

The Australian

Credibility deficit hampers recovery

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ALTHOUGH the extent of the losses remains uncertain, there is no doubt the floods have destroyed substantial capital. Much, but not all, of that capital is worth replacing.

The options for funding that replacement include the proposed levy, increased budget deficits and further public spending cuts.

In theory, each option could have merit. In practice, that the government has done so poorly in providing taxpayers with value for money undermines its claim that it needs more access to funding. Before that claim can be credible, the government must impose far greater disciplines on public expenditure.

Start from the basics. Regardless of which funding option is adopted, costs will be incurred when resources are removed from other uses and devoted to rebuilding.

Funding options must therefore be assessed in terms of whether they help ensure that resources are diverted if, and only if, their value in reconstruction exceeds their opportunity cost.

Had flood-affected assets been fully insured, this would occur naturally. Asset owners would receive payouts covering replacement costs.

They could then decide whether to rebuild those assets, taking account of what else they could do with the funds.

If they decided to rebuild, their projects would have to secure labour, capital and materials. They could only do so if those resources were no less valuable in their projects than in alternatives. Reconstruction would therefore occur where, but only where, there was an overall benefit.

In practice, many flood-affected assets are not insured, and the government's role in financing reconstruction will be pervasive. This creates serious risks of inefficiency, for two reasons.

First, it is by no means certain that it is low-value uses of resources that will be forgone so as to fund reconstruction. There are, for example, many public sector spending programs of questionable merit. But rather than cutting these, more valuable private and public spending may be slashed.

Second, assets may be rebuilt even if their costs exceed the benefits.

This danger is all the greater because losses will largely be made good in kind, as replacement of assets damaged, rather

than as a cash payout on insurance policies.

The lack of any mechanism to ensure reconstruction decisions reflect the risks of future natural disasters makes such inefficiency more probable.

Overall, these outcomes would add to the floods' direct cost a further loss from poor resource allocation.

The proposed levy raises obvious concerns in this respect. Clearly, it is the soft option: additional taxation allows the government to call itself fiscally conservative without seriously reviewing the efficiency of existing spending programs.

At the same time, by relaxing the government's spending constraint, the levy reduces the pressure to ensure reconstruction resources are used wisely.

As a result, poor quality programs would persist while new funding went to equally poorly judged investments in rebuilding.

Nor is the alternative option of an increase in the deficit likely to do better.

True, there are some arguments for relying on borrowing to fund recovery from catastrophic risks. Specifically, funds lent to the government would be provided voluntarily: their value in alternative uses must therefore be no greater than the after-tax bond rate (the income lenders obtain from government bonds). In contrast, additional taxation may impose larger costs on taxpayers, especially if their access to liquidity is constrained.

Ultimately, of course, added taxes would be required to repay increased borrowings.

But those revenues could be raised in future, when incomes had fully recovered and were higher, making it less painful for taxpayers to give up some consumption. At least in theory, this could reduce the sacrifice associated with rebuilding.

Whether that is so depends on whether future tax costs, discounted to the present, are lower than the present costs of taxation, which may or may not be the case. But even if they were, those costs may still be much higher than the costs of funding reconstruction by cutting wasteful spending today. Relaxing fiscal constraints makes those cuts even less likely and invites further deterioration in the quality of public expenditure.

And that is the nub of the problem. Unless the government can do better in ensuring the quality of public expenditure, for instance by subjecting its National Broadband Network (for which \$18 billion was provided in the forward estimates) to proper cost-benefit appraisal, claims that it needs additional resources will be readily dismissed.

After all, the proposed levy is only expected to raise \$1.5 billion in 2011-12, compared with commonwealth outlays of more than \$350bn, including about \$13bn for school halls and other stimulus measures.

Without proper cost-benefit appraisals of these programs and others, how can the government sensibly set expenditure priorities, much less confidently assert it cannot reduce spending by the \$1.5bn it seeks from the new tax?

That the government has performed so poorly in managing crash programs, where its haste has only made for waste, magnifies this credibility deficit. So does the fact that the spending cuts the government has announced are largely smoke and mirrors, and do little to curtail, much less eliminate, wasteful programs.

The absence of cost-benefit disciplines on how rebuilding funds will be spent, and of any attempt to ensure future risk exposure will be properly factored into reconstruction decision-making, adds to these concerns. And so does the lack of any plan for preventing this ad hoc response from becoming the default model for the future, making a repeat of past errors even more likely while increasing future bail-out costs by attracting activity to disaster-prone regions.

Rebuilding flood-devastated areas is crucial. But so are rigour, transparency and accountability in the use of taxpayers' funds.

If the government lacks credibility in these respects, it is only because it has reaped what it has sown.

It will take more than appeals to national sentiment for the government to change that situation. Rather, it must show a serious commitment to spending disciplines.

Until it does, its proposed response will seem little more than hand-waving.

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