

## *A Reassessment of the Role of Government*

This concept of economic and political life and the analysis of the challenges ahead in Chapter 3 suggest that the role of government should be assessed afresh in Australia. The dramatic changes in the world should make us wary of models of governance that were inherited from the fairly closed nation state of the past. A hundred years ago, government administrations were able to rely on stable conditions and exert a considerable measure of control. The nation state and a high degree of socialisation of property were favoured by the emerging technologies of that time. Rail, telegraph, telephone and electric

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13 Modern institutional science and constitutional economics owes much to the writings of Edward Gibbon whose inspiration derived from the study of the decline and fall of the Roman empire (Gibbon [1776] 1983-90). Those who want to guard against an economic downwave are well advised to study the experiences of decline, beginning maybe with the fall of the Soviet empire and the continuing moral, social and economic decline in Russia and other successor states of the USSR. Instructive insights can also be gleaned from looking at cases like the late Roman empire, the decline of Spain after the conquest of the Americas, the long decay of Chinese civilisation from the 15th to the 20th century, the Weimar republic in Germany, and the contemporary problems of the Arab world and Africa. This may be a poor substitute for first-hand experience with economic sclerosis, but as a way of learning the lessons it is preferable.

14 This view will not necessarily be shared by those economists who begin by assuming perfect knowledge and analyse matters in comparative-static equilibrium terms. But in reality, the economy is never in equilibrium. The essence of economics is an open-ended procedure of discovering knowledge about new wants, new assets, new resources, and new solutions.

power supply systems made it advantageous to organise centralised networks. Measuring technologies were primitive. It was often impossible to measure the private use of public domain infrastructures, such as roads. Many infrastructures were therefore financed and run by publicly owned enterprises. Capital markets were thin, so that many saw an advantage in governments financing the expensive new networks of the modern age by taxes and public debt.

This growing role of government was often seen as an 'iron law of history'. More recently, however, technological progress has had a decentralising influence: the radio spectrum can now be split, so that competing communications networks are feasible. Competing electricity generators can offer their supplies in frequent auctions over a shared grid. Road use can be measured through transponders, so that open-access roads can be built and operated privately.[15] Private capital markets have now the capacity to finance huge infrastructure projects. In the past, much of the productive function of government was monopolised and therefore exposed to capture by public sector managers and organised labour. As happens so often the agents became the principals. In most public utilities the quality of service and innovation deteriorated, and public ownership became a budget liability. Little wonder that even Marxists began to sell off collective property and Fabians began to go down the third way! In the process, the entire role of collective action has come up for re-examination.

The dramatic increase in openness to the world, technical changes and the unimagined increase in the complexity of the division of labour also made central political guidance and intervention less and less useful, if not detrimental. Intervention in a market requires foreknowledge of all the side effects, which no one can have. Today's intervention is likely to be tomorrow's obstacle to economic advance. Outcome-specific government actions should therefore be abandoned in favour of promulgating, fostering and enforcing simple and reliable rules.[16]

The advantage of rule-based governance will increase over time. People with money, drive and know-how will be attracted by simple rules that they can comprehend quickly and with confidence; this influx will improve growth. Owners of mobile resources are already fleeing to political environments where

15 A clarification of the word 'public' seems in order here: *Access* of the public to a service neither requires public sector *ownership* of the means of production nor the administrative *management* of production. Access only requires that certain facilities are guaranteed to be in the public domain, i.e. that no-one can discriminate against certain interested users. When the managers are given a degree of autonomy in the day-to-day running of a service, we speak of *corporatisation*. When the means of production are transferred to private owners, we speak of *privatisation*. Experience the world over has shown that corporatisation tends to produce one-off stepwise improvements in productivity and service quality, but that it takes privatisation and ongoing competitive challenges to ensure growing productivity and continuing quality improvements.

16 For what such rules imply and how they work, see Kasper 1998.

outsiders have an equal opportunity and where *what* you know matters, not *who* you know. They have learnt that political privileges are not free. They mistrust a style of governance that relies on privilege creation. Today's political privilege may be aimed at attracting them, but next week's political privilege for someone else will hurt them. Privilege-trading politicians are likely to be corrupt and will sooner or later try to extract 'protection money' or other kickbacks for political favours. More and more multinationals therefore conclude that it is wiser just to stay away from such political regimes.

Australians have learnt that politicians' promises, even when formal and explicit, cannot be trusted. Who believes politicians when they promise specific outcomes? Prime Minister Bob Hawke, for example, was rightly derided when he promised that 'no child will live in poverty by 1990'. The same response was earned by Prime Minister Paul Keating when he had future tax cuts legislated ('read my lips!') and Prime Minister John Howard when he formally promised that the GST tax reforms would not drive up the cost of petrol for the average motorist. The reason for the prevalent popular cynicism about political promises is a sound one: politicians and advisors can neither know what specific outcomes their actions will produce, nor do they normally have the means to bring about promised specific outcomes. In a complex ever-changing economy, politicians are therefore well advised to desist from detailing specific results and setting detailed targets, such as a specific growth rate, unemployment number or income distribution. Collective action is much better at proscribing certain activities that are generally considered harmful—prohibiting theft, lying, fraud, murder and the like—than at prescribing specific outcomes.

The surveillance and control of individual prices is clearly not possible. There is great merit in governments maintaining an authority whose primary function is to cultivate rules of genuine competition. Internationally open markets nowadays do much of that job. Poor competition among domestic sellers or buyers often triggers international competitive participation. In these cases, the cultivation of a competitive culture only demands that information travels freely and that outside competitors can participate on equal terms. In other areas of the economy, open competition is prevented by transport and communications costs, government regulations, subsidies and private cartels. In these areas, the government watchdog—the Australian Consumer and Competition Commission (ACCC)—should investigate whether or not competition fulfils its various social roles. This is, however, often very hard to establish. Nevertheless competition principles need to be defended, as competition is a precious public good.

Prescribing certain outcomes in markets and, in particular, determining prices is not legitimate. Circumstances change all the time; consequences are unknowable. Putting the ACCC in charge of punitive price monitoring at the introduction of the GST and ruling that no price should be raised by more than

10% was asking for trouble. How could prices of a cappuccino be monitored when the price of coffee, labour, rents, and a thousand other costs keep changing continually? The fixing and enforcing of any one price is a futile, misleading and dangerous attempt at engineering outcomes. The whole exercise of post-GST price controls, and pretty much everything else that the ACCC nowadays attempts to do, amounts to governance by confidence trick. Over the longer run, this makes the competitive system dysfunctional and deprives citizens of the freedom of contract.

Australia's well-educated and well-informed population now recognises many of the confidence tricks of governance and know that most of the thousands of pieces of legislation and decrees emanating from the capitals cannot be enforced. Conditions in Australia do not differ much from those in Germany, where careful empirical estimates showed that, at any one time, government 'authorities' can at best enforce, by the means of compulsion at their disposal, 3.7% of the legal norms governments decree (Kimminich 1990: 100). By being too ambitious and too yielding to the proliferating interest-group democracy, governments have thus lost most of their real authority. The remedy is to stipulate simple constitutional rules that constrain parliaments and administrations from decreeing a proliferation of prescriptions.

### *The Three Functions of Government: What Will It Cost?*

Governments have three functions: protective, productive and redistributional (Kasper-Streit 1998: 293-311).

First and foremost, governmens must protect citizens from attack from within and without. Protective government is needed not only against opportunistic fraud, negligence, the use of force and failure to keep contractual undertakings, but also against political privilege mongering and rent-seeking by interest groups. The protective function of government has historically been enhanced when rulers clarified and codified the rules, decreeing and enforcing further protective rules as necessary.

The confidence in protective government is enhanced if rulers subject themselves to rules (rule of law). Abstract constitutional rules can be laid down that determine how more specific rules are to be changed if necessary (constitutional government). Such constitutional rules can only be adjusted by special procedures, for example large majorities. This creates continuity and enhances confidence. The cultivation and enforcement of institutions to protect the citizen's sphere of autonomy and freedom costs money. Rulers therefore tax subjects to meet the agency costs of protection.

The protective function extends to the tasks of law and order, defence and the cultivation of legal security and contract fulfillment, making recourse to violence unnecessary. It would seem that this can be done for a tenth of a citizens' income, as already stipulated in the Bible.

Governments have assumed manifold productive functions. They often produce the means of enforcing the law, so as to maintain direct control over the resources used by the courts, the police, the prison system, and the military. The community has conceded the monopoly of force to government, because most prefer the weapons and the apparatus used by the 'violence professionals' to be controlled by government ownership. History has shown repeatedly that control through the purse strings of public ownership is a most effective means of averting or terminating military coups and of keeping political control over the police. Private mercenary armies who own and operate their own equipment have a habit of turning from agents into principals and of becoming vastly more costly.

The productive function of government has extended far beyond the material support of the protective function. Over time, governments have built up, owned and run infrastructures and numerous other services. Enormous political and bureaucratic creativity has gone into finding reasons to justify this growing involvement, but in practice the motivation has been to collect revenue and distribute advantages from the general public to specific groups through channels outside public or parliamentary scrutiny.

Politicians are often held responsible for poor service delivery, and many now think twice about using public ownership as an invisible means of redistribution. Concerns about political favouritism, the sheer inefficiencies of producing more and more goods and services under central government administration, and the poor track record of the public sector in innovation and efficiency have therefore led to periodic waves of privatisation, most notably on a massive scale over the past quarter century. Privatisation is now a worldwide phenomenon.

It is now widely realised that what matters is not *ownership of production* but *access* to the diversity, quality and effectiveness of public services. Users do not care where the electricity comes from, as long as no one can exclude them from access to the network. Facilities and amenities can remain privately owned if they remain accessible and in the public domain. Prohibiting exclusion from access is a matter of negative freedom, i.e. ruling out discrimination.

A separate concern is positive freedom, namely having the material means to buy access. Public ownership and control of production is frequently defended on the grounds that public enterprise can be used for purposes of redistribution, providing subsidised public services for all. But redistribution and production can easily be separated. If there is a political decision to distribute rights of access, people can be endowed with direct subsidies or vouchers that allow them to buy from the competitive market. Then, production can become private and competitive, offering better efficiency and the discovery potential that comes with competing. There is, for example, no reason to run public schools and universities as if they were public administrations if one favours more equitable educational starting opportunities for all.[17] The solution lies in the distribution of school vouchers, education loans and scholarships.

Once the productive function of government is seen from this angle, it becomes apparent just who will defend socialised methods of production and why. On the one hand, political leaders and lobby groups shun transparent budget processes that reveal the extent of political redistribution. When legislatures are committed to the big productive functions of government, this provides a huge comfort zone for public monopoly producers. The high administrative costs of running a publicly owned and bureaucratically administered production system of course constitute the incomes of the administrators. Public sector monopolies have also frequently been captured by organised labour or public sector managers. They have taken de facto control of operations and arranged matters so that they gain high incomes and comfortable work conditions. As a result, public enterprises are no longer of use to general revenue. Indeed, they are a burden on the budget.

Naturally, those working in public monopoly enterprises resist privatisation most vocally. They have the most to lose. But the evidence of the benefits of privatisation is overwhelming. The quality of service is improved, the costs go down, and innovation tends to become routine. Rather than mass producing one size fits all, privatised services are tailored to the requirements of the customers. Would any Australian, even out in the Bush, really favour the recreation of a national telephone monopoly? The telecom experience will probably pave the way for future privatisations.

There are many other candidates for privatisation. For example, the railways are now costing taxpayers heavy subsidies, are often poorly managed and use outdated equipment and organisational practices. They are publicly owned and under public sector management only because of the political desire to cross-subsidise urban commuters with above-cost levies on bulk transport. Other candidates are universities, schools, hospitals and public housing. Once political entrepreneurs develop vouchers or similar schemes to decouple production from redistribution, many more state enterprises can be privatised. In a generation, people will probably not understand why fast trains to Canberra and slow trains from Adelaide to Darwin should ever have been the government's concern, and why transport, power and waste disposal infrastructures were ever managed by public monopolies.

Government should maintain a few residual productive functions, for example in defence. It may even subsidise some production activities if there is a consensus to do so. We estimate that some 5% of the gross domestic product could be reserved for these purposes.

The government function that is most problematic for economic freedom is the redistributive function. It has expanded more than any other over the past

[17] This was a common theme in The Centre for Independent Studies' *Bert Kelly Lectures* by three prominent Australian Vice Chancellors, reproduced in *Policy* 16 (1): 21-41.

generation. In Europe, rulers have always had a role in providing residual emergency assistance to the destitute. When self-help and networks of family, friends, local community and voluntary charitable associations failed, the rulers used to provide an ultimate (though Spartan) safety blanket. In this respect, the East Asian tradition is different. Self help, family, friends and voluntary associations, such as temples and benevolent associations, are the only welfare supports. None of the new industrial countries of East Asia is—or is ever likely to be—a welfare state. Australians therefore compete most closely with communities that operate with sharper incentives to perform and without the cost burdens of pervasive socialised welfare. Globalisation will exert growing pressures on Australia to revisit the redistributional function of government.

The challenge to do so will also come from the emerging crisis of the welfare state. With about $2500 being transferred by taxation to recipients of social security and welfare for every man, woman and child in Australia, popular acceptance of the redistributive state is waning. Although the concept of the welfare state was widely accepted in the 1960s and 1970s, the transfers have created a big lobby group of recipients, as well as administrators whose careers depend on the number of clients.

This is not to deny Australia's traditional commitment to mateship and solidarity. These qualities are a social strength when they are applied at the personal and the community level. However, the abuses of the anonymous nationalised social welfare system are increasingly worrying voters. Admitting that not all poor people can blame bad luck for their condition is not to 'blame the poor', but to point to the need for remedies for the serious and growing problem of welfare dependency. Many Australians consider public welfare handouts a growing injustice to those who do not drink, do not abuse stimulative substances, do not gamble, do not shirk work and who pay their taxes.

Getting central administration out of the production and distribution of health, education and welfare services and into the hands of competing private producers would benefit those dependent on such support. What matters to them is that the service is tailored to their specific needs. A centrally designed nationalised service scheme can never offer the great variety of qualities that the vulnerable in our society need.

For example, education is not merely a matter of processing targeted numbers of students so that they can pass standardised tests, but a matter of conveying complex knowledge, values and social norms. This is the reason why so many Australian families bear the costs of private schooling. Likewise, the inmates of big public hospitals, which are run according to government and union regulations, would be much better off if they were in the care of competing private hospitals. If some hospitals applied the organisational techniques of competing hotels to attract more patients, then competition would enhance the well being of citizens who are at their most helpless and vulnerable when they are hospital patients. State ownership and central administration destroys the variety and quality of service. Producers become monopolists and clients turn into applicants. In contrast, private property and competition have the potential to make the customer the king.

Once the bounce goes out of the current economic growth wave and the population ages, public toleration of redistribution by government is likely to decline further. Political entrepreneurs may stop merely tinkering with the system and instead tackle it fundamentally. Doing away with the entire welfare machinery could become a fiscal necessity over the next 25 years. As we saw in Chapter 2, old-age provision by collective means will prove insufficient. There will be much political pressure to imitate those countries where savers have tax-sheltered and portable personal superannuation accounts.

There is a fundamental logical contradiction between the protective and the redistributive function of government. Collective action cannot protect private property rights and the incentives that flow from economic success while at the same time engaging in major confiscation and redistribution of private incomes and wealth. If elected parliaments were to make economic freedom a priority, affluent people would have to risk their assets time and again incurring the transaction costs of competing. Such competition would then reallocate wealth in a process with great benefits for overall wealth creation. Growth and full employment would be stimulated. High employment would prove a powerful leveller of incomes and wealth. Competitive economies have rather even income distributions, for example Taiwan, whereas selective government interventions create differences in wealth and income.

Any fundamental overhaul to re-privatise the responsibility for welfare creates complicated and drawn-out transition problems. Given past policy arrangements, many of the elderly will continue to depend on government pensions on the grounds that they paid high income taxes throughout their working lives and trusted the government. A transparent and honest way of de-nationalising old-age provision would be to cash out the supposed savings claims that citizens over a certain age hold with the government. Savings balances could be allotted to individuals who are then obliged to invest these funds towards their retirement (portable, individual superannuation accounts).

An advantage of this method would be that the uncovered liability of the Commonwealth government would become apparent and that this would influence future fiscal behaviour. Another advantage would be that general saving for retirement would be openly integrated with the capital market. Citizens who hold the balances and augment them with ongoing savings would then have realistic views about their material welfare in retirement. If such a clear-cut conversion of past statist arrangements to old age provision is deemed not feasible, the scheme can be topped up from recurrent tax revenues.

In addition to old-age provision, that small portion of the population who cannot fend for themselves or who are not able to rely on family support will have to be supported from government budgets. There will always be a residual of citizens, say up to half a million Australians, who would be forced to live in absolute poverty without government assistance as a last resort. Their fates could be improved greatly by financial handouts that give them the dignity of being customers with a choice of private suppliers. Government would still have to set and supervise standards and assist with spreading information about the quality of competing private services, as is for example the case with nursing homes.

For all of these reasons, we would argue that perhaps some 10% of the national product should be set aside for redistributive transfers and their administration.

## B. Measures to Enhance Economic Freedom

In the remainder of this section, we shall list a number of ideas for reform that are now being discussed in various parts of the world and that could inspire the rejuvenation of Australia's political and economic constitution one hundred years after Federation.

### *Limit Government Spending to 25% of the National Product*

As we just saw, an open and competitive Australia requires a lean state. Collective action will have to be confined to areas where private competitive action does demonstrably less well. It will not do anymore to allege 'market failure' and adduce theoretical models and assumptions. The failure will have to be convincingly demonstrated, and the possibility of 'administrative failure' will have to be explored.

Economic liberals do not preach the dismantling of government. They recognise the importance of external institutions that support and supplement the internal rules of society; they also acknowledge that, on occasions, the rules have to be enforced by the state. In the preceding section, we suggested that a minimal state might claim a quarter of the national income to fulfil these functions. During the era of the growing nation state (late 19th and the first three-quarters of the 20th centuries), government claimed a growing share of what people produced, but with hindsight the benefits of that expansion for individual well being are in doubt. Over the long term, neither government enterprises added value to the life of ordinary citizens, nor did generalised welfare, if one compares this with the welfare that could have been attained by more resources being left in private pockets. Technical change, the competition with non-welfare regimes in Asia and America, and an increasingly well-educated, independent, self-reliant and sceptical population will make minimal government politically more attractive.

Politicians should be protected from themselves by a binding political rule that Federal and State governments must reduce the size of the entire public sector to 25% of the national income within a period of ten years and then keep it there. From the perspective of the early 21st century and from comparisons with the aging welfare states of Europe, such a share may appear unacceptably low. It should, however, be remembered that public consumption and investment accounted for only 18.5% of aggregate demand in 1950/51 and 21.4% in 1970/71, that is the year before the big-spending Whitlam government took over (Kasper et al. 1980: 41, Table 5). Respected observers, such as the eminent Australian economist Colin Clark, argued a long time ago that an excess of 25% of total demand being directed by government would be counterproductive. And public choice analysts, such as Nobel Prize winner James Buchanan, have long supported a constitutional limit to public expenditure (Buchanan 1988).

The savings would allow the Treasurer to hand back more than 10% of the national product to the citizens who produced it in the first place. Imposing a percentage rule would immediately focus political interest on the goal of stimulating the economy, as this would be the only means to a growing but limited public sector. A constitutional fiscal constraint would motivate the streamlining and simplification of administration and the redesign of the division of labour between Commonwealth, State and local governments. Government would be forced to withdraw from areas handled more effectively by private producers or the voluntary organisations of civil society.

A constitutional 25% rule, once in force, is a credible guarantee of lower taxes. After the tax reforms of 1999-2000, there is a real danger that future Australian governments will follow the precedent of most other countries with value-added or similar taxes and jack up tax rates whenever an excuse can be found. An effective and bountiful tax system is a dangerous temptation for political parties to be 'generous'. Tax reform should therefore be tied to rigid and formal limitations on public spending, along the lines proposed here.

A 25% limit on public expenditures will also permit an overdue simplification of the tax system, saving taxpayers the administration and compliance costs of filling in and filing quarterly activity statements and tax declarations, not to mention learning about perpetually changing tax legislation. The political leader who introduces the annual income tax return that fits on the back of a postcard will enjoy loyal support for many years to come. Accountants, lawyers, advisors, tax collectors, investigators and other high-earning professionals, who thrive on high transaction costs, will probably argue that this cannot be done. Reformers should not look to them, but to countries with low and simple taxes.

Those who argue that limiting government to 25% of the national product is unacceptable to the Australian electorate are invited to put their claim to the test of a nationwide referendum.

### *Towards a Regulatory Constitution to Protect Private Property*

Government cannot take private property without offering compensation at market value, but government regulations can diminish the value of private property. In this case, compensation for damage is not universally mandated (Epstein 2000). On the contrary, regulations of market interactions are frequently used to redistribute incomes and wealth 'on the sly'. Governments find it increasingly convenient to pursue political goals and fulfil undertakings to special interest groups, such as environmental and social lobbies, by interfering in private markets through regulation. In this way, they obviate the growing resistance to outright public ownership and critical parliamentary and public scrutiny of the uses of taxes.

A jurisdiction that wants to remain internationally attractive to mobile capital and enterprise will in future probably have to provide such compensation under transparent and explicit statutes. Full compensation for loss of market value of someone's property as a consequence of a new regulation also seems desirable as this will act as a counterweight against regulatory overkill. Economic brakes need to be placed on the proliferation of generally harmful regulations, as this enables public authorities to pursue their political purposes by regulations at the expense of property owners. The quality of the regulatory system in terms of economic effectiveness, natural justice and equity would be greatly enhanced if the takings clause were applied to all specific regulations. The principle of 'no regulation without compensation' would introduce the same balance to public choice that applies to private choice, as regulators would be forced to weigh the expected benefits against the costs of compensation.

Full substance is given to the compensation principle when citizens, who feel harmed by public regulations, have actionable rights against regulators. What we have in mind here can be illustrated by the case of the Australian tariff. Parliaments would not have violated the free trade rule, inflicting sustained damage on successive generations of Australians, had actionable rights enabled citizens to demand compensation. Such rights would greatly strengthen the hand of those parliamentarians who are wary of discriminatory interventions. The flood of preferential interventions would be stemmed. Compensation for takings by regulation should in any case come naturally in communities where the citizens are the principals and the politicians only their agents.

All Commonwealth, State and local regulations should be subjected to a summary review to see whether they meet the criterion of universality[18] (see Kasper 1998: 51-72) and to what extent they violate equality before the law. The political motivation for such a review could come from the compensation rule. Governments would suddenly face material incentives to avoid the risks

[18] Institutions have universal qualities if they are general and abstract (i.e. non-specific), certain (i.e. stable and regularly enforced) and open (i.e. applicable to future cases).

and costs of having to foot the bill for the compensation of regulation victims. The argument that compensation rights increase the litigiousness of society is not convincing. To the extent that fewer prescriptive interventions survive, there would be less and less cause for legal actions against the regulators. The system would self-correct. A great number of distorting statutes that are harmful to Australia's long-term prosperity would be repealed.

Another important constitutional device to stem the regulatory tide would be a general requirement to attach sunset clauses to all outcome-specific regulations. No such legislation should be automatically valid for longer than two parliaments. Legislators are not omniscient. The outcomes of specific regulations are likely to differ from expectations. As circumstances change, given regulations may produce results contrary to original intentions. If a parliament wishes to extend the validity of a regulation, there should be public hearings. Across-the-board sunset clauses for all prescriptive regulations would serve to clean up the regulatory overload that successive activist parliaments and administrations leave behind.

Yet another device that could improve economic freedom is a provision that reverses the burden of proof wherever specific private activities are subject to government approval. All private activities that comply with the common law should be automatically permitted, unless affected private parties or regulatory authorities raise lawful objections within a stipulated period. At present, excessive regulation and obscure contradictory approval procedures frustrate development projects and job creation. It is quite common for investments to be held up by dozens of applications to various authorities as there are no fixed deadlines within which local councils, State authorities and Commonwealth offices must respond. In many instances, regulations are administered in the spirit that private industry is a potentially harmful activity, which can only be made tolerable by detailed public supervision and regulation. What is hardest to assess, however, is how many worthwhile projects are never attempted because Australia's detailed and cumbersome regulatory regime discourages entrepreneurs.

### *Devolution of Powers and Competitive Federalism*

A further important reform thrust, which would rejuvenate the Federation, is to re-examine the various levels of government. Some argue that we have too many politicians and too many jurisdictions. Others argue that the States should be abolished. However, such changes would go against the international trend towards more interjurisdictional competition. Around the world, regional identities are now reasserting themselves. This is a natural and comforting counter-reaction to globalisation and the abuses of central governments (Kasper

1995). One cannot but agree with the Hon. Justice K.M. Hayne of the High Court when he writes: 'federal forms of government far from becoming outmoded, may become increasingly common and important in the years that lie ahead of us . . . Australia . . . may have much to offer other countries as a result of the experience it has had in federal constitutional issues . . .' (Hayne 2000: 374).

We do not have too many parliamentarians, but the ones we have operate within uncompetitive and defective institutional settings. This is the reason for advocating a return to the original spirit of federalism that imbued the Federation in 1901. Indeed, much can be gained by taking the idea of genuine competitive federalism—the concept that jurisdictions compete with each other in producing and administering attractive institutions—further by making local governments fully responsible and autonomous.

Since Federation, the States' role has been emaciated. Throughout the 20th century, centralisation has been driven by Canberra, mainly through often far-fetched uses of the external affairs power and through the growing reliance of the States on the revenue raised by the Canberra. High Courts have also conspired with successive central governments to shift responsibility and influence from the States to the Canberra centre. It was often in their bureaucratic self-interest to do so.

In the process, creative diversity in administrative solutions, the capacity to address local problems by locally specific means and the stimulus of intra-State competition have been weakened. In the fairly closed and regulated nation state of the first 75 years of Federation, this did not matter much. But globalisation is now placing a premium on administrative creativity and the agility and cohesion of small responsive units of government. Government agencies will compete better on the world stage if they have a habit of competing among States. Many functions of government should be devolved to local and State levels where the trade-offs between tax costs and benefits to the citizen are less fuzzy. Federal-State-local financial and governance arrangements need to be reviewed with the intention of both improving the service to the citizen and the capacity of public bodies to support world-market competitors. A high quality of public administration is promoted when constitutional arrangements are made to ensure:

(a) the principle of subsidiarity: particular tasks should be allotted to the lowest level of government that can effectively handle them; in practice that would leave defence, foreign affairs, rules on nationwide traffic, transport and communications, standards of measurement, stable money, and the criminal code to the centre;

(b) the rule of origin: goods and services that are legally produced in one part of the federation are automatically legal for sale and use in all other parts;

this rules out political discrimination amongst different locations and enhances intra-jurisdictional competition and economic freedom;

(c) the exclusive assignment of every task of government action: all tasks of governance are allotted to only one level of government, so that the costly duplication, conflicts and shirking of political responsibility are avoided (for example Federal ministries of health and education exist, despite the fact that the Federal bureaucracy does not run hospitals, medical services or schools); and

(d) fiscal equivalence: each government is responsible for raising the revenues that it needs to fulfil its assigned tasks, which means devolving a great deal of taxation power to lower levels of government, imposing responsibility, accountability and discipline on State and local assemblies and giving Australians wider choices about where to live and produce (Kasper 1996: 31-54).

Competitive federalism can only work effectively if the States are made fully responsible for their development policies. It may well be legitimate for Tasmania to prohibit all agriculture based on gene-modified plants if the citizens are extremely risk-averse. But neither the policymakers nor the citizens should be protected from the full consequences of their political choices: Tasmania must be allowed to feel the consequences of lesser agricultural productivity, job destruction and reduced growth of revenues. Vertical and horizontal fiscal transfers only undermine politically mature and balanced choices. Subsidies only induce widespread moral hazard, allowing some States to shirk the risks of economic development, but to claim their share of the fruit of development.

Such a system will generate a culture of public administration that supports global competitors. But, given the shortsightedness of many political leaders, competitive federalism can only work properly if it is complemented with a non-discrimination rule, blocking opportunistic governments from mortgaging future tax revenues to 'buy' themselves jobs and businesses at the expense of other States. The non-discrimination rule should stipulate that a State or local government that grants a material advantage to one firm in an industry is automatically obliged to extend that preferment to all other firms in that industry. This is the equivalent of the most-favoured nation clause, which was so successful in limiting political opportunism in international trade. Such a 'most-favoured producer clause' should be monitored and enforced by a Commonwealth body such as the Productivity Commission. Without such a clause, there would be a danger of fruitless and distortive 'subsidy wars' (Kasper 1996). The mendicant States have developed a tradition of asking for horizontal transfers at Premiers' Conferences because they suffer from budget deficits. But their real reason is to be able to spend more resources on discriminatory and corrupt subsidies to attract businesses away from the better-managed and more successful States, who in turn bear the costs of the horizontal transfers. If private firms acted like this, they would be punished under trade practices legislation. It is time that the same rules of competition be applied to competing jurisdictions.

### *Competitive Local Government*

The poor performance of local government, with which most citizens have the most direct contact, has done much to raise popular discontent with government generally in Australia. Many of the daily problems faced by rural Australians are wrongly attributed to economic reform when they are actually the consequence of poor local government. Petty and poorly administered regulations at local government level are hindering the discovery of new economic opportunities and competitive success for small businesses on the land. Local council budgets are often squeezed by excessive wage bills and overblown administrative overheads while capital expenditures and services to the community remain unreliable and Spartan.

How can we haul the least progressive part of government into the global era? Some States, for example Victoria, have amalgamated shires to save administration costs. This reform is focussed on technical efficiency. Local government is not only about the regular delivery of water, road mending, sewerage services and the like. In equal measure it is about the dynamic discovery of what citizens want and how services are best delivered. Policies that guarantee permanent staff an uncontested traditional workload and that set yesteryear's administrative procedures in concrete ensure the monopolistic exploitation of the local community. Discovery and entrepreneurship in local government is rarely promoted by mega-councils.

A more promising alternative is to change the institutional set-up of local government. Many traditional local council tasks can be privatised and competitively sub-contracted, with public administrators concentrating on acting as end-user-oriented buyers and guarantors of the quality of services available to the citizens. If local governments function as facilitators and quality controllers, but leave productive tasks to competing private contractors, there is little advantage in mega-councils. Information flows, more direct control of councillors by the ratepayers, and new administrative solutions for diverse tasks at hand are normally served better by small and competing shires. In most cases, fairly small local government areas suffice to capture local externalities and deliver the benefits of resident- and producer-friendly policies. Much could be gained, for example, if local unemployment were made the concern of local government with handouts to the unemployed being met, at least in part, from local taxes. The mayor and councillors might then encourage local businesses to create jobs, and anti-development lobbies would be given short shrift when trying to stop job creation.

The principles of competitive federalism could be adapted to local government. Local governments would then have to be granted greater autonomy and responsibility for 'growing' the local tax base, fostering economic development and employment. Often non-transparent fiscal transfer mechanisms would have to be abandoned. Certain classes of taxes would need to be assigned to local governments, commensurate to the specified tasks for which they are responsible. Local democracy and accountability would need to be strengthened. If a council has managed local affairs badly, the worst penalty is that it gets sacked. Better electoral control, such as term limits or the recall of underperforming councillors as well as fiscal responsibility would go a long way to enhancing the quality of local government. As in international or intra-State competition, local government competition would also require State- or nationwide rules that ban the use of fiscal resources for discriminatory subsidies. Local governments must not be allowed to use revenues to favour one industry or class of citizen over others.

Once based on institutions that guarantee administrative competition, local government can assume numerous public tasks that are now assigned to higher levels of government. The supervision of local councils by State authorities can be confined to rule compliance and adherence to proper procedure. The evaluation of the outcomes of local administration could be left to the wider public. As relocation between small council areas is relatively easy, the feedback from good and bad policies would be fairly prompt and would soon be reflected in the growth of local revenues. At the local level, the 'Eric Jones effect' should therefore work particularly well. The reinvention of local government would certainly fit in with the new era of globalisation and would serve as a testing ground for diverse and innovative solutions to collective tasks. It would also appeal to those self-assured, mobile and educated citizens who see government as an important support organisation for the community, not as a ruler to be petitioned.

### *Reinventing Government: Constitutional Safeguards Against Political Opportunism and Pressure Group Plunder*

A number of specific devices to control the opportunism of political parties, individual parliamentarians and bureaucrats, and ruthless particular interest groups have been tried out in other countries or are being discussed in the literature. Some should be given serious consideration by the political entrepreneurs of the coming generation who may gain support in the next slowdown when the present political system is likely to be perceived as failing.

Some of these ideas are:

(a) Friedrich Hayek recommended in his 'Constitution of Liberty' that a separate chamber of parliament be created which has the task of setting and enforcing the high-order constitutional framework rules to guarantee the fundamental freedoms of the citizens. Periodically elected Governing Assemblies would run the affairs of government and pass enabling legislation that coerces citizens in certain ways and that appoints the executive. They correspond to the existing House of Representatives and Senate. In addition, there should also be a Legislative Assembly that is not organised along party lines, but rather elected by age cohorts. Such a Legislative Assembly would cultivate the rules that protect the citizens' liberties. It would act in ways that a principled and popularly elected High Court might do. The critical aspect of this proposal is to ensure that organised political parties—cartels of political power—do not gain influence over the members of the third chamber (Hayek 1960, 147-65).

(b) Critical voices in corrupt democracies overseas argue for formal qualifications of the active right to elect and the passive right to be elected. Some advocate age limitations, but it seems doubtful, at least to this observer, whether political wisdom and resilience to the temptations of power is in any way age-related. A more realistic qualification of the passive right to be elected might be that candidates must not be drawn from groups with a direct interest in complicated and costly governance and high transaction costs, for example civil servants, officials of interest-group associations, or members of professions that thrive by inflicting high transaction costs on the public. Or one might stipulate that candidates for parliament must meet the requirement that they have worked for a living in non-political activities for a minimum of ten years before they can stand for election.

(c) One may also think of methods of candidate selection that are less subject to the often dubious machinations of political parties. Thus, candidates could be confined to those who have resided in the electoral district for at least three years. Or that nomination and pre-selection of the candidates of all parties is entrusted to non-party committees, selected by lot from residents who qualify for jury duty.

(d) To the extent that rent seeking is advanced by secretive closed networks of loyalty and mutual dealing, it may make sense to impose term limits on office holders. No one should serve in a Federal or State parliament for more than ten years of her or his life.

(e) Consideration should also be given to formal and easily organised ways for citizens in an electoral district to exercise a right of recall: if 10% of the voters sign a public petition, a special court of inquiry is established and must investigate whether there are grounds for recall. If this is affirmed, new elections should be called immediately.

(f) Another powerful tool to enhance citizen control over opportunistic parliamentarians and administrators is the citizen-initiated referendum (Walker 1987). CIRs have hardly ever prescribed additional legislation. They normally abrogate legislation and decrees. Experience shows that, in practice, the CIR has to be employed only rarely to discipline politicians. The very possibility of having a measure thrown out by the electorate is normally sufficient to prevent political frivolity and ensure that the political agents do the citizens' bidding. The use of the internet is now making the organisation and conduct of such referenda much cheaper, both at national and local levels.

(g) There is much scope for shaping rules that improve the transparency and accountability of government. An example is the Australian Federal *Charter of Budget Honesty*, adopted in 1998 against the majority of the Senate. It obligates the Federal government to publish the independently audited accounts of assets and liabilities, as we have discussed. To be effective, however, it is necessary that the citizens make this instrument of control their own and give it political life and substance.

This list is far from complete. The task of creating a government that again protects our freedom deserves the creative effort of many who think about the art of governance. The market for ideas is wide open to those who are not convinced that we live in the best possible of all worlds. But the most important precondition is that citizens take control of collective action, become less tolerant of political opportunism and better consumers of government services. It is widely accepted that the presence of critical and demanding customers in private markets is essential for innovation and high-standard products. The same holds true in government services. If we keep treating politics with rational ignorance and tolerate poor government, we deserve no better.

## *Finally—Three Modest Rules for Better Legislation*

Practicing politicians may wish to promote economic freedom, but they may not always have the expertise and the time to analyse legislation before them as to the effects on economic freedom. We would therefore recommend to parliamentarians three 'rule-of-thumb tests' which they can apply to each bit of legislation on which they are asked to vote:

- First, the '*Fish Shop Test*': How does this legislation affect small business, for example the local fish shop owner? Can he understand the law? Can she manage the compliance costs?

- Second, the '*Battler Test*': How does the bill before parliament affect the life opportunities of the poorest 10% of Australian citizens? Are there side effects that hamper their capacity to help themselves or that make it harder for them to gain self-respect and respect in society by being self-responsible?
- Third, the '*Grandchildren Test*': How does the legislation affect the young who are not yet established in the work place and who enter working life with high hopes? Will an aspect of the bill disillusion some of them and turn them against the community? Is there some long-term consequence of the legislation that would hurt them later in life?

# CONCLUSION
# The Blessings of Economic Freedom

> With competition, things seem to go better. Innovation happens. The world is more focussed on variety than quality. . . . Things will happen in well-organized efforts without direction, controls, plans. That's the consensus among economists. That's the Hayek legacy. As for Milton Friedman, he was the devil figure in my youth. Only with time have I come to have large amounts of grudging respect. And with time, increasingly ungrudging respect.'
>
> Lawrence Summers, Secretary, US Treasury, cited after J.K. Glassman and K.A. Hasset 1999: 261.

### *What is at Stake?*

Improving the institutions that underpin confidence and economic freedom would not make much difference initially. But over the long term liberal institutions have a decisive impact on material living standards, as well as the fundamental non-material aspirations shared by most.

As long as the current wave of accelerated growth in the world economy continues, the Australian community can probably drift along quite satisfactorily. But long-term economic history suggests that the challenges and obstacles to economic growth discussed in chapter 3 will again come to the fore. It is more likely that not that we will then have to cope with a supply-side crisis and economic downwave, as in the 1970s. That will be when society's institutions are tested, and when the quality of institutions makes a big difference.

The long-term effects of economic reform will be considerable. Applying the method used in the 'Crossroads study',[19] we would venture the following estimates for economic growth over the next 25 years:

- In a scenario of 'cricket-like' carelessness and political foot-dragging with some backsliding on past reform, for example in labour markets, and with reliance on top down political direction, the national income might grow by 2¼% p.a. Per-capita living standards would then rise by only 1¼% p.a.
- In a scenario of comprehensive forward-looking, 'bee-like' institutional reform to strengthen economic liberties, the long-term growth rate of national income could rise to some 5% p.a. The growth rate of per-capita incomes could average 3½ % p.a., that is if we manage to duck the next Kondratieff downturn by being competitive and innovative.

[19] For more on the methodology employed there, see W. Kasper 1992: Appendix.

Major turnarounds in growth will put a high premium on spontaneous private choices and the creative responses of individual competitors. If these responses are coordinated in markets, some will even discover new opportunities in a general downturn. If, however, much is left to coordination by slow-moving centralised public choices, political bargaining and power plays, recognition lags will be much longer. Individual disappointments may then reinforce themselves to become a general crisis of the entire system.

Whatever quantitative assumptions are made, it is clear that much is at stake economically. Readers who find my estimates implausible are referred back to Graph 1 in the Introduction. It showed the effect of good and bad institutions on living standards. It must also be kept in mind that globalisation and economic change will in future make reactions to poor institutional designs and bad policies more immediate and more costly.

Economic freedom is desirable not only because it favours economic growth and welfare, but also because it is a fundamental value in its own right. Personal autonomy and mastering one's own fate is appreciated by most despite the costs and risks. Most of us do not like it when too many choices on our behalf are made somewhere on high.

## *Of Crickets and Bees*

In a scenario of political foot-dragging and resistance to change with some backsliding into more regulation, especially of key labour markets, and much reliance on collectivist but inevitably ignorant top-down direction of economic life, one can plausibly assume that from 2000 to 2025:

- the growth rate of labour inputs will average 0.9% p.a.;
- the growth of capital inputs 2.5% (some capital saved in Australia will relocate elsewhere and an aging population will draw down accumulated assets);
- the share of labour incomes in the national income will be relatively high, say two thirds, and;
- 'third-factor growth', the result of competitive innovation and learning, will be comparatively low, say contributing one third to total growth (This is higher than the historic contribution, but less than is typical of the more open and innovative economies where institutional design creates competitive conditions and where everyone is consequently involved in the search for new useful knowledge).

Because this scenario amounts to a carefree fiddling away of reform opportunities during the 'summer of the Kondratieff upwave', we might call such a game plan a 'cricket scenario'. Crickets make no provision for the winter when many of them die off.

By contrast, one can imagine a 'bee scenario': the opportunities of the economic good times are used to make provision for leaner times by timely reform. One can plausibly assume that for the next 25 years:

- the growth rate of labour inputs will average 1.4% p.a. (higher than in the 'cricket scenario' due to less unemployment, clearer work incentives and more immigration);
- the growth of capital inputs will average 4% (because more capital will be saved due to better incentives and better trust, and because capital will on balance be attracted to Australia from elsewhere);
- the share of labour incomes in the national income will be lower, say 55% (but the real incomes of workers will grow faster, see below), and;
- 'third-factor growth' (or 'multi-factor productivity') will be higher—as a more competitive economy forces people to shoulder the transaction costs of innovation and learning—say contributing half of total growth[2].

Putting these assumptions together, one would predict that:

| | *Under the 'cricket scenario'* | *Under the 'bee scenario'* |
|---|---|---|
| (a) the economic growth rate will be | around $2\frac{1}{4}$% p.a. | around 5% p.a.; |
| and | | |
| (b) per-capita economic growth rate will be | around $1\frac{1}{4}$% p.a. | around 3% p.a. (better on average than the delayed and slow recovery of 1975-2000) |

Over the 25 year period, and taking likely but slight differences in immigration and population growth into account, real per-capita incomes can be expected in the year 2025 to grow to nearly double present living standards under a comprehensive set of economic freedoms, whereas defensive collective action would allow a growth in living standards of less than one third.

* The Productivity Commission has produced considerable empirical evidence to show that microeconomic reform in Australia has helped to accelerate productivity growth, which had been poor from the mid-1970s to the early 1980s. In the business cycle from 1993-93 to 1997-98, 'multi-factor productivity' rose by 2.4% p.a., as against a long-term trend (1964-65 to 1993-94) of only 1.2%. For the first time in a long while, Australian multi-factor productivity now grows faster than the OECD average (Productivity Commission 1999, xx and 32).

Economic freedom—secure protection of one's property, including the self-ownership of one's labour, the freedom from economic discrimination by encroaching private and public powers, the freedom of contract and the like—is not only for the rich and the big corporations. It affects everyone—how much tax we pay, what life opportunities we can aspire to and attain, how we work and consume, how secure our savings are and, with it, our entire personal security.

The non-discriminatory protection of economic freedom is more important for the economically weak, the young, the low income earners, those not born with silver spoons in their mouths. They do not have the resources to hire lawyers or lobby governments against infringements of their life opportunities. Often they cannot even find out why their chances are diminished—they won't know that a tariff raises the prices they have to pay for purchases, a zoning regulation prevents them from opening a shop, high costs are inflicted on them by a labour monopoly, a closed shop or apprenticeship restrictions. The principle of non-discrimination is the ordinary citizen's friend, and political interventionism his foe.

### *Economic Freedom is Complementory to Non-Material Goals*

The merits of economic freedom do not end with prosperity. Over the long term, properly shaped and enforced institutions of economic liberty are important for the attainment of non-material goals.

Economic freedom is an important precondition for freedom overall. Citizens of property cannot be so easily pushed around by tyrants; they have the means to fight back. Exercising one's rights nearly always requires resources, and these are more readily available and more evenly spread in genuinely free economies. Nobel Prize winner Milton Friedman made this point very clearly in his famous essay 'The Relation between Economic Freedom and Political Freedom'. He wrote: '. . . economic freedom . . . gives the people what they want instead of what a particular group thinks they ought to want' (Friedman 1962: 15).

A community of educated independent-minded people with an enormous diversity of cultural backgrounds like that of Australia could never be satisfied content by satisfaction designed and produced by a well-meaning administrative elite or other groups of Guardians. Each wants to set her or his own agenda in the pursuit of happiness, and pursue goals of his or her own choosing. These differ from those of their neighbours and may be changed at whim or in response to new circumstances.

The social value of security derives from the fact that security is nothing more than the protection of future freedom from coercion and deception, either from within or from without. It is also obvious that a free prosperous society will be better able to afford the resources for the defence of its future freedom. Admittedly, a free open society continually generates uncertainties. Socioeconomic positions can never be securely protected from all competitive challenges or ongoing changes. This is the nature of life, particularly during economic turnarounds and periods of rapid innovation. But coping with the myriad of tiny challenges under free competition provides for a more fundamental existential security, as people respond creatively. People trained in the spirit of competitive enterprise acquire the self-confidence and the resources to avert the major risks that constitute existential insecurity. They also have a track record that breeds the confidence to face the future without fear.

A prosperous free society is also likely to be internally harmonious and peaceful. Conflicts are inevitable among independent people, but they are likely to be broken up—pulverised and dispersed—into small manageable conflicts, which those directly involved have an interest to resolve. A politicised collectivised society is by contrast characterised by the bunching of conflicts between political groups and coalitions. Conflicts are often sharpened by the agents of collective action so that they can gain support and followers. Political power holders thrive if conflicts are acute and battle lines are clearly drawn, whereas conflict is dispersed in a pluralist society, in which much is coordinated informally and spontaneously in markets.

For example, a free labour market based on simple universal laws induces workers and employers to keep sorting out small conflicts as they arise. They do so to keep the work relationship productive. Resort to judicial adjudication or formal law enforcement is likely to be rare. On the whole, however, universal laws avert conflicts before they arise and lay down standard solutions; law enforcement settles disputes along known predictable lines without recourse to violence. By contrast, an organised labour market is managed by those who have to prove their worth in conflict. They thrive on industrial relations confrontations. The more sharply defined and concentrated the conflict and the higher transaction costs, the better.

More generally, there is much empirical evidence to show that free societies are more harmonious. Civil strife, civil war and other major conflicts are much more likely in unfree societies (Gwartney-Lawson 2000). This is an extremely important consideration for a community that is multicultural. In a free economy much coordination is done through markets with reciprocal give and take. This is where people of very different background can cooperate closely and gain in the process. Markets are a powerful tool of integration. Even at the peak of ethnic strife in the Balkans members of the warring parties met and bartered in markets. Moreover, there are material obstacles to racial discrimination when people operate in free markets. If someone decides not to employ the best candidate for a job, because she has blue eyes, he will suffer an economic penalty. Political coordination, by contrast, leads to loyalty gains due to discrimination. This is why the 'theory of racial harmony' is founded on economic freedom (Rabushka 1974).

In a just and equitable society, as understood by most, the same rules apply to the same circumstances. This is procedural justice. Discrimination is perceived as unjust and inequitable. Since discrimination is also the enemy of freedom, it follows that freedom and justice/equity are two sides of the same coin.[20]

Many injustices occur when freedoms are curtailed by collective action and political discrimination. In Australia, much remedial welfare is necessary only because economic freedoms have been violated in the first instance, either by private power groupings, such as monopolies and unions that deprive individuals of access and opportunities, or by legislatures and administrations that disadvantage the less well connected. Genuinely free labour markets, low taxes, and minimal regulations all around—as advocated here—would prevent many of the violations of what some call 'social justice'.

Finally, we have to ask: what about economic freedom and the conservation of a livable environment? Many environmentalists assert that a free society and economic growth are environmentally destructive. But we do not have to remain poor to enjoy a sustainable environment. A free and rich community such as the Swiss treats the environment much better than unfree and poor countries in the third world or in the former Soviet Bloc. Freedom is based on private property rights. Owners normally conserve what they have for selfish material motivations. To despoil one's own land or to neglect the environmental properties of one's possessions soon imposes costs and losses. The value of the property declines. Running down what one owns is therefore unwise. Moreover, poor conservers of valued environmental property are bought out by those who dedicate more thought and resources to conservation.

Economic freedom fosters self-responsibility and that normally educates people in more careful stewardship (Gwartney 1991). In a free market system, resource owners have to balance the private costs and benefits of drawing on scarce natural resources. This makes for responsible stewardship. It introduces natural limitations on resource use. Socialised property belongs to no one and can therefore be readily despoiled. In regimes with poor economic freedom, the planners exploit and run down nature to promote production plans, as the costs for doing so are not entered into the ledger. Moreover, in free societies affected third parties are able to castigate publicly those who despoil nature and can gain political support for corrective action. In unfree societies, they lack the means do so; often they cannot even form free civic associations to initiate effective action.

With the growing onslaught of globalisation, Australians will not be able to do without greater and better protected freedom, namely 'that faculty', as Immanuel Kant wrote in 1775, 'which enlarges the usefulness of all other faculties'.

20 This of course applies only to 'procedural justice. It does not apply to 'social justice' or 'outcome equality'—the guarantee of equal outcomes irrespective of what free people choose to do (Kasper-Streit 1998: 78-80).

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# Building Prosperity

*Australia's Future as a Global Player*

Wolfgang Kasper

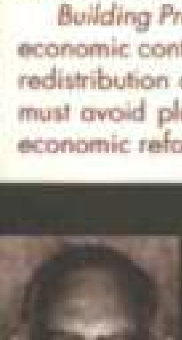
Over the past two decades, Australia has been transformed from a protected backwater on the global periphery to an outward-looking player. Considerable progress towards greater economic freedom has been made, but the reform momentum now appears to be flagging.

In *Building Prosperity,* author Wolfgang Kasper argues that periods of plenty are the best time to prepare for eventualities by cutting back on unnecessary government activity and placing economic freedom on more solid foundations. He warns that the present phase of high worldwide economic growth is likely to peter out before too long. When it does, flexible and creative responses in free and open markets will be the only way for Australia to avoid the consequences of a global slowdown in economic growth.

Kasper begins by revisiting the past quarter century from 1975 to 2000 from the standpoint of having engaged in a little futurology in the late 1970s when he co-authored *Australia at the Crossroads—Our Choices to the Year 2000*. He then examines continuing trends and possible challenges in an effort to identify harbingers both here and abroad that may foreshadow a slowdown in economic growth.

Kasper also looks at the complex issues facing policymakers, from transnational environmentalism to rampant welfare statism. In the remaining chapters, he argues that global competition is forcing a review of the size and functions of government, and recommends that Australia adopts a decentralised model of 'competitive federalism' to improve governance and enhance economic freedom.

*Building Prosperity* is an important and timely book. During periods of easy economic growth social-economic contradictions build up, and policy typically shifts from giving priority to growth in favour of redistribution and the conservation of old structures. If Australia is to prosper as a global player, we must avoid plunging into backsliding and reaction and instead press ahead with further social and economic reform.



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