Labor's Commitment to Smaller Government

Paul Keating

The ALP has traditionally been the main political force for bigger government. In this significant article, the Federal Treasurer, Mr. Keating, sets out the commitment of the "new Labor Party" to a practical policy based on reducing the share and role of government in economic life. Ideology has been replaced by a commitment to sound, pragmatic analysis based on a recognition of the fundamental importance of private enterprise and the market economy. In his comment on labour markets, Mr. Keating further develops one of the nation's most important policy debates.

In making the invitation to contribute to the *Institute of Public Affairs Review*, the Editor commented that the small rate of growth in Government outlays in the August budget was encouraging. I welcome this indication of support for the 1985/86 budget.

This financial year's Budget was, of course, the first to be brought down in conformity with our trilogy of Budgetary commitments. These required the Government to contain the rate of growth in Commonwealth outlays and tax revenue to no more than the overall rate of growth in the economy and not to increase the deficit as a proportion of Gross Domestic Product. In addition the Government pledged to reduce the 1985/86 deficit in money terms.

These commitments were more than met in this year's Budget — the first time in 17 years that any Government has done so. The last time that the three commitments expressed as a ratio of GDP were met was in 1978-79. But that year, while the three ratios declined, the money deficit level increased. The last time that all three ratios declined, and the deficit was reduced, was in 1968-69.

In addition, this year's budget contributed to a further very significant decline in the Public Sector Borrowing Requirement. In June this year, as we did last year, the Commonwealth won from the States agreement that the States' borrowing programmes would be subject to a "global" borrowing limit. Within that global limit the States agreed that there would be a cut of 10 per cent in real terms in state authority borrowings. In addition they agreed that there would be no increase in real terms in basic general revenue grants to the States. As a result, the total Public Sector Borrowing Requirement, which in net terms had fallen from 7.2 per cent of GDP in 1983-84 to 5.7 per cent in 1984-85, was reduced further to 4.5 per cent in 1985-86.

The Government is committed to continuing this restraint.

We have recognised that as the recovery proceeds it is necessary that we progressively withdraw the level of fiscal stimulus to the economy. More generally, the trilogy enables us to fulfill our desire to place a strict limit on the size of the Government sector and the associated overall burden of taxation. By now I would expect that most readers of your magazine should be familiar with the broad thrust of these achievements.

The question that arises in this discussion, however, is why the Government has chosen a course of moderating public sector involvement in the economy. To canvass this issue I will briefly background the economic policy we have implemented.

The success of the Labor Government's policy for growth should now be apparent. GDP grew by around 5 per cent in each of our first two full years in office, and another year of similar, solid performance is well underway. This remarkable transformation from the stagnation of the preceding decade is now sufficiently long-lived to dispel earlier suggestions that it is a simple product of luck.

Much of the credit is due to an incomes policy, as operated through the Accord, which has ensured that there is an operating mechanism working to prevent inflationary blow-outs of the sort endemic to previous Australian recoveries. At the same time monetary policy, despite the immense world-wide difficulties with implementation caused by the twin processes of deregulation and innovation, has been kept firm. In short, macroeconomic policies have been set to deliver sustainable economic growth. This is a matter of empirics not ideology.

As an integral part of this approach, outlays have been constrained because there is an economic need for that to happen in the context of a maturing recovery, not because obeisance needs to be paid to any dogma.

In both Britain, in recent years, and in Australia, in the Fraser era, we have been provided with ample proof of the dismal results to be expected from a blind pursuit of deficit reduction at any cost. And as the EPAC office has recently demonstrated, no simple correlation is discernible across countries between either the size of government or its rate of increase in recent decades and the level of economic performance. Neither a low government share of GDP relative to other countries, nor a small rate of increase by international standards, prevented Australia from turning in one of the worst performances in the industralised world during the Fraser era.

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Budgetary policy has to be placed in the context of what is appropriate for the economy at the time. Australia's need for budgetary restraint in the years ahead occurs precisely because the private sector is expected to expand solidly. Public stimulus in this context is not only unnecessary; it would be positively harmful to the prospect of sustained growth. For this reason the logic of our economic policies leads to an expectation of smaller government as a proportion of the economy over future years.

In essence, then, the reduction in Budget outlays this year, the trilogy and the cutbacks in the Public Sector Borrowing Requirement form part of a comprehensive growth strategy being pursued by the Government. They have been made for that purpose; they have not been made in pursuit of any simple-minded dogma that dictates that the public sector must be cut back regardless of the consequences.

While macroeconomic policy inevitably takes centre stage in short-term consideration of economic growth, the Government has been very mindful of the major long-term contributions that can be made by microeconomic policy. These considerations gain sharper focus against the backdrop of Australia's overriding need for a long sustained spell of steady economic growth to overcome the legacy of the late 1970s and early 1980s. Of necessity, our planning has had to adopt a medium to long-term framework.

Properly functioning, the market mechanism is a powerful engine for economic growth. By focussing attention and resources on those areas where our true opportunities exist, and by reducing the rewards of those areas whose time has passed, competition can facilitate the transformation to a structure that encourages growth. The benefits of the market mechanism are therefore widely appreciated by this government.

Exchange Rates

Where we have been persuaded by the substance of argument that deregulation will lead to net benefits, we have not hesitated to sweep away outmoded regulation and to introduce arrangements that foster genuine competition. For example, Australia's attempt to maintain an overvalued exchange rate in the early 1980s provides a salutary lesson. The damage that an overvalued currency does to domestic industry through increased foreign competition inevitably breeds responses aimed at "correcting" the position through extra protection. The sorry stream of plans for problem industries implemented by the previous government must be seen against the backdrop of the overvaluation of the Australian dollar.

Industry policy became a short-term band-aid to alleviate the damage caused by inappropriate external policy. Little hope of long term growth remained in these industries once the corset of protection had been imposed. Moreover, it takes considerable time to unwind in sensible fashion these complicated and restrictive packages once they are in place, even against a backdrop of healthy overall growth.

Time is also required to recover from the effects of an overvalued currency even where extra protection has been absent. The incorrect signals sent out to industry by an overvalued exchange rate encourage industry to run down its own capacity and to set up new importing arrangements.

Consequently, when inevitably the Canute-like attempt to maintain the exchange rate fails, these industries are not well placed to take quick advantage of their opportunities. Both the capital and labour stock have to be recreated, and contracts allowed to expire. In short, the flexibility of the economic system to respond to our growth policy was impaired by the misguided exchange rate stance adopted for so long by our predecessors.

Previous banking arrangements also restricted flexibility. The whole web of regulation administered through a very small number of banks encouraged the safe and narrow range of loans and discouraged the innovative and more risky financing on which competition and development depend.

As the OECD Employment Outlook pointed out anew recently, employment growth depends very heavily on the creation of new firms, usually, almost by definition, small firms. With loans subject to rationing at fixed prices, and with alternative investments often providing safe returns due to their tax shelter status, the life juices of the competitive system were severely diluted simply because new ventures appeared to be risky.

The opening up of the banking system to genuine competition further contributes towards our aim of greater efficiency. Our reforms to the tax system, the details of which I have canvassed extensively elsewhere, will make our economic system more efficient as well as equitable.

Underpinning each change was a persuasion that the new arrangements would constitute a sounder base on which economic growth could proceed. Actions needed to be taken to ensure that the market signals coming from the taxation system were encouraging people in productive enterprises.

The principle that a well functioning market economy is a prerequisite for growth has been kept constantly in mind while we have considered a range of seemingly unrelated issues. This is powerful testimony to the importance we attach to the growth objective.

The benefits of the market, however, depend upon empirics rather than textbook ideology. That something works well in the textbooks does not mean that it will also work well in real markets. The labour market is an excellent example.

Labour Markets

There is now a large literature on the respective anti-inflationary virtues and vices of centralised and decentralised wage determination systems. My position on this issue is by now well known, and I would argue, strongly supported by the wage restraint evident under the Accord. Recent wage restraint is clearly superior to anything experienced for some very long time. In effect we have achieved a major degree of macro-economic wage flexibility.

Putting this important aspect of the wage flexibility issue aside, I remain unconvinced of the microeconomic case advocated by the deregulators. Both here and overseas microeconomic wage setting does not seem to proceed in the fashion depicted by the competitive models of the textbooks. Evidence recently produced on the actual working of wage flexibility in the US economy suggests that it is inconsistent with textbook competitive processes.

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The prominent American economist, Professor Richard Freeman of Harvard University, in association with Linda Bell, points out the existence of a strong correlation between the size of wage increases and the growth of productivity, as measured by value, across industries. That correlation has no counterpart in the textbooks.

Bell and Freeman also show that rather than expanding industries using larger wages to attract extra labour and vice versa, the actual correlation is negative. They conclude "the flexibility of the US industry wage structure has not contributed to employment growth; if anything, it has been inimical to employment and the competitive allocation of labour across sectors".

Similar results have been obtained in Australia. Professor Hancock has shown long ago that the non-centralised portion of wages, over-award payments, exhibit the same correlation with industry value productivity that Bell and Freeman show to be inconsistent with the textbooks.

Another study of over-award payments, published last year by a team based at Flinders University, also shows the actual conduct of individual firm bargaining to be contrary to the results expected from standard competitive processes. The size of over-award pay depended not on the supply-demand balance facing a particular occupational type of labour (as the textbook would suggest), but instead varied systematically with the profitability and practices of the firm concerned (contrary to the textbooks).

Hence, although the microeconomic flexibility of the textbook is intuitively appealing, it is extremely doubtful that decentralised wage setting would contribute to employment growth, for the good reason that actual wage processes do not at all resemble those of the textbook — here or elsewhere. Indeed, the evidence suggests that such microeconomic flexibility could set back growth, quite apart from its clear tendency to do so by promoting inflationary wage spirals.

I hold a very healthy respect for the advantages of market processes, but that respect falls short of deification. Where they can be shown to assist our central economic objective of sound, sustained economic growth, market-based arguments will receive a receptive audience. Where they represent mere propaganda, they will go the same way as other dogmas which unnecessarily encumber our progress.