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# WHAT SHOULD ECONOMISTS DO?

**Inaugural Lecture**
**20 September 1991**

J.J. Pincus
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*Working Paper 91 09*

**DEPARTMENT OF ECONOMICS**

**UNIVERSITY OF ADELAIDE**

**SOUTH AUSTRALIA 5001**

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The University of Adelaide,
Department of Economics,
G.P.O. Box 498,
ADELAIDE, S.A. 5001

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Thank you Vice Chancellor. It is an honour to be delivering this inaugural lecture at so distinguished a University as Professor in the excellent Department of Economics. In my lecture I will be proposing that economists give more serious thought to the economic aspects of constitutions and, in particular, to the possible advantages of entrenching in the Constitution the mostly-unwritten rules that give rise to our system of private property, of voluntary but enforceable contracts, and of competition. On Prosh Day, I will probably have no difficulty of convincing you about the importance of there being a good set of enforceable rules governing social behaviour. Well, today I am interested in the rules governing exchange or trading.

I will begin with a definition:

*Economics is a social science that studies exchange under conditions of scarcity or competition.*

A distinguished economist, Geoff Harcourt, formerly with the Adelaide Department of Economics, but now with Jesus College, lectured the Academic of Social Sciences some years ago, criticising economists as being Social Science imperialists, of encroaching onto the turf of sociologists and psychogists and political scientists and so Well, my definition of economics is surely imperialist insofar as the study of exchange under conditions of scarcity or competition would seem to include all family life, social life, political life as well as economic life strictly defined. True; but also true is that although economics has something to say about all these, it definitely does not say *all* that can usefully be said. Economics brings to bear its deeper study of aspects of exchange, whenever exchange occurs.

Most exchanges do *not* involve the passage of money in return for goods and services. Most exchanges, especially the most significant ones, do not involve explicit and enforcible contracts, and should not. E.g., good collegial relations in a University involve exchanges of papers, ideas, support, esteem, criticism and so on among colleagues, but not of money between colleagues in return.

It is the understanding of exchange or trade that makes economics, contrary to Carlyle's calumny, not a dismal science but an optimistic one. The voluntary exchange of money for a meal suggests that there are mutual gains made: the seller prefers the money to the meal, the buyer prefers the meal to the money. Nothing physical is created by the exchange itself, but there is an increase in well-being of both parties.

Thus, voluntary exchange is not zero-sum: it is *not* true that what one party gains in value, the other party loses. On the contrary, if exchange is voluntary, then the exchange process is expected by the parties to be *mutually beneficial.*

Of course, sometimes a party to an exchange is disappointed by the results, or makes a mistake, or acts imprudently. But the expectation of those engaged in the trade is for mutual gains from trade.

It is important to note that the gains are *subjective*; that the extra value created by exchange is, as it were, revealed to outside observers by the very act of exchange. If down at Victor Harbor, Ms Smith exchanges 1 kg of hothouse tomatoes for a little over two kilos of Mr Tan's cabbages, then there are created no extra tomatoes or cabbages; yet economic value has been enhanced: Mr Tan and Ms Smith each exchange something he or she values for something else he or she values even more (e.g. Mr Tan now enjoys greater friendship from Ms Smith's neighbours who hate her tomato chutney; and he gets to eat the tomatoes).

How much is the gain? Psychologists have yet to come up with a meter to measure a person's pleasure or pain, hopes or disappointments. Therefore, we infer from the fact that an exchange takes place that the parties to the exchange expected to enjoy additional benefits as a consequence of the exchange; but we have no scientific way of knowing how great or small were the additional benefits, or how great was the sacrifice made to obtain them. Value and cost are subjective and not able to be measured directly and, therefore, not able to be aggregated across individuals. It might be desirable to secure the greatest good for the greatest number, but it is not possible to measure the subjective good experienced by any of the greatest number.

Therefore, the economist who agrees with the two central motions I have outlined, and who is concerned to increase the general good, will either have to resort to unscientific guessing at magnitudes, or will take another tack, and return to the first central idea: that voluntary exchange is undertaken because the parties to the exchange expect to further what each individually regards as the good or of value.

A full understanding of the subjective nature of valuation led Friedrich Hayek decades ago to predict, confidently, the ultimate demise of central planning, a demise we have witnessed in recent months.

The year 1991 saw the collapse of the centrally-planned economies of the USSR and its former satellites in middle Europe. The implosion has come too late for the common peoples of the USSR, Poland, and elsewhere, who are dead or impoverished because of the false economic doctrines. It came two hundred and fifteen years after the publication of the remarkable book by Adam Smith, *The Wealth of Nations*, now a best seller in those countries, along with the works of Hayek and Mises and others. Smith taught us the unexpected advantages of *a* *system of private property, voluntary exchange and free competition*; he argued the superiority of a particular set of rules for the advancement of human happiness. We could call those rules the liberal economic constitution. In contrast, the advantages claimed for the illiberal system of state ownership, central planning and of monopoly have proved illusory; worse, they are the opposite -- productive neither of affluence nor of equality and certainly not of freedom.

We are therefore present at the destruction of a failed economic system, a system that formerly captured the allegiance many adherents. In those countries, there is a great debate about how to create what we already have and a lively discussion about whether or not the market economy can be brought into being in the form of a constitution. We have what they want, but not by way of the formal Australian Constitution.

In view of these momentous events, you would expect that central to the study of economics in our universities would be a discussion of comparative economic systems; or of the long sweep of economic history and economic development; or the history of economic doctrines. Alas, Adam Smith is read more in foreign translations than in Strine. We train economists to be up-to-date with the latest techniques; but neglect to educate them enough in why the study of economics is important (as opposed to why the study of economics can secure you a high-paying job).

Worse, we miseducate the young economics student when we give the impression that the liberal economic package -- private property, enforceable contracts, competition -- can be unpacked. Janos Kornai is a brilliant Hungarian economist who has travelled a long road from belief in the efficacy of modern (i.e. mathematical) central planning to an understanding that you cannot specify the *output* of the economic system. Kornai warns that you cannot say, I'll have full

full employment, high prosperity, and equality, by a skillful mixing of the capitalist and the socialist systems. Unlike hi fi systems, you cannot freely choose to combine components of one maker with those of another, in order to get specified output characteristics.

Economic constitutions are therefore important, and cannot be freely chosen so as to produce results specified in advance. They are the rules under which the economic system operates, not specification of the outcomes.

Economists have not been prominent in the analysis of the workings of the current constitution, nor in the debate about possible revisions of it. E.g. at the May 1991 meetings to celebrate 1891, despite C. Walsh former Professor of Economics here, being on the organizing committee, I was the only other academic economist. Critical remarks were made about this fact in the newspapers (P.P. McGuinness).

What explains the absences?

(a) Maybe the constitution is not important and economists sensible in neglecting it.

or (b) that economics has little to say about Constitutional matters.

or (c) that many economists have taken a narrow view of economics, narrow enough to rule them out except as "technical experts" to be hired to give valuable detailed advice on, say, the effect on state tax revenues of a transfer to the states of exclusive access to sales taxation.

Thus, my lecture today is as much about what economists should do, as about the Australian Constitution.

The point of view I import from economics is the one associated with the Virginia School, the most prominent member of which is James M. Buchanan, Nobel Laureate of 1986 (from whom I have lifted my subtitle). Thus, I wish to push forward a set of economic ideas known variously as contractarianism or constitutional political economy. The central emphasis of that School is upon the regime of rules - the constitution, mores, custom, institutions and so on. Economic analysis points to the conclusion that different kinds of outcomes flow from different kinds of rules and institutions, in particular, that it is not possible for decision makers freely to *choose* among particular outcomes -- a point to which I will return.

Therefore, what economists should do is to study constitutions as the embodiment of an exchange; as a contract among citizens about the use of the coercive apparatus of the modern state.

To undertake such a study requires us to switch emphasis from the usual interpretation of the Constitution as a document to achieve national aims (whatever they are). Rather, the Constitution should assist the attainment of individual aims or aspirations, some of them quite diverse, some of them held more or less in common. The constitution is, therefore, part of the rules of societal life, including political and economic life narrowly conceived.

Unfortunately it would take me much longer than 30 or 35 minutes to explore adequately the complexity of the arguments adduced in favour and against the liberal economic constitution advocated by Smith and his followers -- private property, freedom to enter contracts, enforceability of contracts; and the necessity of competition. Rather, let me briefly outline some of the complications.

A sensible community with an attractive social contract will impose restrictions on the right of people to engage in exchange: It is not permitted to sell yourself into slavery; incompetents and minors cannot make binding contracts. And so on. More significantly for my argument, sensible communities modify the exchange process, by putting in place a social security safety net. Of the many possible arguments in favour of the safety net, let me give one that arises from the ideas I have briefly outlined. The argument is that, prior to entering into a system of free exchanges, most people would worry about the possibility that by a run of bad luck, the system might leave them or others very poor. There is no *guarantee* that *all* participants will benefit from a system or sequence of exchanges, even though, as the experience of the centrally-planned economies warns us, even though the system on average does produce more of what people value. At a constitutional convention in which no one could be sure of how well or ill a system of exchange would treat them, there would be *agreement in advance* to give a wide scope for voluntary exchanges, but also to put limits. I have argued the liberal contractarian case in favour of a social safety net in more detail in a paper in a volume honouring Austin Holmes.

What, then, should economists do? I propose that we should give serious thought as to how to safeguard the system of exchange, the liberal, mostly unwritten economic constitution of private property and enforceable contracts.

There are two ways to entrench the economic system in the Constitution.

(1) by a bill of individual economic rights.

(2) by express prohibitions on governments.

Before turning to these let me note this: Australian constitutions contain little that can be used to defend or extend the system we have evolved of a modified free market based on private ownership and voluntary exchange.

Although the Australian constitution requires that the federal government pay fair compensation for property it converts to its own use those of the States do not. This clause protects the private owners, but does not protect a *system* of private ownership. Nor is it a strong bulwark for those people whose property consists mostly in what we economists call human capital. For them the chief safeguard is the prohibition against civil conscription.

Many economists are amazed by the way that Section 92 has been interpreted, laboring under the fond but incorrect belief that Section 92 is really a charter of individual economic liberty, which it decidedly is not. Section 92 and associated sections are useful, nonetheless, because they provide limited protection to the system of economic exchange across state boundaries. They provide no protection to exchanges within a state.

As to foreign trade and international capital movements, our federal constitution was formed when the one major colony, Victoria, was committed to a policy of favoring some Victorian producing interests at the expense of other producing interests, Victorian or elsewhere, and at the expense of Victorian consumers. I believe that it is arguable that Australians would have been better served by a constitutional rule which prohibited customs tariffs or changes in them. In any case, a chief argument in favour of taxation of imports at the turn of the last century -- that governments lacked convenient sources of taxation revenue -- has long since become redundant. The present government is committed to reducing tariffs, that is, to reducing the discriminatory interference in the free exchanges between residents and foreigners. We should examine the case for enshrining into the constitution the presumption that government should not be allowed, except in emergencies, to discriminate not only against interstate trade, but also against intra-state and international trade.

The "economistic" approach, taken by many economists in policy debates, is always and in every way to advocate changes which are designed to improve economic efficiency. The constitutionalist approach, in contrast, focuses on general rules, not particular policy decisions, and upon rules which would attract widespread (even unanimous) support.

For example, consider tariff reform. It is one thing to argue in favour of a rule prohibiting discriminatory taxation on exchanges with foreigners, on the grounds that a system of free exchanges is generally desirable, and that taxes on imports provide a very poor social safety net. It is quite another to argue that we should reduce the tariffs we have in such a fashion that some low paid workers will be thrown out of jobs and probably never get another, in order that Australian consumers can buy cheaper shoes. The usual "economistic" argument is that the economic benefits of tariff reductions exceed the economic costs. How do we know, if the tariff cut is not the result of a voluntary exchange? To some extent it is this kind of question which had caused government recently to compensate those hurt by policy changes designed to help others.

The advantage of a sequence of changes at the Constitutional level is that the detailed consequences or effects can be so hard to predict in advance, so that few will suffer visible and substantial damage.

To return to an economics bill of rights: There are dangers in proposing an economic bill of rights which is designed to entrench the decentralized market economy. One danger is that what will be entrenched instead is a declaration of what can only be the outcome of economic processes, rather than an entrenchment of *rules* governing that process. Let me take some examples.

If you want a high national income, why not directly require it by Constitutional means? That sounds silly and is, because national income is the result of economic processes, and cannot be legislated or mandated. What if you want equal pay for equal work - I certainly do? why not put that requirement into the constitution? Well, economic analysis of exchange processes warns you to ask if "equal pay for equal work" is a description of a desirable outcome, rather than a "rule of the economic game". Competition among workers for well-paying jobs and competition among employers for good workers can determine what work gets what pay. Maybe you are unconvinced that competition can do the job, and your scepticism is fuelled by a study you have commissioned into pay and conditions in a particular occupation. You look into it, and conclude that some workers in that occupation, for reasons *you* believe are unrelated to the work they do, are paid more than others. Unjust, you say. Because Adam Smith taught us that exchange processes do not necessarily have desirable properties if there are monopolies present, you commission a study which tells you that monopolies or monopsonies do not explain the pay differences. What to do? Say the Constitution mandates Equal Pay for Equal Work and the Court declares equal pay for all in that occupation, and specifies the median rate of pay as the one and only pay. Well, some workers will lose their jobs: they get no work for no pay, not the sort of equality we want. And employers have an extra incentive to sort workers into the more highly productive and the less highly, and give the more highly productive some incentives to stay with them, rather than be bid away by another employer who offers them, say, a better working environment, or less onerous work and so on. I draw some lessons. First, value is subjective, and not revealed accurately enough by inquiries made by persons who do not foot the salary bill. Second, attempts to determine economic outcomes in advance will, on closer examination, fail.

To entrench the market order or regime, would it be possible or desirable to impose limitations on government? For example, consider a rule prohibiting governments from owning assets, or owning entities that own assets. Many South Australians would, in retrospect, be happy if such a prohibition had been imposed. Would such a rule be a powerful restraint upon a government determined to de-privatise the economy? I am not a lawyer, but I suspect that government can come up with a legal scheme to do everything involved in State socialism but without state ownership.

## Competition

The final element in Smith's scheme is competition. Competition is the goad that drives producers or suppliers to offer good deals to consumers. When I think of Australian governments, I tend to think of monopoly. The federal government clearly has the constitutional power of monopolizing communication services. As to private monopolies, the fact that the Trade Practices Act is only a couple of decades old is an indication that there is no strong constitutional rule forcing governments to act against those private monopolies which government itself has not created.

What is the role of competition among governments? Well, that depends on your point of view. Mine is that of the civil society (or what economists term "consumer sovereignty"): government or the State is there to serve the citizens, actual or potential, and not vice versa, even though (as in all contracts) citizenship involves the acceptance of obligations to the rest of society.

A person can make a promise and later be tempted to avoid fulfilling his or her promise. Thus, people can give a hostage to the other parties to the exchange to encourage them to enter into contract. In formal contracts, we give hostage to the law, which might be so used to enforce the agreement. Therefore, a person could join a society which promises to deliver benefits, but which in some circumstances can enforce an apparently involuntary transfer, like the payment of a fine or tax.

Thus, when we observe the reluctant payment of taxation, we cannot be sure that the exchange yields mutual gains, nor can we be sure of the negative - maybe yes, maybe no.

Competition between governments is one way of increasing the chance that the answer is yes - that the benefits exceed the costs, that the political exchange is mutually gainful.

In a federal system, the citizen is a member of more than one polity, the state and the national. That is to say, a characteristic of a federal system is that it can preserve an element of competition among levels of government for the patronage of citizens. There can be more than one supplier of public services, and citizens can play one off against the other. At the most simple level, Australians are very mobile and can move from one State to another if the terms of exchange with the one state government -- the trade-off of public services for taxation -- is sufficiently less attractive to warrant the costs of removal, including the disruption of familial and social ties. It might be sensible, however, for citizens to impose, through constitutional means, some restrictions on the capacity of the various states to compete for citizens. In particular, there is a danger that fiscal competition, between states or countries, could so degrade the tax base of all governments that they all fail to do a satisfactory job. A possible example is the "Death of the Death Duty". The income tax was centralised during the emergency of World War II, to prevent the various States from competing by setting lower rates in order to attract income tax payers and income tax-generating activities. Similarly, fear of international tax competition by foreign governments, and not merely the well-known tax havens, has been used to justify reductions in company tax rates.

Our federal system has been criticised for a high degree of fiscal imbalance: the feds raise much more in taxation than they spend directly; and the states spend tax monies not collected by state taxation. This arrangement may well be conducive to irresponsible behaviour on the part of states and is arguably unjust. However, there are justifications derived from the notions of political exchange, in which there is an agreement of property rights, as it were, in the form of ownership of tax bases, so that the feds act as revenue-collecting agents for the states. The argument is that there is a trade-off for citizen-taxpayers: the states can more readily tailor services to local demand; but the superior taxing power of the feds prevents the excessive competing away by individual states of the essential tax base. Geoff Brennen of the ANU and I are engaged in studies of this issue.

Some final remarks: My emphasis on the notion of agreement is consistent with the idea of a recognition of the rights of the descendants of the original inhabitants of Australia, to ensure that they agree to be included with the social contract embedded in the constitution.

We have a valuable, mostly unwritten liberal economic regime of rules or constitution with a small c. My plea is that we consider more seriously entrenching it in the Constitution, with an upper case C.