

PROBUS CLUB of PORT PHILLIP

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8 November 2011

PRIVATE ENTERPRISE IS BEST

I thought I should start by telling you that, despite the arrival of an Occupying Melbourne group, I still live in South Yarra and none of the 99 percenters has sought to force me to vacate my residence. Perhaps that will come when they find I am a member of The Australian Club, outside which they briefly assembled - presumably looking for a fat cat to emerge!

The current eruption of such groups attacking the so-called rich is not of concern in itself but it is symbolic of a wider development suggesting there is a fundamental problem with capitalism and the private enterprise system that has developed within it. It is also worrying that few if any of our political leaders have suggested that the occupiers are on the wrong track.

Indeed, in February 2009 one of Australia's political leaders took it upon himself, in the midst of the global financial crisis, to pronounce that:

“FROM time to time in human history, there occur events of a truly seismic significance, events that mark a turning point between one epoch and the next, when one orthodoxy is overthrown and another takes its place. The international challenge for social democrats is to save capitalism from itself.”¹

No surprise that the prominent politician was Australia's then Prime Minister, Kevin Rudd. But he was far from being the only political leader to postulate that capitalism was the problem. President Obama and other leaders have chalked up a record of public criticism of major participants in the highly regulated financial system and this criticism is undoubtedly contributing to the continued low level of business and consumer confidence in the US and other countries.

Obama's latest proposal is to impose a 5.6 per cent surtax on those making more than a million to help pay for his \$US 447 billion program to increase jobs. This highlights the

¹“The Global Financial Crisis”, The Monthly Essays, February 2009. According to Wikipedia while “there is no consensus on the precise definition of capitalism... there is ... little controversy that private ownership of the means of production, creation of goods or services for profit in a market, and prices and wages are elements of capitalism ... The designation is applied to a variety of historical cases, varying in time, geography, politics and culture. Capitalism, as a deliberate economic system, developed incrementally from the 16th century in Europe ... became dominant in the Western world following the demise of feudalism ... and in the 19th and 20th centuries, it provided the main means of industrialization throughout much of the world.”

failure of the leader of the world's most important private enterprise economy.² He is sending the wrong message, that is, we can't cut government spending so we will cut the spending of the estimated 534,000 millionaires who can afford it and never mind that half of the richest 1 per cent own small and medium-sized companies or that many might be the very employers to whom we are looking to add to jobs. Incidentally, contrary to media reports, the latest US census data show that there has been no increase in inequality of incomes in the US in recent years.³

The blame game played by many political leaders that the bankers and chief executives and neo-liberals are to blame for the GFC is adding to uncertainty in the private sector and doing nothing to prevent future crises.⁴ Those leaders encourage the spread of Occupy Wall St type protests and they leave unanswered why governments and central banks failed to use the powerful weapons in their hands to prevent or at least slow the increase in public and private sector debt. In my view, the excessive increase in debt is a major cause of the GFC and the continuation of uncertainty.⁵

It is worth recalling what happened under President Roosevelt in the 1930s depression. Roosevelt is widely portrayed, including by Rudd, as having acted quickly to pull the US out of recession in the 1930's with a large increase in government expenditure and other government interventions. But in reality he undermined private sector confidence by attacking big business and encouraging unionism.⁶ This undoubtedly contributed to the US being the only country to have a double dip recession in the 1930s. By contrast, Australia cut government spending and between 1933 and 1939 strong growth returned with falling unemployment.⁷

Rudd's portrayal of saving capitalism from itself overlooked the fact that many financial crises, and recoveries there-from, occurred before capitalism became widespread and well

² A modified version of this plan has been rejected by the US Senate with two Democrats voting against it. But the Administration appears intent on continuing with the proposal on a bit by bit basis, just as the Republicans appear intent on rejecting them.

³ It is also misleading to think that re-distributing incomes of those at the top would result in a significant improvement for those with lower incomes. If in Australia we were to re-distribute the income of all households in the top income bracket of over \$260,000 a year (which constitute about 240,000 or about 3 per cent of a total of 8.4 million households), that would initially add an average of about \$1250 a year to every individual's income – worth having but scarcely a game-changer for the economy. Such action would also act as a disincentive to earning above \$260,000.

⁴ In late October a group of experts reported to the G20 on how impending currency/systemic crises might be identified and how they might be overcome. This indicates the paucity of knowledge on this important issue.

⁵ While it is impossible to say how much of the blame for the GFC should be attributed to a failure to limit private sector debt levels, my belief is that the risks from developing high levels of such debt have not been given sufficient weight. It is pertinent that in 1974 Professor Hyman Minsky argued that "a fundamental characteristic of our economy is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles", with the tendency for a speculative euphoria to develop, resulting in debt levels exceeding what borrowers can pay off from their incoming revenues. According to Minsky, a key mechanism that pushes an economy towards a crisis is the accumulation of debt by the non-government sector.

⁶ Shlaes, Amity, "The Forgotten Man", 2007.

⁷ "Monitoring the World Economy 1820-1922", Angus Maddison, published by the OECD, 1992. Maddison estimated that between 1929 and 1933 real per capita GDP fell in Australia by only 4 per cent. It then increased by 15 per cent between 1933 and 1939. In the US per capita GDP in 1939 was still below its 1929 level.

before governments adopted policies to (supposedly) save us all. History also shows that countries adversely affected by such crises showed the strongest economic recoveries when the structure of their economies was based on private enterprise. Indeed those economies have led the way to higher living standards in both advanced and developing countries.⁸

My thesis is that, while economies based on private enterprise are subject to fluctuations and recessions, they perform best. True, in 2009 world GDP fell by 3.5 per cent. But that was the only fall over the last 30 years and over the whole period there has been a strong increase in living standards in both advanced and developing countries.

My *private enterprise is best* slogan derives from my experience of 28 years as a federal Treasury officer and my over 20 years experience in the world of think-tanks following my resignation from Treasury in 1987. That resignation reflected my inability to persuade both my Treasury colleagues and Treasurer Keating that Australia would have a recession if government spending was not reduced and monetary policy was not tightened. I find no comfort from the fact that a recession did ensue, although it does provide a useful example of excessive government intervention. Other such examples, although not directly involving me, include the dreadful experience of Treasury under the Whitlam government, which came to office with a bunch of ministers with no experience in governing but with each having plenty of ideas about what they believed could be achieved through government.

That produced a very large increase in government spending in 1974-75 (20% in real terms) and in 1975-76 (15.7%) but it also produced a slowing in growth in the economy (to 2.0% in real terms in 74/75 and then 3.0%) and a large increase in prices (17.0% and 15.1%) that clearly indicated an economy out of control. The Rudd government's very large increase in government spending in 2008-09 (13.5% real) in response to the global financial crisis was also followed by only a below average rate of economic growth in 2009-10 (2.3% cf 1.4% in 2008-09) and, in some ways more important, serious doubts about the usefulness of much of the spending.⁹ IMF forecasts published on 8 October suggest an increase in GDP of only 2 per cent in 2011 and 3.3 per cent next calendar year. These imply considerably lower growth rates than those predicted by the Government in the May budget, which were for growth of 4 per cent in 2011-12 and 3.75 per cent in 2012-13. But the Reserve Bank has now reduced its forecast and that is likely to be repeated in the mid-year review of the Budget in December.

Even so, Treasurer Swan is sticking to his stated plan for an almost complete reversal of the spending splurge, with a repeated promise to limit the increase in government spending to no more than 2% pa in real terms and a commitment to achieve a budget surplus in 2012-13 compared with what looks like too low an estimate of a \$23 billion deficit for 2011-12. Many other countries also have programs to reduce spending and deficits, because of their debt problems, although the recent re-emergence of financial uncertainty may limit this so-called fiscal consolidation program.

⁸ Ibid. Maddison's estimates of growth in incomes per head from 1820-1992 show that, over that period, the four mainly private enterprise economies of the US, Canada, Australia and New Zealand did best by increasing their incomes per head 17 fold. The more government oriented 12 major European countries increased theirs by 13 fold and, at the bottom, the more tribal 10 African countries by only 3 fold.

⁹ The main contributor to the increase in GDP in 2008-09 was the external sector, with exports increasing and imports falling.

What of the Howard government? It experienced the Asian financial crisis of 1997, and although it did implement a big increase in spending in one year in the early 2000s, government spending fell¹⁰ over its whole period in office. However, that was entirely due to the fall in interest rates and the consequent cost of servicing government debt and Howard failed to seize the opportunity to reduce other spending even though the economy was growing strongly and unemployment fell from 8 per cent to just over 4 per cent. Moreover, although his government did make tax cuts, the overall burden of taxation in real terms actually increased slightly - in other words the tax cuts were simply returning to taxpayers the increase in taxes due to inflation. The Howard government has a good story to tell about the rate of economic growth¹¹ but that story could have been much better told in a smaller government context.

Why have I focused attention on the size of government and its spending when talking about private enterprise? The basic reason is that the relative roles of the two raise questions fundamental to considering the kind of society we have or should have. Yet many governments seemingly fail to accept that it is predominantly private enterprise that determines how well the economy operates. That failure is evident around the world today and is reflected in the emergence of the rather scatter-brain Tea Party movement in the US. I believe, incidentally, that some say the “Tea” in Tea Party stands for “taxed enough already”!

My experience in the Treasury and in working in US think-tanks led me to decide that there would be better opportunities for promoting the cause of private enterprise if I moved out of the public service into a think-tank. And that is what I have been doing since I resigned from Treasury in 1987.¹² The public choice theory¹³ developed in the US provides a basis for arguing that there is a need to respond to the inbuilt tendency in our political systems for politicians to increase the size of government. How is this supposed to occur? The thesis is that politicians are able make promises to marginal voters - but without upsetting the electorate provided the cost of implementing such promises is relatively low. Hence, it is argued, there is a potential upward creep in government.

A striking example of government failure was the mess produced by the attempts at economic planning in Eastern Europe and the old Soviet Union. But on a smaller scale we Victorians also experienced government failure in the 1980s. I became closely involved then in the debate on government activity when I organized a group of Victorian business associations to form a group identifying desirable reductions in the role of government and restoring the downgraded debt rating. The policies that group advocated had a significant influence on the Kennett government reforms from which we are still benefiting.

The fact that government manipulation of the economy is also much harder than Keynes thought in the 1930s, and than experience demonstrates, should have reduced support for government intervention. The academic works that won this year’s Nobel Prize for economics have been described as “destroying the false certainty of an older Keynesian

¹⁰ As a percentage of GDP.

¹¹ On average income per head income increased by 2.4% pa during the Howard era.

¹² In May 2005, for example, I was invited by the Australian Chamber of Commerce and Industry to examine the scope to reduce Commonwealth spending. My assessment was that there was scope to save \$19.5 bn, a cut of 8.2% then equivalent to 2% of GDP.

¹³ Public choice theory is based on the idea that political decision-making can result in outcomes that conflict with the preferences of the general public. For example, many advocacy group and pork barrel projects are not the desire of the overall democracy. Despite this, it may pay for politicians to support such projects if it will benefit them and be difficult to organise substantive opposition.

orthodoxy” but, at the same time, as indicating that “macroeconomists lack a clear consensus of what should be done.”¹⁴ An American academic wrote recently in the Wall St Journal that “advocates of Keynesian policies [in the US] have grown silent as government spending has failed to bring an economic recovery.”¹⁵

Despite all this there seems to be an instinctive reaction, leading to a policy increase in government spending, when a recession actually arrives. In 2009 both the US and Europe experienced large falls in GDP (-2.6% and -4.1% respectively) and each responded with large increases in government spending (3.2 and 3.9 percentage points of GDP respectively). But “normal” or average growth is far from restored and the underlying problem of excessive debt in both the public and private sectors remains. It is not surprising that on 1 November the OECD sharply revised downwards its forecasts for both the US and Europe, the latter from 2% to 0.3% in 2012 and the former from 3.1% to 1.8%. Despite the OECD saying there is a sovereign debt crisis, debt to GDP ratios are forecast to “keep rising” and unemployment to remain “high”.

The G20 shambles in Cannes highlights the abysmal failure of world leaders to identify that what is needed is not to create even more sources of funding for governments but to agree that the role of government in member economies must be reduced in ways that will encourage an expansion of business enterprises. Moreover, individual countries not international institutions should be responsible for framing and implementing the policies best suited to their economic and social environments.

I would also emphasise here that, in considering the financial crises over the past 80 or so years, the role of central banks should be assessed. Those banks are government agencies and, as such, are subject to government influence.¹⁶ But central banks are supposed to exercise control over both inflation and the extent of borrowing. In my view they failed to exercise sufficient constraints on the extent of private sector debt and share much of the blame for the global financial crisis.

Private Enterprise Supports Income Redistribution

My support for private enterprise does not mean that I seek a completely laissez-faire situation in which government plays little role outside the operation of defence and police forces. As an advocate of private enterprise I certainly favour allowing markets and competition to operate more freely than at present. This still means, of course, that governments have a role in regulating both the economy and society including by using the taxation and social welfare system to effect some redistribution of income. But there is now widespread recognition that this redistribution has gone much too far.

In a modern society with a relatively high degree of education, individuals should be relatively free to pursue their own interests and should be better able to look after themselves. A better balance is needed between the equity of assisting those on low incomes and the equity of rewarding individuals for their economic contribution.

¹⁴ “Nobel Winners Saved Macroeconomics After Keynes” by Professor Edward Glaeser, Harvard University.

¹⁵ “Why the Recovery Falts: What Keynes Overlooked”, by Professor Allan Meltzer, as published in *The Australian*, 31 October 2011. Meltzer claims Keynes did not allow for, inter alia, the reluctance to spend cash handouts because many assume the handouts will be followed by increased taxes.

¹⁶ In Australia the Reserve Bank Board decides on levels and changes in interest rates but within an economic framework set by the government that focuses primarily on preventing high rates of inflation.

The perception that the "fairness" of society would be improved by reducing inequalities is part of the supposed Australian culture of egalitarianism – the idea of giving everyone a "fair go". This is also reflected in the popular criticism of business chief executives being paid salaries or their equivalent of \$5 million a year and in some cases more than that.

Theorizing by academic and other economists also favours wider distribution and surveys of economists generally show a majority supporting actions to reduce existing levels of inequality. This is typified in the recent report that the leader of the UK Labour Party has suggested to his colleagues that their summer reading should include a book by two academics entitled "Why Equality is Better for Everyone".¹⁷ However, such theorizing fails to recognize the desirability of maximizing the use of the most intelligent and physically capable in society. Football teams do not win with equalization policies!

In Australia since 1994-95 the proportion of disposable household income going to those categorized as receiving "high" incomes has increased from 37.8% to 40.2%.¹⁸ However the ABS acknowledges that its survey underestimates incomes in the lowest income quintile, which indicates that this apparent increase in inequality is overstated. It also needs to be recognized that this is a snapshot in time and that most people move up the income scale during their working lives.¹⁹ Incomes at almost all levels also generally increase in real terms except in recessions and the low income group in the ABS survey increased its real income by 25% over the period from 1994-95. If one examines the inequality of incomes as between countries we also find that incomes have increased significantly in most low income, developing countries.²⁰

But what about the calculations showing that up to 20 per cent continue year after year to live below the poverty line? These poverty line figures are highly misleading and do not in fact mean that we are stuck with a large number living in perpetual poverty. The poverty line is constantly being raised at about the same rate as national income, which means that the standard of "poverty" becomes ever-higher and that, while the population increases, there will always be *growing* numbers of "poor" as defined.

¹⁷ The full title is "The Spirit Level: Why Equality is Better for Everyone". The thesis, apparently, is that that equality produces happier people and better-functioning societies. Another theoretical justification for greater redistribution is the notion that those on low incomes get more satisfaction from spending an extra dollar than do those on high incomes. Adoption of a policy designed to equalise all incomes would, however, be a sure recipe for revolution!

¹⁸ ABS Household Income and Income Distribution, 6523.0, 2009-10. The mean income of those in the highest income quintile was \$88,608 pa and in the lowest quintile was \$16,328 in 2009-10, an increase of 25% on the figure for 1994-95. It should be noted that the ABS explanatory notes indicate that the survey underestimates incomes in the lowest income quintile and states that "It can therefore be reasonably concluded that many of the households included in the lowest income decile are unlikely to be suffering extremely low levels of economic wellbeing. Income distribution analysis may lead to inappropriate conclusions if such households are used as the basis for assessing low levels of economic wellbeing." For that purpose it suggests a better guide can be provided by examining expenditures by income groups.

¹⁹ A UK Government report on *Households Below Average Income 1994/95 - 1997/98*, for example, showed that only 4 per cent of households were stuck in the bottom income quintile for the whole of the period covered by the report (The Economist, 23 October 1999).

²⁰ According to press reports of 2 November 2011, however, UN Secretary Ban warned that world leaders face mounting pressure from a world of seven billion people unless they tackle inequality. The reports did not include any comment by Ban suggest that developing countries should improve their own domestic policies.

Of course, believers in private enterprise do agree that governments should assist those on low incomes and that higher income earners should be net contributors. In fact, personal income tax data show this is the case, with those in the top 15 per cent of incomes paying about 56 per cent of taxes. But there is also concern to minimize the many adverse effects that can come from government involvement in redistributing incomes.

One major problem is the growth in welfare dependency. The proportion of the working age population on income support has increased to around 20 per cent and now extends to over 2.7 million people.²¹ At the end of the 1980s only 15 per cent received income support and in 1969 it was only 4 per cent. This increase has occurred despite the strong rise in average incomes per head. The principal reason for the higher level of income support is not increased need or poverty. It is action by political parties that make it easier to obtain benefits – *and* for politicians to obtain votes! If we count in education and health benefits, households with incomes in the *top two* quintiles receive over 30 per cent of government benefits and allowances.²² As it is these households that pay most of the taxes, the effect is that many of them pay taxes with one hand and receive back benefits with the other. This is called churning and illustrates dramatically what is called “middle class” welfare and where there is potential for reform.

Competition, Privatisation and Monopolies

Ensuring a competitive economic environment is another issue where private enterprise believers have no in principle difficulty in supporting government regulation and intervention. Preventing monopolies or at least regulating them helps to protect consumers and to level the playing field for those who want to be competitors.

This of course also means support for the privatization of monopolistic public sector enterprises. Such action will expose the enterprises to competition of various kinds and is most likely to produce a more efficient use of resources that provides a better quality service. There is no doubt that Victoria has benefited from the privatization of electricity under the Kennett government and the resistance up to now to such privatization in NSW has basically reflected the strong connections between the Labor party and the union movement in that state. World-wide there have been over 15,000 privatisations in recent years, including even under Labour in the UK.

Some complain that privatizations mean that low income groups have to pay a market price. However if politicizations want customers of former state enterprises to have access to their services at lower prices, this could be achieved by providing low income consumers with subsidies either directly or through the enterprise. Such subsidies are in fact already quite widely available although the need for them is dubious given that those on low incomes are provided through the social security system with the purchasing power needed to allow the basics to be obtained.

²¹ An estimate made by the Department of Family and Community Services for the July 2000 report on *Participation Support for a More Equitable Society* by the Reference Group on Welfare Reform put the figure at 22 per cent. The estimate was not published in the report and covers direct benefits only.

²² “Commonwealth Spending (and Taxes) Can Be Cut – And Should Be”, A Discussion Paper by Des Moore, commissioned by the Australian Chamber of Commerce and Industry, May 2005. This paper shows that the benefits received in 1998-99 by households with incomes in the top two quintiles were equivalent to 47 per cent of the taxes paid by them.

Supporters of private enterprise also acknowledge that competition from overseas should be accepted. This is a very topical issue world-wide. The government is under pressure from unions to introduce measures to provide additional protection to manufacturers of cars and textiles from overseas competition because the increase in Australia's exchange rate caused by the boom in mining is having increasingly adverse effects on manufacturing (and other areas). Since 2008 employment in manufacturing has fallen from 9.9% to 8.7% of total employment but we are shifting resources into more "efficient" areas and economic growth is continuing. The relative decline in manufacturing and the growth in service industries have been happening for a long time and will almost certainly go further.²³ Private entrepreneurs and their employees have to accept that over time changes will occur in the structure of the economy.²⁴

Environment and Education

The environment and education areas provide further examples of the in-principle acceptance of government intervention by supporters of private enterprise. The basic logic here is that, while such intervention imposes costs on individuals or impinges on their individual freedom, it produces more-than-offsetting benefits for the community at large.

Government intervention is justified to ensure free and compulsory primary and secondary education because there are net "spin-off" benefits both economically and socially from having an educated community. However, on both economic and equity grounds limits to government assistance for higher education are needed: qualified individuals have ample incentive to invest in educating themselves as graduates generally earn higher salaries. There is also a case for having privately run universities and for supporting private schools and hospitals. It is not widely realized that Australia is one of the few countries in the world to benefit from having extensive systems of private schools and hospitals. These bodies not only save the taxpayer considerable sums but provide a competitive framework that helps lift standards.

Government intervention to regulate and control the level of pollution is also usually appropriate because individual factory or car owners have no economic incentive to limit the extent to which they emit pollutants and there would otherwise be excessive pollution. Without going into detail, I hasten to add, however, that there is no sound basis for the government to act to control emissions of carbon dioxide. Analysis shows that temperatures have fallen or not increased in periods when there have been strong increases in emissions and, when temperatures have increased, the rate of emissions has either been low or the main cause seems to have been fluctuations in natural influences (the graphs I have circulated provide some relevant indicators). The decision to introduce controls over emissions is based on faulty analysis.²⁵

Industrial Relations

²³ Not so long ago 20% of employees were in manufacturing. In the US manufacturing provided one-third of all jobs in 1950 but that is now down to just above Australian levels.

²⁴ A similar argument is occurring in Europe with the Germans refusing to move to having its own exchange rate partly because that would be higher than the euro and would initially cause losses in some industries. However, over time their economy would adjust to the changed situation, just as it has in Australia. If this isn't allowed to happen there will be continuing crises in Europe.

²⁵ For a range of papers analysing this false science, see my web site at www.ipe.net.au

There is a similar objection to the high degree of regulation of employer-employee relations imposed under legislation implemented by the government and applied by the so-called Fair Work industrial tribunal. The perception that fairness requires such regulation is quite wrong. It reflects the false belief that, unless the government regulates the operation of the labour market, there will be a bargaining imbalance between employers and employees that will lead to exploitation of employees and a greater inequality in earnings.

However, this idea is based on a widespread failure to understand that, with over 800,000 employers competing for the services of over 11,000,000 employees, there is little scope for employers to impose conditions on workers. The regulatory system imposes unnecessary costs on employers, seriously inhibits them from managing their businesses, and limits the employment of low skilled workers. For example, the setting of the minimum wage at a high level relative to the average wage has almost certainly kept out of employment many with low skills and earning capacity, convicting them to reliance on social security.²⁶ It is also absurd to try to protect the wage levels of low wage earners when the majority of them live in households in the upper half of the income scale. It is the function of government social security, not wage decisions by tribunals, to protect the incomes of those in need.

Quality of Life

Finally, can private enterprise be blamed for the perception that the quality of life has declined? There is little evidence to support such a view. It probably reflects concern at the increase in competition and the associated perception of increased stress. Yet Australians have continued to become healthier, life expectancy has increased steadily and the death rate from almost all diseases (including cancer) has fallen.

Conclusion

I hope I have helped explain my support for a bigger role for private enterprise. Perhaps I can remind you of four points. First, private enterprise does not mean a free-for-all laissez-faire system but it should mean a major reduction in government intervention in industrial relations, in the provision of middle class welfare and in policies designed to reduce the use of fossil fuels. Second, in addition to defence and policing, governments have a role in instituting some form of redistribution of incomes and of the provision of education, as well as regulating monopolistic practices - but this role tends to be over-done. Third, reduced government would improve economic efficiency and living standards. Fourth, there would also be an improvement in equity resulting from the elimination of government assistance to particular groups that have no needs basis for it.

²⁶ In 1907, Justice Higgins became famous when he pronounced in the Harvester case the need for a minimum wage for an unskilled worker, his wife and three children. This allowed the Commission to portray itself as a protector of the low paid and a provider of social welfare. However, by setting the wage above market rates, employment was deterred.