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Party of thrift shouldn't be timid about cutting taxes

Fiscal policy
The Liberal Party has ditched the obsession with debt and deficit to pay for massive pandemic suppport. But that shouldn't deter it from its old focus on tax.

Richard Holden

There has already been much discussion about how next week's federal budget will confirm what we already know – we will be running the biggest budget deficits in Australian history over the coming years. And yes, by necessity, it will.

But perhaps the biggest change to the Australian fiscal landscape will be that the Liberal Party sheds its brand as "the party of thrift" – as one MP put it to me.

Good. The Liberal Party's obsession with "debt and deficits" has led Australia to underuse fiscal policy as a means of investing in social and physical infrastructure to boost productivity and drive long-term economic growth. Bizarrely, it has even caused it to be timid on cutting taxes.

Remember the "enterprise tax plan" that sought to lower the company tax rate by 5 percentage points to 25 per cent – from one of the highest rates among advanced economies, mind you – over a decade? The glacial pace of that proposed reform was squarely because of concerns about the short-term budget impact over the four-year forward estimates period.

The same can be said of the gradualism involved in the three-phase personal income tax cuts Josh Frydenberg announced in last year's budget – all of which should be brought forward and enacted right away.

It seems as though, finally, the Liberal Party is being forced to realise that while thrift can sometimes be an individual virtue it can also – in the aggregate, and at certain macroeconomic times – be a collective vice.

This is, of course, the great lesson taught to us by John Maynard Keynes in the 1930s.

But none of this is to say that debt and deficits don't matter in the medium run. They do. And while there is little reason to be concerned that the Liberal Party will morph into a collection of democratic socialists like Bernie Sanders or Alexandria Ocasio-Cortez, it is important to resist the temptation to think that because we should spend aggressively now, and for a while, how and eventually how much we spend does not matter.

Josh Frydenberg should bring forward all of his proposed tax cuts. PHOTO: ALEX ELLINGHAUSEN

Let this be the time when we stop seeing debt and deficits as a morality play.

The ability to spend big when needed depends on our net debt to GDP ratio giving us the "space" to do so. Indeed, Christina Romer, a former chairwoman of Brack Obama's Council of Economic Advisers, and one of the world's leading macroeconomists, David Romer, have persuasively demonstrated the importance of such "fiscal capacity".

We came into the pandemic with a lot of fiscal space. And we will likely come out of it with more than most countries.

But at some point, when debt levels relative to the ability to service that debt get too high, markets essentially freak out and drive up government interest rates quickly, with devastating consequences. Countries rarely see the "bond vigilantes" coming, and it's usually too late even if they do.

We tend to have a fairly unnuanced way of describing approaches to economic policy in Australia. People (and policies) are either "neoliberal" or "Keynesian" – heartless or reckless. That reflects a misunderstanding of mainstream modern economics.

Most well-trained economists understand that when monetary policy has run out of puff, fiscal policy is an important and useful tool for stabilisation.

So too do economists understand that markets left to their own devices tend to underinvest in social and physical infrastructure because not all of the benefits are reflected in market prices. There are "externalities" – and government policy has a powerful role to play in internalising these externalities.

Yet those same mainstream economists have learnt the lessons of Milton Friedman and Edmund Phelps that there is no long-run trade-off between unemployment and inflation, and that trying to push it lower at the price of higher inflation eventually leads to more inflation without permanently lowering unemployment.

So too modern empirical economics – with rich data and clever methods for teasing out the causal effects of policy changes – has highlighted what basic economic theory has always emphasised. Namely, that high income taxes significantly distort labour supply, and high capital taxes lead to less investment, hurting workers – especially younger, less skilled, and female workers.

And while taxes are indeed, as Justice Oliver Wendell Holmes jnr put it, "what we pay for civilised society", inefficient and overly distorting taxes make it harder to fund civilised society.

Next week's budget will reflect the grim fiscal reality we face. And we should not be embarrassed by the size of the deficit. It reflects the magnitude of the crisis, and a government that has jettisoned its political brand to do the right thing (if perhaps not quite enough of it) and provide strong fiscal support for an Australian economy in crisis.

But let this also be the time when we end silly comparisons of the federal budget to a household budget, and stop seeing debt and deficits as a morality play. They are not. They are about using government resources to the maximum effect for all Australians.

That involves more spending and more debt than we have been used to as a nation, but not nearly as much as some on the left hope for.

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How China is preparing for Washington's decoupled world

Beijing's plan
The dual-circulation strategy is not fortress China. It's a plan for resilience whatever the US does now.

Andrew Sheng

Xiao Geng

China's leaders are currently putting the finishing touches to the country's 14th five-year plan for 2021-25 period. But one aspect of the plan – the so-called dual-circulation strategy – is already attracting the world's attention. Many fear that China is "turning inward" just when the global economy is staring down the barrel of a recession. These fears are misplaced.

According to President Xi Jinping, the dual-circulation strategy means China will rely mainly on "internal circulation" – the domestic cycle of production, distribution, and consumption – for its long-term development. This will reduce its dependence on overseas markets and technology.

But that doesn't mean China is withdrawing from the world. To understand what it does mean, one must first comprehend how Chinese policymakers think about the country's long-term development trajectory.

Unlike Western leaders, who typically have degrees in law or economics, Chinese policymakers are mostly scientists and engineers. As a result, they are more likely to think in systemic terms. China's five-year plans are crammed with engineering and systemic terms, such as "top-down architectural design", networks, platforms, and processes.

This approach means that Chinese policymakers look beyond mainstream micro and macroeconomic models to account also for meta and meso-considerations.

At the meta level, Chinese policymakers are dealing with what the father of the country's nuclear program, Qian Xuesen, called an "open complex giant system". As Qian and his co-authors noted, one cannot expect to manage such a system using

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"exact science',' with its underlying reductionism. Instead, they should engage in "meta-synthetic engineering from the qualitative to the quantitative" – that is, a process of qualitative analysis followed by rigorous testing against empirical facts.

Deng Xiaoping summed up this approach with his axiom, "crossing the river by feeling the stones". Decades later, Nobel laureate Robert Shiller would take this concept further, showing how qualitative factors such as popular stories influence complex systems and are therefore essential to enable us to explain outcomes accurately.

At the meso or institutional level, the dual-circulation strategy evolved out of the "circular economy" model – a systemic approach to reducing consumption and waste, thereby enabling natural-resource regeneration. The dual-circulation model is built on the recognition, derived from decades of manufacturing the world's goods, that supply chains operate through multiple cyclical production, distribution, and innovation processes that are endogenously self-co-ordinating and synchronising.

When these processes, cycles, and feedback loops do not synchronise well with government policies and procedures – say, because taxes or bureaucratic barriers are too high – supply chains stall. The dual-circulation strategy aims to avoid such obstruction, by applying flexible, adaptive, institutional, and structural approaches.

Focusing on internal systems is crucial to this objective, not least because of increasing macroeconomic disturbances. For starters, the COVID-19 pandemic has highlighted just how vulnerable our "just-in-time" global supply chains are to disruption, fuelling calls for "globalisation."

At the same time, tensions with the United States – China's largest trade partner – are escalating, exemplified by recent moves by President Donald Trump's administration to cripple the operation of the popular Chinese-owned mobile apps WeChat and TikTok in the US. Economic decoupling now seems likelier than ever.

China's dual-circulation strategy is a pragmatic response to the rapidly changing internal and external pressures the country faces. Policymakers' goal is to boost supply-chain and market resiliency by leveraging China's massive population of 1.4 billion – including 400 million middle-class consumers.

This brings us to micro-level considerations. Given China's meritocratic system, one generally reaches the highest levels of policymaking only after working at the development "frontlines": directly managing the construction of physical and social infrastructure in villages, cities, and provinces. This instils in Chinese leaders an awareness of people's needs and the dynamics of social and economic engineering that never dissipates.

Today, most Chinese enterprises, as well as local governments, are struggling to adjust to fast-changing domestic and international market conditions. The dual-circulation strategy will help, by creating freer and more unified national markets for physical, financial, and human capital, products and services, technology, and information. It will also ensure that all of the system's stakeholders know what to expect. But strengthening internal production and consumption cycles does not mean destroying external trade, investment, tourism, and education networks; on the contrary, China is set to continue opening up its economy, especially its financial market.

Rather, dual circulation means that external exchanges will be expanded and deepened in ways that complement the domestic economy.

If the rest of the world wants to co-operate in such ways – say, on developing green products and services – China will oblige. If it doesn't, China will rely on its own formidable strengths, from a large consumer base to fast-growing innovative capabilities, to sustain its growth and development.

Simply put, if the world is not ready for co-operation, China will adapt to polarisation.

From Made in China 2025 to the Belt and Road Initiative, the world has often misinterpreted pragmatic or strategic Chinese policies and projects as devious or destructive schemes.

But China can't control how others interpret its actions, and it will not change its policies to appease its critics. With China poised to be the only major economy to record positive growth in 2020 and 2021, according to International Monetary Fund forecasts, there is no reason why it should.

PROJECT SYNDICATE

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