

FINANCIAL REVIEW

Talk of reform
is not enough

Prime Minister Julia Gillard and Finance Minister Penny Wong stepped out this week to promote the benefits of economic reform. Ms Gillard told a Brisbane audience we risked becoming a “patchwork economy” unless we all knuckled down to boost productivity. Ms Wong said in Canberra that returning the budget to surplus was “not negotiable”. Ms Gillard said: “One or two big-ticket reforms is not enough. We’ll walk the reform road every day.” Yet these words camouflage a worrying absence of detail from two of the politicians responsible for crafting Labor’s economic reform agenda. A commitment to returning the budget to surplus by 2012-13 is commendable, but hardly difficult given the revenue windfall from the highest terms of trade since the 1950s. As consultants Macroeconomics said in a report yesterday, Australia would now be in the “economic doghouse” if its terms of trade were the same as those of Britain, the United States or Greece. Once commodity prices normalise, the budget will sink back into the red and the government’s pledge to cap real spending growth at 2 per cent won’t cut it as a “quick fix” for chronic imbalances. Treasury acknowledges the structural deficit but not to the same extent.

Ms Gillard and Ms Wong also talked up the government’s commitment to improving Australia’s dilapidated infrastructure and building human capital through education and skills enhancement. The problem is that the government’s approach to infrastructure, health and education reform is haphazard and selective. After that the content of Labor’s reform agenda, starts to fall away.

The bruises from going from first term winners to a second term minority should have taught the government that it must demonstrate higher economic credentials. It is time for the second act. But there been no mention of a new round of tax reform — other than a passing reference by Ms Gillard to the small cut in company tax her predecessor offered as a sweetener for the mining super profits tax. As for federal-state relations, and the unfinished business of energy, transport and other reform, these have also ended up on the cutting-room floor. And don’t even think of reforms to clear up the thicket of red tape created by modern awards, or cuts to overgenerous industry support to help balance the budget.

It is still early days for the Gillard government, and perhaps it deserves the benefit of the doubt. But the economy is getting more lopsided, productivity growth is stalled and Labor’s record over the past term and its populism during the campaign do not make us optimistic. There is little point in delivering a major speech on reform if all you do is skirt the issue.

China must mature
on world stage

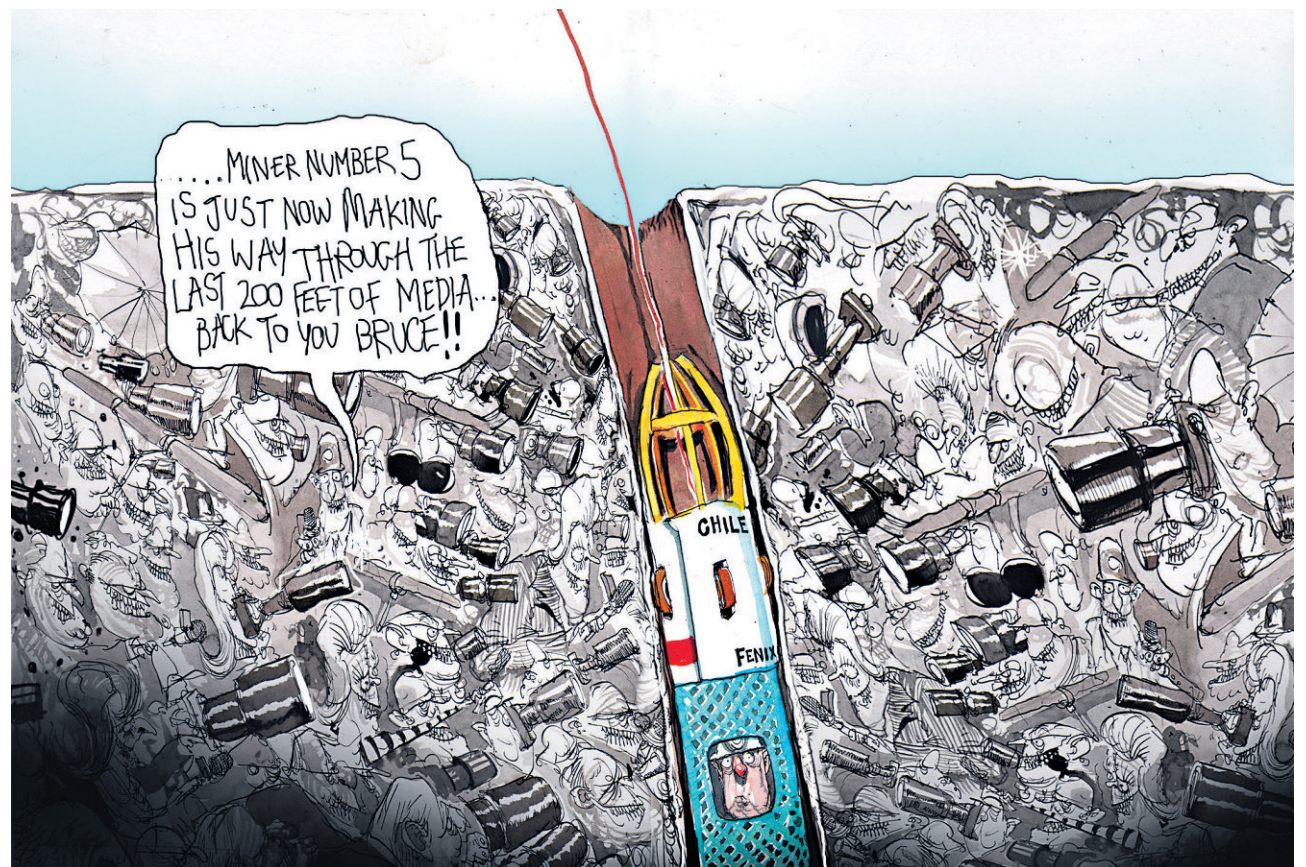
China’s Communist Party Central Committee begins its annual congress tomorrow just as Beijing, once again, finds itself firmly in the international spotlight for its poor record on human rights. The award of the Nobel peace prize to Liu Xiaobo, a human rights activist jailed for 11 years for his role in the framing of the Charter 08 document that called for an end to one-party rule in China and the introduction of democracy in that country, elicited such a strong reaction from Beijing that it has raised questions about the country’s ability to match its rising economic power with responsible international statesmanship.

The decision by the Nobel committee was a “desecration” of the Nobel prize and a blatant attempt to impose Western values on China, officials declared. The tone of the reaction reveals a level of defensiveness and insecurity among China’s leaders. That same sentiment has been reflected in Beijing’s negative reaction to growing calls from central bankers and finance ministers around the world to loosen controls on its currency and allow the yuan to appreciate to a fair value, in a bid to resolve global economic imbalances. Beijing deflected these calls and claimed, with some justification, that structural imbalances in the United States economy were more to blame for the global economy’s woes. It is highly likely, however, that Beijing will have to make some concessions on its undervalued currency, the next crunch point being the Group of 20 leaders’ summit in Seoul on November 11.

In the past year, China has surpassed Germany to become the biggest exporter in the world, overtaken Japan as the second-largest economy in the world and beaten the US to become the largest consumer of energy and the biggest global polluter. If China continues to grow its economy at the pace it has maintained for the past three decades, it will be more than four times the size it is today by 2030.

China’s impact internationally, in both economic and political forums, is set to increase. But events of the past week suggest a clash of values, and a level of immaturity in dealing with developed nations, that is likely to hamper Beijing’s role as a responsible stakeholder in international forums. It is hoped that the elite of the Chinese policymaking apparatus takes this opportunity to reassess China’s role in the international community and refine its leaders’ response to valid criticism.

GALLERY DAVID ROWE



The \$6bn water question

The debate over the proposed Murray-Darling Basin Plan has thrown up lots of questions about lots of numbers. But the \$6 billion question has gone unanswered, if not unasked.

In early 2007, faced with bad polls and a resurgent opposition, then-prime minister John Howard pulled a political rabbit from his hat, in the form of the \$10 billion National Plan for Water Security. Dumping the market-based approach that had characterised the National Water Initiative, and bypassing the Treasury, Howard proposed to spend \$6 billion on engineering works aimed at increasing the efficiency of water use. Another \$3 billion was allocated to the repurchase of water rights, but this was to be a last resort.

The scheme was a disaster in the making. The fiasco of Victoria’s Food Bowl Modernisation Project has shown that without careful project selection and rigorous cost-benefit analysis, investments in “efficiency” improvements turn out to be wasteful boondoggles.

The first stage of the Food Bowl project involved spending more than \$1 billion to upgrade irrigation facilities in the hope of reducing “losses” of water through leakage, seepage and evaporation (leakage refers to water that flows through the walls, and seepage to the absorption of water into the soil from the bottom of channels). The water saved as a result, estimated at 225 gigalitres, is to be divided equally between agriculture, the environment and urban use in Melbourne.

Claimed environmental savings are particularly dubious. From the historically dominant viewpoint of irrigators, “leakage” and “seepage”

represent a loss of water that could otherwise be put to use. But because ground water and stream flows are closely linked, a substantial proportion of the water that leaks or seeps from irrigation channels eventually returns to the river system from which it was taken.

Even accepting the government’s estimates, the cost of water saved through the scheme is about \$4000 per megalitre (1 million litres), compared with a market price for high-reliability water entitlements of about \$2200/ML. Since irrigators are already able to trade in this market, the water provided to them must be evaluated at this price, yielding a benefit of about \$160 million for 75 gigalitres (1 billion litres).

The remaining water for the environment and urban use amounts to 150GL at a cost of about \$840 million, or more than \$5000/ML. If the double-counted return of leakage and seepage is disregarded, the cost of water for Melbourne reaches more than \$10,000/ML, at least five times the price for which the water could be bought from irrigators willing to sell it.

The only saving grace of the Howard plan was that most of the expenditure was “back-loaded”, meaning very little had been spent by the time the government lost office in 2007. The Labor government dodged this looming disaster by adopting the Howard plan but reversing the priorities and focusing initially on water repurchases. So far, entitlements with an average annual

allocation of 700GL have been purchased at a total cost of about \$1.5 billion, or \$2200/GL.

It seems likely that the same average price could be sustained for further purchases. Those who sold first can be assumed to be the more marginal producers but the breaking of the drought means that the sale price of temporary water allocations will drop sharply. That is likely to spill over into the market for permanent entitlements.

And here is the \$6 billion question. Acquiring another 3000GL at \$2000/GL would cost the government \$6 billion, which is almost exactly the amount that has been allocated, in principle, for water efficiency measures. If those measures were subject to a market cost-benefit test, so that only schemes with a cost less than or equal to the market price were approved, the goals of the Murray-Darling Basin Plan could be met with the funds now available.

But the government is already facing huge pressure to spend up big on engineering works. And, on past experience, it can count on irresponsible obstructionism and scaremongering from Tony Abbott and the Nationals party. Almost certainly, we will end up with an expensive compromise in which various lobby groups are bought off. Even so, the plan is the best hope we have had for a sustainable solution to the problems of the Murray-Darling Basin.

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NOTEBOOK

The relative speed of US spending

The Wall Street Journal, October 13.

Perhaps you missed it, but then so did the Washington press corps.

Late last week the Congressional Budget Office released its preliminary budget tallies for fiscal year 2010, and the news is that the US government had another fabulous year — in spending your money.

We didn’t expect President [Barack] Obama to hold a press conference, but why are Republicans so quiet?

Spending rolled in for the year ended September 30 at \$US3.45 trillion, second only to 2009’s \$US3.52 trillion in the record books.

But don’t think this means Washington was relatively less spendthrift. CBO reports that the modest overall spending decline results from three one-off events: the costs of TARP [Troubled Asset Relief Program] declined by \$US262 billion from 2009 as banks repaid their bailout cash; payments to Fannie Mae and Freddie

Mac were \$US51 billion lower (though still a \$US40 billion net loser for the taxpayer); and deposit insurance payments fell by \$US55 billion year over year.

“Excluding those three programs, spending rose by about 9 per cent in 2010, somewhat faster than in recent years,” CBO says.

Somewhat faster. You’ve got to laugh, or cry, when a 9 per cent annual increase qualifies as only “somewhat faster” than normal.