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Fiscal lessons from the school of hard shocks

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CHRIS Higgins, former director of economics at the Organisation for Economic Co-operation and Development and treasury secretary in 1989-90, once described the 1970s and 1980s as "the school of hard shocks".

Increases in oil prices and spiralling inflation tested to the limit governments' ability to manage economic policy. In the process, vital lessons were learned which deserve not to be forgotten. As governments struggle with the global financial crisis, three of those lessons seem acutely relevant.

- Lesson 1: Don't reduce labour market flexibility.

During the period of the two oil shocks (in 1973 and 1979), a slew of European countries strengthened unfair dismissal provisions and gave unions greater bargaining powers. Without exception, the result was to increase unemployment and make it far more persistent.

Moreover, somewhat paradoxically, the harm was greatest in those countries where union membership in the private sector was relatively low, as it now is in Australia. This is because unions in those countries had incentives to make more aggressive use of their increased powers, as this helped in membership drives and in any event, less of the resulting unemployment was likely to fall on union members.

The Government's proposed new IR laws are therefore especially dangerous, and may well impose a heavy cost for many years to come.

- Lesson 2: Don't trash the capital stock.

The oil shocks made large parts of the capital stock uneconomic, especially in manufacturing, as it was designed for an era of low energy prices. The result was to accelerate the scrapping of capital, particularly in Europe, at a time when new investment had slumped. As successive OECD studies showed, shrinkage in the capital stock reduced employment, even once wage growth abated, because there was not enough capital to make use of the available work force. Tighter environmental regulations, which accelerated the closure of old plants, made the effect more pronounced.

An emissions trading scheme is like a self-inflicted oil shock. The implied tax on carbon makes carbon-intensive production processes uneconomic, and accelerates their scrapping. That China and other developing country exporters are not imposing the same tax on themselves merely accentuates capital scrapping in those countries that do, particularly for import-competing manufacturers. The consequence will be to reduce the capital stock, as in the late '70s and early '80s, and employment with it.

The cost in unemployment will be increased by the interaction between the move to an emissions trading scheme and the new IR legislation. Firms that risk facing stringent restrictions on dismissal are not only more cautious about hiring, but also tend to downsize sooner. Once trouble looms, the fear of being trapped with fixed labour costs leads them to lay off employees as soon as they can.

The Government's combination of an ETS and new IR laws may therefore provoke anticipatory shutdowns in capacity and reductions in employment.

- Lesson 3: Trying to spend your way out of recessions is a mug's game.

When the economy slows, government outlays increase due to higher welfare payments while tax revenues diminish. This fiscal weakening cushions the extent and effect of the slow-down. Governments can try to augment this "automatic stabiliser" by a further, discretionary, weakening in their fiscal position, through increased outlays, lower taxes, or both.

It is debatable whether such discretionary fiscal policy is desirable. As the eminent macroeconomist John Taylor recently noted, the evidence is mixed as to whether discretionary fiscal stimulus works, and if so, when, how and by how much. But even if it is desirable, the '80s showed that approaches centred on increased outlays can be both ineffectual and inefficient.

They are ineffectual because the lags between government spending decisions and ultimate economic impacts are difficult to predict and, at least for some kinds of expenditures, likely to be very long. Long but variable lags are especially marked for infrastructure programs, particularly if those programs are to be properly thought through and implemented. Increased social spending has shorter lags, but often reduces incentives to work and save, creating problems for the future.

Increased outlays are additionally likely to be inefficient because the setting of spending priorities is so vulnerable to rent-seeking. As spending increases are targeted to favoured constituencies, a steep deterioration typically occurs in the quality of public expenditure, making the community worse off.

The Rudd Government's spending initiatives seem a case in point. While the Building Australia Fund is still in its early days, its refusal to implement best-practice transparency, with full disclosure of project evaluations and of contracts, is a sure sign of trouble. As for the car plan, which promises the industry far more by way of new assistance than it loses through the tariff cut, it marks the first increase in effective rates of protection since the ill-conceived Whitlam automotive plan of 1974 and is every bit as foolish.

Ultimately, the greatest difficulty with poor-quality public expenditure is that it is difficult to reverse. Concentrated benefits and diffuse costs create a political economy as resilient as it is toxic. As that political economy plays itself out, deficits prove more durable than they ought to be, and eliminating those deficits comes at a higher-than-desirable cost in terms of increased taxes.

If a discretionary fiscal stimulus is required, it is consequently far better delivered through general cuts in taxes than through targeted increases in outlays. Rather than once-off bonuses, the tax cuts should be locked in for a sufficiently lengthy period to genuinely stimulate consumption and encourage initiative. And if they can be designed to reduce the most severe distortions in the tax system - distortions particularly pronounced at the bottom and top of the income distribution - so much the better.

History, Henry Kissinger observed, provides powerful analogies, but in choosing among them, we all too often seal our fate. Misplaced references to Munich and appeasement provide an obvious example; the tendency to compare our current situation to the Depression of the '30s is as misguided and dangerous.

Perhaps intentionally, that comparison glosses over the far more relevant lessons of the troubled years from Whitlam to the "recession Australia had to have". Repeating the mistakes of those years would be the worst possible way of reacting to the economic problems we now face.

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