

# BARKING UP THE WRONG TREE: ROSS GARNAUT'S DOG DAYS

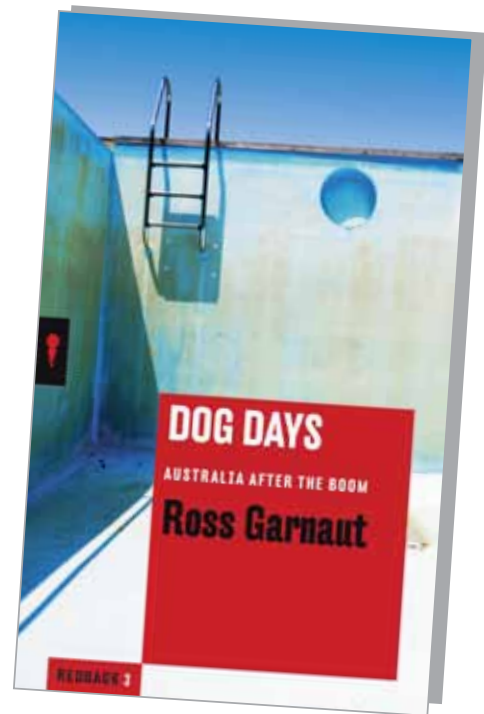
*Dog Days: Australia After the Boom*

By Ross Garnaut

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Australia is facing dog days due to the end of the mining boom, according to Ross Garnaut, professor of economics at the Australian National University. Many other commentators too agree that Australia's boom times are over, but there is limited agreement on what to do about it. In *Dog Days: Australia After the Boom*, Garnaut, who has had a distinguished career as adviser to Prime Minister Bob Hawke and as Australia's ambassador to China, presents his own prescriptions for the patient but they are not ideal solutions: While Garnaut's microeconomic proposals are of considerable value, his recommendations for the macroeconomy are problematic.

Garnaut's analysis of the problems Australia faces is mostly accurate. We have high wages and we face challenges from an ageing population and 'locked in' government spending. Productivity growth has slowed, and Garnaut usefully surveys the reasons for this slowdown, including a lack of reforms and the delay between new investments and production from that investment. He also correctly notes that the windfall gains from the mining boom made us complacent and reduced the imperative for reform to address oncoming challenges.

However, Garnaut is misguided in suggesting that economic reform ended after the GST was introduced in 2000. What perhaps did end then was an era of massive reform. There were some economic reforms after 2000: the Australian Building and Construction Commission (ABCC), tightening of eligibility for the Parenting Payment and the Disability Support Pension (under both the Coalition and Labor), WorkChoices, and the quarantining of budget surpluses in the Future Fund. With the possible exception of WorkChoices, none of these were big-ticket reforms. But just because there has been insufficient reform since 2000 does not mean there has been no reform at all.

A slowing of reform is one reason for Australia's current and future economic woes—another



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is the implementation of detrimental economic policies. It is here that there is a major gap in Garnaut's book. He feels free to argue, with some validity, that the Coalition's direct action plan is more costly than a carbon price, and the Coalition's paid parental leave scheme is unaffordable. But he does not criticise Rudd-Gillard policies relating to the *Fair Work Act*; abolition of the ABCC; poor budget management (discussed below); increased protection for coastal shipping; the National Broadband Network; increased industry support; and erratic policies relating to live animal exports, supertrawlers, the Australia Network Tender, and temporary immigration (457 visas).

Garnaut is on stronger ground when he proposes reforms to address Australia's existing and forthcoming challenges. He supports exercising moderation in award wages, removing trade barriers, abolishing anti-dumping and local content rules, lifting foreign investment restrictions, finalising a preferential trade agreement with China, initiating reforms to social security payments to encourage employment, and providing funding for better quality teachers rather than smaller classes. He also proposes improved regulation of utilities, arguing that electricity and gas networks in particular earn returns well above the returns appropriate for their level of risk.

Garnaut argues that federalism potentially has high economic value (generating benefits from decentralisation, consumer choice, and competition) but that significant reform is necessary to deliver these benefits, including by distributing GST revenue more equally to the states and introducing more independence into funding decisions for individual transport projects. In addition, he says lower immigration and higher government spending are not appropriate policy responses.

Garnaut supports tax reform but focuses on changes that broaden the tax base, including through the improved use of rent taxes—he correctly argues that rent taxes are more efficient than the company tax. He however does not support tax reductions. In two of the rare criticisms of the Rudd government, he says the original mining tax had many problems and the Henry review was not truly independent of government.

Given all these good arguments about microeconomic reforms, it is disappointing that Garnaut devotes a large part of his book to macroeconomic policy proposals that are misguided at best.

To increase Australia's international competitiveness, Garnaut suggests a large depreciation in the exchange rate by further reducing interest rates. The rationale for this prescription is that depreciation will lead to higher import prices, causing a decline in real living standards; as long as wages don't increase, Australia will become much more internationally competitive.

Garnaut argues that federalism potentially has high economic value.

Garnaut implies that the short-term cost of lower living standards will be more than offset by the long-term benefits of a more competitive Australian economy. This may well be true, but he doesn't present any convincing evidence (or any evidence at all) as proof. It is also notable that Garnaut's proposal is similar to protectionism, which helps business at the expense of consumers, and Garnaut has long been an opponent of protectionism.<sup>1</sup> He again doesn't present evidence that artificially deflating the exchange rate is OK while protectionism isn't.

Normally, higher inflation would lead to the Reserve Bank of Australia (RBA) increasing interest rates. Garnaut says this won't happen if the RBA puts appropriate weighting on maintaining full employment. However, it is hard to see this working in practice. It would require a fundamental change in the RBA's approach and the policies of both political parties (at least for now).

Garnaut also doesn't explain how higher inflation won't cause a wages breakout. While he commendably argues for restraint in award wages, wages could increase faster for the majority who are not on award wages—particularly under the pro-worker (and pro-union) *Fair Work Act*. If higher wages are incorporated into prices, then the competitive devaluation wouldn't work as the real exchange rate would remain unchanged—and

Australia would have just ended up with higher inflation and no improvement in our international competitiveness.

Garnaut also doesn't acknowledge that a lower exchange rate will ease competitive pressures on Australian businesses, reducing incentives for innovation and productivity improvement, while reducing the incentives for economic policy reform. This is in contrast to his arguments elsewhere in the book that Australia needs higher productivity and economic reform to address forthcoming challenges.

Garnaut's views on the federal budget—that surpluses should have been larger before the global financial crisis, and didn't need to be tighter in 2011—have major flaws.

Fiscal policy is largely ineffective in an economy with a floating exchange rate and limited capital controls.

He argues that a higher surplus before the global financial crisis would have taken the heat out of the economy and cut the current account deficit. However, fiscal policy is largely ineffective in an economy with a floating exchange rate and limited capital controls. These arguments are well covered elsewhere, including in CIS publications.<sup>2</sup> Broadly, a higher surplus could have led to increased private spending and increased exports, thus offsetting the 'cooling' effect of the surplus.

Garnaut also ignores the potential for lower taxes to increase the supply of labour and capital, thus limiting any 'overheating.'<sup>3</sup> In addition, there would have been substantial political problems for any government running excessive surpluses—there is the distinct possibility that greater saving before the global financial crisis would have just encouraged Prime Minister Rudd to spend more. In making this argument, Garnaut (similar to many other commentators) states that the tax cuts before the global financial crisis were 'spending,' even though the government reducing its mandatory appropriation of taxpayers' income is hardly 'spending.'

Later in the book, Garnaut suggests that fiscal policy wasn't particularly loose after the global

financial crisis, when in fact there were very large budget deficits. Extraordinarily, he argues that fiscal policy was 'tight' after the stimulus (p. 71), and that 'there is no credible argument that the Budget was too loose from mid 2011' (p. 72). There was a budget deficit of 3% of GDP (\$44.7 billion) in 2011–12 and 1.5% of GDP (\$23.5 billion) in 2012–13, when the economy was growing. The budget was also in substantial structural deficit.<sup>4</sup> This was clearly loose fiscal policy.

Garnaut also downplays the importance of a reduced deficit after 2009 for lowering the exchange rate, which sits oddly with his earlier arguments that a greater surplus before the global financial crisis would have lowered the exchange rate.

There are also a few flaws in Garnaut's book relating to climate change and renewable energy. Garnaut presents several arguments in favour of the renewable energy target (RET) (p. 206). However, an RET is unnecessary with a (well-designed) carbon price, and is in fact harmful under an emissions trading scheme (ETS), as the Productivity Commission has argued.<sup>5</sup> To be fair, an RET may have had some value in the absence of a broad carbon price, but Garnaut doesn't make that argument. He also doesn't adequately justify his arguments that voluntary carbon emission reductions are better than a multilateral agreement, and his implication that emissions reductions in Australia will lead to similar policies in other countries.

Garnaut also seeks 'culprits' for the current economic difficulties in Australia (and the world). However, many of these points are misguided and may reflect his Labor leanings.

In particular, he argues that 'extreme' deregulation in the United States was a prime cause of the global financial crisis. However, there are a number of causes related to poor quality (or excessive) regulation. Some poor quality interventions included excessively low official US interest rates; the distortion of markets by the government-sponsored Fannie Mae and Freddie Mac;<sup>6</sup> and the *Community Reinvestment Act*.<sup>7</sup> Notably, David Gruen, an executive director at the Australian Treasury, highlighted these causes (among others) in 2009.<sup>8</sup>

Garnaut cites News Ltd as causing the slowing of reform by opposing the carbon tax, but he does not decry the opposition to economic reforms in the ABC and the Fairfax metropolitan papers. Where is his criticism of commentators in these outlets for opposing workplace reform, lower tariffs, prudent budget management, and reduced industry support? And where does he acknowledge the (sizable) support for such economic reforms in News Ltd newspapers such as *The Australian*?

He also blames some of the lack of reform on greater corporate influence on policymaking, particularly the mining tax, even though he acknowledges flaws in the original tax. He does not criticise the adverse impact of union lobbying on economic policy, particularly under the Gillard government. If it is wrong, as Garnaut argues, for a minister to quit parliament and work for a business they previously regulated, why is it OK for a former unionist to be minister for workplace relations?

Garnaut's book is a useful addition to the debate about the direction of Australia's economy. It has some sound analysis of the issues Australia currently faces, and has many valuable suggestions for reforming individual markets. It is unfortunate, however, that his views on the causes of current challenges, and his proposed macroeconomic solutions, are significantly wide of the mark.

## Endnotes

- 1 For example, Ross Garnaut, *APEC, the WTO and Asia-Pacific Leadership for Global Trade and Investment Liberalisation*, paper for panel discussion in the conference to mark the 10th Anniversary of Columbia Business School's Center on Japanese Economy and Business, *Japan, Asia and the United States: Economic Interactions and Business Interests* (Columbia University, 15 November 1996).
- 2 Stephen Kirchner, *Strengthening Australia's Fiscal Institutions*, T30.06 (Sydney: The Centre for Independent Studies, 2013). See also Tony Makin, 'Fiscal stimulus did not save us,' *The Australian* (28 July 2010); Nicolaas Groenewold, 'Australia and the GFC: Saved by Astute Fiscal Policy?' Economics Discussion/Working Papers 12–28 (University of Western Australia, Department of Economics, 2012).
- 3 The then Secretary to the Treasury, Ken Henry said in 2007 that the tax cuts in that year's budget 'might increase labour supply by about 0.1 hours per week. If this additional supply is fully employed, the increase in labour utilisation will lift the employment ratio by about a third of a percentage point.' See Ken Henry, Address to the Australian Business Economists (15 May 2007).
- 4 Parliamentary Budget Office, *Estimates of the Structural Budget Balance of the Australian Government 2001–02 to 2016–17* (May 2013).
- 5 Productivity Commission (2008) *What Role for Policies to Supplement an Emissions Trading Scheme?*. Productivity Commission Submission to the Garnaut Climate Change Review, May.
- 6 A warning about the potential for adverse impact of these firms is in W. Scott Frame and Lawrence J. White, 'Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?' *Journal of Economic Perspectives* 19:2 (2005). See also Viral V. Acharya, Matthew Richardson, Stijn Van Nieuwerburgh, and Lawrence J. White, *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance* (2011), reviewed by Stephen Kirchner in *The Conversation* (17 May 2011).
- 7 Sumit Agarwal, Efraim Benmelech, Nittai Bergman, and Amit Seru, 'Did the Community Reinvestment Act (CRA) Lead to Risky Lending?' Working Paper 18609 (National Bureau of Economic Research, 2012).
- 8 David Gruen, 'Reflections on the Global Financial Crisis,' address to the Sydney Institute (16 June 2009).