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Beware bold economists

Henry Ergas | *December 10, 2008*

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THE open letter to Kevin Rudd issued on Saturday by eight respected Australian economists cannot but raise concerns. The letter's motivations are as laudable as the clarity and strength with which its authors' views are presented. But its three key recommendations are unconvincing and, if implemented, are likely to make things worse rather than better.

The economists' first recommendation is to immediately reduce compulsory superannuation contributions from 9 per cent to 6 per cent, then to increase those contributions, from 2010 on, up to 12 per cent.

The aim is to provide an immediate fillip to consumption, while subsequently raising compulsory savings.

There is, however, little reason to believe the effects would be as claimed. Consumption decisions are shaped not by transient changes in income but by expectations of income going forward, a proposition known as the permanent income hypothesis. A short-term reduction in compulsory savings, soon reversed and followed by a sequence of rapid increases in mandatory contributions, amounts to a pre-announced reduction in disposable incomes. As households respond to the news that their disposable incomes will fall once the temporary cut is reversed, consumption is likelier to decline than to increase.

A better approach would be to reduce the taxes that most distort incentives to work and invest. In particular, why not lower income taxes, cutting effective marginal rates at the bottom and the top of the income distribution, where they are especially distorting? Going ahead with the income tax cuts that were supposed to be made in 2011, but which the Government recently cancelled, would provide immediate benefits and increase efficiency and national income in the longerterm.

As for the economists' second recommendation - a significant debt-financed increase in public spending on "nation building" - it, too, raises more questions than it answers.

To begin with, the letter asserts that there is "a deficit of high-quality infrastructure"; but there is no evidence that benefit-cost ratios for infrastructure projects have increased in recent years, as they would were infrastructure gaps becoming more pronounced. Rather, the key problem seems to lie not in the quantum of public infrastructure spending but in its poor governance, with state governments wasting resources on projects that are as poorly chosen as they are badly implemented. Increasing funding for projects of this ilk is as sensible as turning up the volume on a faulty amplifier.

It is true that capacity has badly lagged demand in the coal ports of Queensland and NSW. It is not funding constraints, however, that are to blame, for those facilities' users are willing and able to fund needed capacity expansion. Rather, as study after study has shown, the problems arise from flawed regulation which, for so long as it persists, will entrench the present bottlenecks.

Tipping buckets of public money at these problems risks merely papering over the cracks left by a sequence of shockingly incompetent state governments. The letter does call for "strong safeguards" to ensure the efficiency of increased infrastructure spending. But the Rudd Government just rejected all attempts to build such safeguards into its "nation building" funds, with senator Nick Sherry bizarrely labelling suggestions that the Productivity Commission review the funds' performance as "Stalinist red tape". How then can the letters' authors possibly endorse the Government's policy in this area? And if they do not, why not say so?

As for funding the increased infrastructure outlays through substantial increases in public debt, the scale of the proposed increases is disturbing. The letter recommends "new borrowings of up to 10 per cent of GDP" which "should be deployed as rapidly as possible". While it is not easy to know exactly what this means, what is clear is that when combined with the Government's economic security package, the

implied growth in public spending would be enormous, far exceeding the Whitlam government's fiscal splurge. Even putting aside the short-term harm this would likely cause, is it plausible that an amount equivalent to 10 per cent of gross domestic product could be shifted to nation building without crowding out efficient private uses of scarce resources?

This brings me to the letter's third recommendation, which is that substantial incentives be provided to boost spending on energy efficiency. These incentives would be strictly time-limited, so firms and households would have to spend the money as rapidly as possible. Smart meters, insulation and solar hot-water systems are cited as examples of the type of spending to be promoted.

The letter claims that firms and households underinvest in energy efficiency, but that claim is controversial. Firms have every incentive to minimise unnecessary costs and there is little evidence that they systematically fail to do so. As for households, some are constrained in their access to credit and cannot finance investments that would otherwise seem worthwhile at market interest rates. However, it is reasonable to believe that what investment funds those households do have are allocated efficiently among competing uses, including energy efficiency.

There is, in other words, no market failure reducing household investment in these types of assets relative to other equally durable capital goods.

Given that, and especially with an emissions trading scheme providing price signals for emissions abatement, it is not clear why public subsidies for household capital spending should be compulsorily allocated to outlays on smart meters, insulation and solar hot-water systems rather than to renovating kitchens, extending patios or painting roofs. After all, once price signals are properly set, subsidising households to reduce their energy use is no more sensible than subsidising them to reduce their consumption of toilet paper, cat food or tinned beans. To suggest otherwise is to attribute a magical status to energy, as if it were uniquely worthy of being economised on.

The costs of throwing money at energy efficiency are likely to be compounded by the forced pace of the subsidised spending.

Goods such as solar panels are in relatively fixed supply in the short run, especially when account is taken of the need for specialised installation labour. A transient boost to spending therefore mainly increases prices, converting the subsidy program into a mere inefficient transfer from taxpayers to a favoured group of producers. Even by unexacting local standards, this does not seem a sensible use of public funds.

All of this is not to slight in any way the letter's authors, whose initiative in engaging a debate on these issues should be commended. It takes courage to make proposals as bold as those they recommend, and that courage helps illuminate the choices that lie ahead. But in considering those choices, it is crucial to recognise the severe limitations that afflict our ability to forecast and centrally manage the economy, and hence to view with scepticism interventionist cures and fiscal finetuning that may only aggravate the malady.

Nothing fortifies scepticism more, Blaise Pascal said, than that there are some who are not sceptics. By casting caution to the winds, the letter's bold recommendations make the case for taking great care all the clearer and more compelling.

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