Ten Lessons for the Recession

Hon Sir Roger Douglas
“When a man, a business, or an entire society is facing bankruptcy, there are two courses that those involved can follow: they can evade the reality of their situation and act on a frantic, blind, range-of-the-moment expediency – not daring to look ahead, wishing no one would name the truth, yet desperately hoping that something will save them somehow – or they can identify the situation, check their premises, discover their hidden assets, and start rebuilding.”  

- Ayn Rand

Introduction

As a nation, New Zealand faces a choice over which course of action we adopt. So far, it seems as if New Zealand is following the first course of action.

Unfortunately for us, that course of action will delay the correction that is needed to end the recession.

The “rolling maul” of initiatives supported by National will increase the size of Government. In so doing we will begin to forfeit more and more of the money we earn to the Government.

There are some positive things going on. Rodney’s work on regulatory reform is one of the things that will get the economy started again. But we need to do more.

Borrowing beyond our means to increase the amount of spending is what households have done over the last 10 years. It has led to our current recession. Now the Government wants to try the exact same strategy to get us out of the recession.

The only effect of borrowing and spending will be to create ever-larger boom and bust cycles.

Alternatively, we could take the second course of action.

The second course of action will see a correction take place sooner. That correction will hurt. But the hurt is unavoidable – it will have been caused by large household debt, a spiralling balance of payments deficit, and an unaffordable spending binge undertaken by the Labour-led Government.

Pretending we can avoid the pain of economic contraction may make us feel better in the short term. But pretence will add to the pain that we feel when the inevitable adjustment occurs.

If we are going to take the second course of action, then we need to learn some lessons. Today, I am going to talk about the Ten Lessons for a Recession.

Lesson One: If a company fails, the free market has not failed

There seems to be this idea that if finance companies collapse, or Fisher and Paykel downsizes, that this is somehow the failure of the free market. The reality is the complete opposite.

The capacity for free markets to reveal failure is one of its great virtues. Capitalism relies on a system of profit and loss.
The capacity for profit ensures that companies aim to meet consumer demand. The capacity for loss weeds out the failures and stops more resources being wasted on them.

Whenever anyone suggests that a company is failing because of the free market, what they are really saying is that the company is failing because consumers do not want to buy their product. That is a force for good.

In terms of the failure of the American financial system, it is becoming increasingly clear that that crisis was not caused by deregulation. The banking sector is the most heavily regulated sector of the American economy. Laws that forced lenders to make loans to those who could never pay it off created a housing bubble and resulted in large amount of sub prime loans.

If anything, the financial crisis should make us more, not less, sceptical of Government interference in markets.

**Lesson Two: If you’re in a hole, stop digging**

New Zealand’s economy has been shrinking since the beginning of 2008. We have been getting poorer. Other countries that we like to compare ourselves to, like Australia, are not yet in recession. The financial crisis has been affecting us both, so why have we been in recession so much longer?

We have been in a recession for longer because of failing Government policy. In New Zealand we have been moving in the wrong direction. We have moved from a Government geared towards growing our wealth to a Government geared towards redistributing it. This pushed us into a recession, and now the financial crisis will hurt us further.

We need to admit that we have been digging ourselves a hole. As citizens, we got it wrong. We have been adopting policies that have stopped productivity growth. These policies have effectively halted our economic growth.

By admitting that we got it wrong, we can reverse these failing policies and implement new ones. We can move away from high taxes and low growth, and start aiming for a low-tax high-growth system of Government.

**Lesson Three: Quality Government decisions can help**

The decisions that the Government makes during a recession significantly impact on how quickly the country will move out of the recession.

As evidence of this, look no further than the Government response to the Great Depression in America. They managed to turn a stock market crash into a 10 year slump. As Roosevelt’s Treasury Secretary, Henry Morganthau, said in 1939:

“We have tried spending money. We are spending more than we have ever spent before and it does not work. … I want to see this country prosperous. I want to see people get a job ... I say after eight years of this Administration we have just as much unemployment as when we started ... And an enormous debt to boot!”

Clearly Government can worsen a recession.
But they can also alleviate the harmful effects. New Zealand found itself in a recession in 1991, and the Government decided that it had to cut the overall level of Government spending to share the pain equitably between the public and private sector. The effect was obvious and beneficial.

By 1993, New Zealand was back to solid economic growth. Between the third quarter of 1993 and the end of 1997, growth never slipped beneath 3%. For much of that period it was above 5%.

So how do we restore economic growth? The only way out of a recession is to reverse our trend towards low productivity growth. Productivity growth drives wage growth.

Since 2000, our relative labour costs – the costs of hiring and employing people – have increased by 60%. Labour told us that these policies – policies like the extra week of annual leave, were employee benefits. They were benefits for people in jobs, but hurdles for those out of work. They will now act as a major barrier to re-employment for those who lose their jobs.

The most important thing we can do to reduce the amount of unemployed people and end the barriers for productivity growth is to make the labour market flexible again. That means freedom to contract between employer and employee over wages and other entitlements. Eventually we should move to dismantle the Employment Court and rely on the common law.

Lesson Four: You can’t spend the same dollar twice

The Wall Street Journal, after an interview with John Key, recently reported that New Zealand was not adopting the so-called “fiscal stimulus” approach that other countries were.

Unfortunately they were wrong. Government expenditure, which was already out of control under Labour, has been brought forward. Costly campaign promises are being implemented. There is even talk of building a cycleway to create jobs. In addition the Government is thinking of paying people not to work – the nine day fortnight.

The tax reductions could have been very positive, had they been accompanied with suitable reductions in spending.

Whenever I hear talk of the Government “creating jobs,” I am reminded of a story that is told about Milton Friedman.

Friedman was in China and the Government was taking him around construction sites showing what they were doing. At one particular dam project, the workers were using spades to move the earth, while some diggers lay idle around the construction site. When Friedman asked why they were not using the diggers, the wise bureaucrat responded that construction of the dam was being used as a job-creation scheme. By not using diggers, they could employ more people!

Milton Friedman replied that if the Chinese Government wanted to create even more jobs, they should take the spades away from the workers, and give them all teaspoons instead.
The point of the story is that making work is easy. But making work does not make us wealthy.

Make work schemes, like the cycleway, will divert people from productive work to less productive work. That is a recipe for poverty, not prosperity.

In the 70s and early 80s we learnt that there was no such thing as a free lunch. Today, we need to learn that there is no such thing as a free fiscal stimulus.

Let’s think critically about the fiscal stimulus.

Every extra dollar taxed by Government is a dollar that employers are not spending hiring someone new.

Every extra dollar borrowed by Government is a dollar that companies are not borrowing to last through the recession or expand output.

Every extra dollar spent by Government is a dollar not spent by the productive sector.

Fiscal stimulus comes at a real cost to every one, and benefits a few special interests. The costs to every one will disproportionately fall on the poor. The special interests who will gain from stimulus are the well-organised lobby groups.

Lesson Five: Incentives matter

When Labour introduced free physiotherapy as part of ACC in 2004, it was meant to cost $9 million. It is already costing $139 million. That’s an increase of over 1400%.

How could the Government get the figures so wrong?

It happened because Labour did not understand that incentives matter.

If something is “free” to the consumer but charged to the taxpayer, they will seek more of it. It doesn’t cost them, and instead the costs are spread across every one. In the process, overall costs will go up and taxes or levies will have to rise to meet them.

That is why promises of “free” services, like doctors visits, healthcare, or transport for superannuitants, always end up costing far more when paid publicly than they ever would if paid for by the individuals themselves.

Equally, incentives work in the opposite way too. If we get the incentives right, we can harness every individual’s concern for their own self-interest and use it for the public good.

Every one cares about their wages. If we lowered taxes across the board, people would have higher post-tax wages. That would encourage them to work more. That work would produce more goods and services for other people to consume.

Self-interest only works against the general interest if the incentives are wrong. Let’s all clearly understand once and for all that incentives affect behaviour.
Lesson Six: Focus on the dollars, not the cents

Government expenditure and tax are directly related. All Government expenditure must be paid for – be it through current taxation, or future taxation. That is why tax cuts without cuts in spending are meaningless.

Government waste must be eradicated – we can’t afford it at the best of times, let alone an economic downturn. Any waste we can get rid of means that we can cut taxes. Cutting taxes frees up resources for the productive sector to usefully employ.

When I say cut Government spending, that’s not just spending on conferences like National seem to think. They’re worried about the cents; but we should be far more worried about the dollars.

We need to prioritise. Every dollar that Government spends should be going towards ensuring people have access to needed social services. That means we should be axing whole programs and Government bodies. The Families and Charities Commissions, the Ministry of Economic Development, and the Ministry of Youth Development, do not deliver the things that voters actually need. They should be amongst the first to go.

Longer term, the only real way to slow Government spending is to leave the money in the hands of individuals, who have an incentive to seek quality social services while keeping costs down.

That system requires competition. Competition does not just mean private hospitals competing against public hospitals. It should also mean public hospitals competing against public hospitals.

Tax credits for education, health, and welfare (sickness and accident insurance) would see control restored to individuals and costs decreasing. Let’s give people back the control and responsibility over their own lives.

In this scenario, the role of Government would be in ensuring that every New Zealander had the capacity to actually purchase their required social services within the marketplace. Every one could and should have access to the best medical treatment, schooling, and insurance protection that only the wealthy can currently afford.

Lesson Seven: Lift our sights, aim high

Over the last two years we have had $30 billion dollars wiped off the stock market. Over the last year we have lost $30 billion dollars on our housing stock. If you add in finance company losses, New Zealand Super Fund and ACC losses, you get between $70 - $80 billion dollars.

That’s about $18,000 for every man woman and child in New Zealand. The economic downturn is hitting New Zealanders hard.

Within that context, it is very easy for New Zealanders to lose hope. The Government could respond by working hard so it appears that they are doing something. But doing something is a poor substitute for doing the right thing.
If we look beyond the short term pain to the medium and long term, we can move beyond the present despair. Only by lifting the sights of New Zealanders, who are rightly concerned about the future, will we be able to work through the mess Government has created.

We could set a goal, and measure all new policies against the goal.

I want that goal to be making New Zealand prosperous again. Let’s beat Australia by 2020.

The 80s and early 90s reforms were very successful at stopping us getting relatively poorer. But we want to be getting relatively wealthier. We need to achieve sustainable economic growth of 5% per year. That should be our target. Every policy proposal should be tested against that target – does it help or hinder?

**Lesson Eight: Costs of the downturn must be borne equitably**

I have already talked about how the average New Zealander is suffering – how the losses so far from the economic crisis has seen a loss of value of $18,000 for every man woman and child in New Zealand. For your average family, that is $72,000.

It is unfair that the private sector bear the full cost of the crisis. Promises that there will be few reductions in the number of bureaucrats and that spending will not be cut forces the private sector to suffer more than it needs to while the public sector continues on as before.

Why should we not insist that the public sector, staffed by well-paid bureaucrats, also face the kind of cuts that a recession requires? Why should some be protected while the more vulnerable are not?

Statisticians talk about rates of unemployment. The real rate of unemployment felt by an individual who loses their job is 100%. Someone who loses their job at Sealord does not care what the rate of unemployment is. They want another job.

Is the best we can do - a nine day working fortnight? Look, if we free up resources from the public sector, and if we ensure that there are few barriers to the offering of employment opportunities, we can do a lot better for those who lose their jobs. We can grow the number of jobs and ensure people can get back into work quickly. But we need to grow the number of productive jobs, not the number of unproductive ones.

Any person who runs a household knows what a reduction in household income requires: spending must be cut. If government taxation revenue goes down – as it has – then any responsible Government must also cut expenditure. There’s plenty that one can describe as wasteful. That is the only way to ensure that the pain felt by any one individual is not unmanageable.
Lesson Nine: We need choice and competition

I've already talked about the need for choice and competition within health, education, and welfare insurance. But the real domain of the central planners is in infrastructure – in roading, water, and electricity.

No politician or bureaucrat knows enough to plan for us all. We must rely on more spontaneous forms of organisation – those that occur through the market.

If you think of your life as a series of interactions with private and public organisations, you will quickly become aware of the failures of the public sector.

We queue in cafes for a minute; we queue in traffic jams for hours. We can choose what we want to have for lunch; but we cannot choose the level of coverage provided by workplace insurance. We never seem to have a shortage of food, but we all know of someone waiting on a hospital waiting list.

Those areas that are dominated by central planners deliver poor services for too high a cost. Only through choice and competition can we unleash the potential of the marketplace.

At the end of the day innovation comes down to individual entrepreneurs with good ideas. Central planners suppress good ideas and prevent them taking hold. We know that bureaucrats are far less innovative than entrepreneurs like Alan Gibbs or AJ Hackett.

If we really want to solve our problems with infrastructure, let's replace the planners with the entrepreneurs.

Lesson Ten: Communication matters

Voters place a higher value on enhancing their medium-term prospects than on action that looks successful short-term, but only by sacrificing larger and more enduring future gains.

People fundamentally understand that sometimes decisions that create short term pain will be worth it in the longer term. Politicians need to communicate that reality to the public, and stop trying to sell free lunches that always turn out to cost far too much.

There is a deep well of realism and common sense among the ordinary people of the community. They want politicians to have guts and vision to deliver sustainable gains in living standard.

Inadequate politicians see instant popularity as the key to power. If their rating slips, they feel threatened. They look for policies with instant appeal to create continuous public bliss.

That approach flies in the face of reality. There is no free lunch. Every decision involves trade-offs, which do not vanish just because some politician chooses to ignore them.

The sordid fact is: instant solutions do not have instant popular appeal. Notoriously, they are peddled by politicians who actively blind themselves and others to the facts about the situation.
The problem with compromise policies is simple. They do not produce the right outcome for the public at the end of the day. So they come back to haunt the politicians responsible for them.

As costs and distortions accumulate, such Governments resort to misrepresenting and suppressing vital information about future economic prospects, to warp the judgement of the voting public.

Too often, they end up locking themselves and the public into their own nonsense. No one escapes until a crash has liberated the suppressed information, and consigned them to oblivion.

Politicians need to be honest and upfront with the public. They need to communicate not only what they are doing, but what they hope to achieve. If politicians are consistent in what they say and how the inform the public, then they will be seen as credible. Consistency leads to credibility, and credibility creates the kind of confidence that people need before they are willing to change.

**Conclusion**

Look, this recession will end. We can control how quickly it will end and how fast we will grow once it has ended.

We can continue down the redistribution path. But that is a path to poverty.

Alternatively, we could aim to increase our productivity and stimulate economic growth. That will require a change of direction and a change of culture.

We should celebrate free enterprise and entrepreneurship. We should adopt policies that encourage innovation and competition. We should move away from tired old state monopolies and introduce new ways to deliver our social services.

We can be wealthy again, but only if we finish the job.