



IMAGE: ORGANIC SYNTHETIC LAB, BASF INDIA

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**John Denton**

## **GOING LOCAL: Why sub-national governments are the key to success in Asia**

Engagement with sub-national governments in Asia, including by Australian sub-national governments, will be fundamental to enhancing Australia's prosperity and wellbeing in the Asian Century. To understand why, we need to understand how sub-national jurisdictions work in Asia.

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While there is no “Asian model of development” there is undoubtedly the enormous influence of the Japanese Meiji reformation in the late 19th Century, in which the heads of four domains returned their lands to the Emperor. These lands were the four fiercest critics of the shogunate at the time and their return saw the whole of Japan united, creating – arguably for the first time – a central government in Japan which exercised direct power through the entire realm.

The idea of this “return to emperor” – familiar to the Chinese as represented by the same characters as their traditional phrase for the subjects they governed, “all under heaven” – was a major influence on the subsequent development of the modern Asian state. Because let us not forget that Japan’s subsequent defeat of Russia in 1905 made Japan a role model for the region: the first Asian state to defeat a European state.

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China in particular took this idea of centralisation and ran with it: the failed thinkers who tried to reform China before the fall of the Qing dynasty in the early 20th Century overtly derived some of their theories of the state from the Japanese success. The aspiration of centralisation was influential all over the region – from China, to Vietnam, to Thailand, and further afield. However the reality is that the task of governing in Asian states usually falls to sub-national governments. China, for example, has a higher percentage of spending at sub-national jurisdictions than any other country.

This means there are considerable levels of regional pride that are often seen as being more important than one’s national pride. It means that most sub-national jurisdictions have their own language, not to mention culture and identity. Often they will have a dominant ethnicity or religion.

Finally, it means that central governments have a complicated relationship with sub-national governments. They clearly wish to control these governments and stop regional fiefdoms, cliques or separatist movements developing – but at the same time, they know that they need to delegate many of the tasks of governing to these jurisdictions.

The method used by most central governments to deal with this dilemma is to encourage competition between different sub-national jurisdictions. This so-called “yardstick competition” is thought by some scholars to have been vital to the development of the Chinese economy, for example.

Understanding this competition is vital for Australia. The story of how Japan-style centralisation in Asia came up against stubborn local institutions and traditions explains why we need to engage more with sub-national jurisdictions – because that engagement allows us to have more clout than we might have under “normal” conditions.

Sub-national leaders in most Asian nations are often very senior decision-makers within the central government as well as in their sub-national jurisdictions. And if they are not central leaders as well, they are usually being groomed to take up these positions in the future. Moreover, these sub-national leaders often control populations and groups much larger than the entire Australian state.

And these sub-national leaders often have an enormous range of policy flexibility. Sub-national leaders in Indonesia and China, for example, can often enact their own laws as long as they do not conflict with central laws



or regulations. This policy flexibility and dynamism gives sub-national governments considerable discretion in launching their own policy initiatives.

In considering how this political economy dynamic is developing across the region, let us start with the development success stories – the advanced economies in Northeast Asia of Japan, South Korea and Taiwan. These markets are mature economies and are highly likely to grow slower than other Asian economies. All three also have significantly ageing populations, and this demography will greatly change the structure of their economies and society.

Building better relationships through engaging on government services advice to these countries would be an excellent strategy for any Australian or state government. Local leaders in these countries will be seeking advice on how to manage pensions and public-good provision for their elderly populations. This will be an area of particular interest for Japan and Korea, whose sub-national politicians are keen to find reforms for their local constituents that may propel them into the higher echelons in their respective countries.

In Taiwan's case, they will be keen to look at how Victoria has continued to reform and manage its decentralised mental health care system. The major Taiwanese health reforms of the 1990s were most successful in improving coverage and care across the nation, but mental health still remains on the agenda.

While these countries will no longer have the explosive growth of China or India, they remain enormously attractive as partners. They are large and highly sophisticated markets. They focus on high value-add goods and services that use advanced technology. They have highly educated and skilled workforces and are – and will continue to be – major sources of investment globally. They are also likely to be heavy consumers of tourism, education and high-end food exports.

China, meanwhile, remains the major success story of the Asian Century. It has averaged close to 10 per cent GDP growth for the past three decades, growing to become the second-largest economy in the world. And even though it is likely to fall in the next few decades, it is unlikely that growth will be below 7 per cent per annum for the next decade at least. With this GDP growth will come a rise in household consumption as China's middle and high-income households grow. McKinsey and Company estimates that, in less than a decade's time, China will have around 91 million households with incomes over \$35,000 per annum, up from around 24 million high-income households in 2010.

These households will have growing policy expectations of their government. The central government has made clear its wish to provide citizens with "higher quality" economic growth, including far better public service delivery. This will require radical, and difficult, reforms. The central government is able to do things far more efficiently than the levels of government that people actually see and interact with every day. If a project is big, glitzy and demanded by the central government, it shall be done, and done well.

Yet on the day-to-day level, the lower levels of China's sub-national governments (such as the counties and townships) are highly underfunded. These unfunded mandates make every-day Chinese citizens view their public services as incredibly expensive and inefficient. It also means that China's regulatory bodies are famously underfunded.

China has long been enormously open to advice on how to fix some of these problems. It allows high levels of experimentation at the lower levels, and promotes sub-national leaders that run successful programs. They even give awards every year for the most innovative policy experiment undertaken at the sub-national level.

This sub-national competition is a major opportunity for Australia. In China, the local is primary. Sub-national leaders will be far more motivated to engage with

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Australian businesses, governments and delegations if there is an element of local competition involved. This requires more efficient targeting of Chinese sub-national tendencies and trends, and treating the country as being more than just three big cities and four provinces.

It is important to note that other countries have already recognised this in China as well. Singapore, for example, has long followed a highly efficient sub-national strategy, sending well-respected former leader Lee Kuan Yew out to four different provinces each trip and carefully targeting their message to each. This offers a possible model for Australian governments to study carefully.

India is expected to be the third-largest economy in the world by 2025<sup>1</sup>, behind China and the United States. Its economy is projected to grow at 6.75 per cent a year on average from now until 2025. And India's young population means that – should it reap its “demographic dividend” – economic growth will remain high for a long time to come.

India has also undertaken considerable reform in sub-national governance in the past few decades. The 73rd constitutional Amendment undertaken in the 1990s, for example, introduced elections at the very lowest levels of the Indian state. And most of the financial powers and authorities in India remain in the hands of their state legislatures.

So while, in the past, businesses and governments were able to just have a ‘Delhi policy’, that is no longer possible. The regional variation of development in India, and the vast range of cultures and operating environments there, make a centrally focused government engagement policy inefficient. We now need more nuanced engagement, with state-by-state analysis.

India is to be mentioned for one other reason: it remains an excellent example of one of the underlying themes of the Asian Century White Paper – the unforeseen benefits that flow from the Asian Century.

We often discuss higher education for example. But often this discussion is limited to the benefits of higher education as an export market for Australia. What is sometimes overlooked is the by-product of the massive upgrading of education currently occurring throughout Asia. Asia's upgrading of its human capital will mean it will increasingly be a source of ideas, innovation and world-class practice which we go to study, rather than the other way around.

India, for example, has not only been very successful in publishing scientific papers, but has also opened up new markets for high technology through the concept of “frugal innovation”, such as water filters using silver that do not need electricity or moving parts. Ideas such as this matched with Australian human capital advantages could be a boon to investors, inventors and instructors. Frugal innovation-based heart surgery products are already being adopted in healthcare in Sydney, for example.

Finally, moving closer to home, it is predicted that Indonesia will be the 10th-largest economy in the world by 2025. And Indonesia's large population and rapid recent economic growth mean that its economy is highly likely to surpass ours in the next few years.

Indonesia's “big bang” decentralisation following the overthrow of Suharto also makes it an interesting test case for dealing with sub-national governments. In a flash Indonesia went from being one of the world's most centralised states, with everything that matters decided in Jakarta, to having most functions of government decentralised to the district level. Each district now has its own directly elected mayor or district head, as well as an elected parliament.

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1. Note: this is in nominal terms – in real terms, it should be the 3rd biggest in the next decade.

This decentralisation has not yet led to “big bang” improvements in public service delivery. And in some cases it has added an extra layer of political risk to investment due to the ability of district governments to change some of the terms and conditions of investments (particularly in the mining sector).

But trade and economic links between Australia and Indonesia are far lower than they should be given Indonesia’s proximity, potential for economic growth and size. Indonesia currently ranks as Australia’s 12th-largest trading partner, behind other Southeast Asian neighbours Singapore, Thailand and Malaysia. This should change.

Australian state governments can be leaders in this area, particularly if they are able to deal directly with sub-national governments. This links to an important broader point: government services are a significant market. There is a huge opportunity here for Australian businesses.

And establishing a reputation for giving honest policy advice is a part of creating this market. There is a huge appetite for policy advice at sub-national level – with topics covering anything from road safety to national security issues.

Another key takeaway of this point is that we as a country need to think of more targeted sub-national strategies. The high levels of competition between sub-national actors in most Asian states could possibly allow Australia to take advantage of a number of arbitrage situations. But making this happen will require us to engage far more deeply with Asia than we have before. Even in countries such as China that capture so much public attention, much of our focus in the past has been in three provinces and four states.

Another part of this greater engagement and greater elevation of sub-national strategies is the ability to use sub-national competition to build genuine relationships with the up-and-coming levels of Asian leadership.

Success in Asia requires building long-term relationships throughout Asia. Personal relationships can begin in many ways – as students, visitors or business contacts. But benefits from these relationships only come when they are long-term partnerships shaped through time. These partnerships come through doing things together with our government, business and educational partners in Asia and through committing to each other’s prosperity in a way that transcends the transactional.

Particularly good targets are second and third-generation leaders in sub-national entities. Inter-generational transfer of leadership is common in Asian governance and business. Sometimes this can lead to stagnation and decline. But so far, the second and third-generation leaders of government and business are forced to compete in such dynamic and competitive environments that the ones who survive are often very good – and well-connected.

More importantly, accessing these leaders while they are young and emerging is often the only way to build genuine relationships with them – access gets much more difficult as they get higher up the ranks. But these up-and-coming leaders will only be up-and-coming for so long. A good way to build relationships is while they are at the sub-national level of government, or in sub-national subsidiary enterprises. Or finding their way in the big, family conglomerates that characterise so much of Asian business.

As I have argued, sub-national governments within countries compete far more strongly with their peers than with other actors. The same goes for their state-owned enterprises or regional champion businesses – as sub-national representatives, these businesses also need to perform.

We need to remind ourselves of this competitive dynamic frequently, when we are facing pressure to reduce the openness of Australia’s economy. Engaging well with sub-national actors requires us to have our own house in order.

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We need to make clear that we are open for business, that we welcome foreign trade and foreign investment, and that we are more than happy to compete with any business (state-owned or not) on a level playing field. The role of government at all levels is then to make sure that this level playing field remains.

Much of the current hyperbole over the funding sources of state-owned versus private enterprises misses the point – if these enterprises are facing competitive pressures, and they can go out of business, then they are acting in a market situation.

This need to keep our economy open leads me to my final point, which is the need to maintain momentum coming out of the White Paper process. There is a wide array of governance arrangements that have been put in place to institutionalise and build on what has already come before in the White Paper.

I need to emphasise this point – we need to act. This is not a case of maintaining the status quo, or even trying to embrace business as usual. The very nature of doing business in this century is changing. The 21st Century business model is likely to be very different from the successful business models of the last quarter of the 20th Century.

Today, success comes from partnerships. It comes from making the most of complementary interests and working collaboratively with partners in Asia, not just competing against them. More sophisticated relationships between our firms and Asia will encourage us to share knowledge, and to specialise in the things we do best.

In some cases, Australian businesses will be able to access large Asian markets through export, including as part of regional supply chains. In other cases, business opportunities will be secured through the establishment of enterprises, including business partnerships, in Asian countries. Either way, this means business will need to know Asia's legal institutions, political leaders, commercial practices, cultures and governance standards better across the board.

And this doesn't just go for business. Greater knowledge, and this push to make Asia our partner rather than our supplier, will need to come at all levels of society. This will require us to develop a raft of new capabilities.

I think that one of the most exciting and promising of these is the ability to engage well with sub-national actors in Asia. But making the most of this prospect will require us to work together.

Acting in isolation – both from the region, and from domestic partners – will lose many of the benefits that will spill over from the Asian century. We all – business, government, society – need to act together to make the most of this opportunity.

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