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At last, at last, economists are getting what they've longed for: the return of micro reform. With the Howard Government's acquisition of a majority in the Senate, the good times are back. We've had completion of the privatisation of Telstra and now the Holy Grail of economic rationalism, reform of the labour market. What's more, and as we shall see, the next cab off the rank looks likely to be that other economists' chart-topper, tax reform. Yippee! But whether the reform is what economists imagined it would be is another matter, as is whether what we're getting will do much good to the economy.

Take Telstra. I suspect it's now dawning on some economists that privatising a near monopoly isn't such a wonderful thing, and that much turns on the ability of a quite intrusive regulatory regime to ensure a hugely resourced and political powerful company doesn't abuse its market power. It's clear the natural monopoly element of Telstra should have separated from the contestable element before privatisation began, but I don't recall hearing many economists saying this back in 1996 - especially those working for outfits hoping to win the contract to organise the float.

The economics of WorkChoices

Similarly, I doubt if many economists now think WorkChoices is all they had in mind when they dreamt of labour market reform. It certainly can't be thought of as deregulation. It's hugely prescriptive about what unionised workers may and, more particularly, may not do. I've written that only the employers have been deregulated, but even that may be too generous. Employers will find the new system more complex and legalistic. The new act is more voluminous and prescriptive, there'll be more work for lawyers, no tribunals have been abolished but additional ones created, and the minister is given greatly increased discretion to intervene in bargaining.

Rather than reduce regulation of the labour market, WorkChoices simply biases it in favour of employers by doing all it can discourage collective bargaining and shoving the old system of awards and arbitration into the background. Because economists' neoclassical model abstracts from the question of relative bargaining power, WorkChoices assumes (possibly correctly) that economists won't notice what's amiss. Likewise, it picks up the economists' point that restrictions on the ability to fire end up being restrictions on the willingness to hire, while ignoring the more subtle point that workers (including even economists) derive much utility from perceiving that their job is secure.

If you draw a distinction between trying to swing one to employers and trying to improve labour market outcomes, it's hard to see how WorkChoices will do much for the economy. In the OECD's rating of different countries' employment protection, it gave our unfair dismissal regime quite a good (ie low) score, and when you remember that getting rid of the unfair dismissal provisions encourages firing as well as hiring, you wouldn't expect much net increase in employment.

Most economists' main hope of employment growth would come from lowering the minimum wage, but as Mark Wooden of the Melbourne Institute has pointed out, the Fair Pay Commission's freedom to lower the minimum in real terms will be greatly constrained by the indexation of unemployment benefits. The most the commission's likely to be able to do is slowly lower the minimum <u>relative</u> to the faster-growing median wage. And, as Saul Eslake of ANZ has reminded us, this was already happening under the much-reviled Industrial Relations Commission. Over the eight years to 2004, the federal minimum wage fell as proportion of median earnings from 60.6 per cent to 58.4 per cent. Without the ability to change tax and transfer policies, there won't be a lot Ian Harper can do.

You might hope that less protection of penalty rates would permit greater flexibility in the deployment of labour, but make sure you get your analysis right. One little acknowledged point is that, while the penalty payments specified in awards may be arbitrary, it's perfectly legitimate for workers to set a higher reservation price for work at unsociable hours. And when the cost of labour falls simply because of unequal bargaining power, what results is a transfer of income from workers to employers without any net gain to the economy.

The politics of WorkChoices

But let's turn to the <u>political</u> implications of WorkChoices. Reading my various columns on the subject, one of the young chaps at work concluded that I'd changed my mind about it. No, I said, it's just that my views are complicated. I regard WorkChoices as bad in principle, but not likely to be terribly bad in practice. It's clear the public is most disapproving of the changes, and this accounts for John Howard's quite serious slump in the polls.

But let me make this fearless prediction: the changes won't stay a hot topic now they're through parliament and I'll be surprised if they're a significant issue at the election in (presumably) October 2007. There are five reasons for thinking this. First, the changes won't be as bad as some have painted them. When bush lawyers pore over new legislation, they have a tendency to see worst-case scenarios and imagine they'll be the new norm. They forget that acts are always conferring rights that are rarely exercised because they're considered impractical or impolitic. Second, it can take quite a while for people to change their behaviour in response to changed legislative opportunity. Much of the fear of WorkChoices rests on the spread of Australian Workplace Agreements, but these have been available since 1997 and so far have spread to less than 2.5 per cent of the workforce.

Third, the changes are <u>designed</u> to be slow release, with some taking a year, three years or even five years to take effect. Fourth, and this is a point for economists to note, the very nature of decentralised wage fixing means it's hard for observers to know what’s going on. Whereas all decisions by the IRC were made public, and the terms of all collective agreements are on record, the Act goes to much effort to ensure the terms of AWAs are kept secret. So, in the event of AWAs becoming much more significant in the wage-fixing process than they are today, it will be hard for the public to know if a lot of employers are driving hard bargains, it will hard for the firms and workers in an industry to know what the going wage is (meaning there’s likely to be a fair bit of variation), and it will be hard for the Statistician and economists to know what’s happening to wage growth.

But my fifth reason for distinguishing between principle and practice is, to me, the killer: it won’t be long before the Government’s efforts to shift bargaining power in favour of employers are overtaken by the marked shift in the balance of supply and demand for labour brought about by population ageing and the retirement of the baby boomers. Many people can’t conceive of a time when even the unskilled are in short supply, but everyone over 50 lived through such a time. People say a recession would speed up employers’ exploitation of WorkChoices. That’s true, but it would be wrong to assume the next recession, when it comes, will be as severe as those of the early 1980s and 90s. I think we could be returning to the pre-1974 period where recessions were much milder because, in an era when shortage of labour was the norm, there was a lot more labour hoarding. We’ll soon be entering a period where workers have the upper hand. It may prove that the one great virtue of WorkChoices was to remove any <u>institutional</u> addition to workers’ bargaining power, thus limiting the extent to which the economy is dogged by perpetual worries about excessive wage settlements. This will, to an extent, offset the ill-effects of the Howard Government’s chronic underinvestment in education, training and skill-formation, which will be coming home to roost.

What’s next?

Even so, it seems clear Howard will want to find a new, and preferably less unpopular, reform issue to fill the vacuum left by the IR changes. He’ll want to change the subject and he’ll want to look busy - whether he’s going or staying. He’ll want to get the business urgers off his back and he may well want to add to his tally of economic reforms something that fits with his long-held views about the key reforms needed. That all points to one thing: more tax reform, this time focusing on personal income tax and, in particular, the top rate.

But he can’t just cut the top rate. That would be too simple - too little to occupy people’s attention - and too much like a blatant handout to his rich mates. It would compound the impression given by the IR changes that he’d switched to doing the dirty on Howard’s Battlers. It would also be relatively cheap. No, he really needs to do something where he’s seen to be working on the tax problems of everyone, even if some people end up with much bigger tax cuts than others.

One of the people leading the campaign for further tax reform has been Malcolm Turnbull, of course. You can understand why Peter Costello has been trying to hold back the push for further reform. He knows that his big achievement in this area - raising the top threshold to $125,000 a year so that only 3 per cent of taxpayers are still subject to the top rate - hasn’t even taken effect yet, but has already been brushed aside and threatens to be subsumed by something even bigger. He would have a

Treasurer's caution about leaping to early conclusions on how big the 'surplus surplus' is likely to be looking in five months' time. And he would be aware (as most people have failed to realise) that at present he's committed to half a tax cut next July - one for everyone earning more than $63,000 a year - and that he'll be in trouble politically if he doesn't come up with the revenue for the bottom, far more expensive half. In other words, he knows he's up for the cost of another expensive tax cut for the punters, before he worries about making the tax cut for high income earners even more generous than already planned.

Is his reticence on the question of tax cuts also influenced by rivalry with Turnbull? Quite likely. It may even be influenced by his preference for making further income-tax reform the first big reform of the Costello Government rather than the last reform of the Howard Government. But that's all the more reason why Howard's likely to insist the question of further tax reform be explored immediately rather than left for later. The test of whether this exercise proves to be anything more that a government with an embarrassingly large surplus finally giving in to pressure from the most well-off taxpayers in the land is, first, whether anything significant is done about a far more important problem - the work disincentives facing mothers returning to work and people moving from welfare to work created by their much higher effective marginal tax rates - and, second, whether high income earners are required to contribute to the cost of their tax cuts by way of base-broadening measures.

So tax 'reform' presents an opportunity for genuine reform, but it remains to be seen whether that opportunity is taken. What else is there on the reform agenda? Not much that I can see. The next item on Howard's list is media regulation, but he's made it clear he won't proceed with anything unless the two media barons to whom all politicians are in thrall, Murdoch and Packer, can agree on what they want. I wouldn't hold my breath waiting for any competitive opening up in this area. My colleague Alan Mitchell has argued that, while labour market reform never looks like it adds up to much, its power comes from the opportunity it provides to firms now facing increased pressure from reform of their <u>product</u> markets. His line is that, if the Government wants to maximise the economic gain from WorkChoices, it will need to come up with a lot more product market reform. Not a bad argument, but I don't see the Government obliging.

The Liberal leadership

As soon as I turned my mind to preparing this talk I knew I'd have to say something about the leadership, whether Howard is going or staying, and I knew an audience such as this wouldn't let me get away with any two-handed economist routine. I wouldn't be allowed out of the room without making 'a call'. That's quite a tall order, since I doubt if Howard himself yet knows which way he'll jump. But, just so you've got something to throw in my face if I'm invited back next year, here's my call: I think Howard will announce his retirement early in the second half of next year. He'll be tempted to stay - he'll feel fine, and more Liberal members will want him to stay than want him to go - but in the end he'll go because he knows he has to go sometime and now's a more propitious time than in three years' time. That's a point to note: since he can't resign too soon after an election and must give his successor at least a year (and preferably longer) to settle in before the next election, if he hasn't resigned before the end of next year, he'll have to stay on for pretty much another three, by which time he'll be 70. Another technical parameter is that he won't leave before next March, which is when he'll have notched up 10 years as PM. The Costello camp had set March-April as some kind of deadline, but by then it would be too late to hand the budget to a new boy, so the revised expectation is not long after the budget. Howard won't want any appearance that he's been pushed out, and I think Costello and his camp have realised that being too overtly pushy could prove counterproductive and prompt him to dig in his heals. Like Bob Carr, Howard may delay his announcement for a month or two till people had concluded he was staying, but I'm sure Howard will want to avoid the unpleasantness and diversion that could arise should Costello and his troops fear they'd been cheated. Few prime ministers have had the judgment and self control to quit while they're on top, but I believe Howard will be one of them. Should he stay, however, I confidently predict Costello will cop it sweet - he won't challenge (he's way short of the numbers), he won't go to the backbench and he won't resign. Party support for Costello would gather should the Government stay well behind in the polls, but I'll be surprised if it does.

Why the rush?

A related question is why we've witnessed the unseemly, undemocratic rush of Howard banging his key legislation on Telstra, terrorism and WorkChoices through the Senate before Christmas with insufficient time for scrutiny. And this after he'd promised to use his Senate majority wisely and not provocatively. Could it be he's getting these key items on his personal reform agenda on the statute books so he can retire in triumph as early as he likes next year? It could be. But there are two other, equally plausible reasons for his haste. One is that both the Telstra privatisation and the WorkChoices legislation are highly unpopular, and the Government knew it would bleed for as long as they were in the public eye. It follows that the way to minimise the bleeding was to get them through parliament as quickly as possible.

The second is interesting: now Howard has a one-seat majority in the Senate, the opposition seems to have moved inside his own backbench. While Barnaby Joyce is the only one threatening to cross the floor, there's been a lot of rumbling on the backbench and a fair few changes made to accommodate that dissent. It's as though there must always be a balance of power, and when it doesn't reside with the minor parties it moves to whoever on the government backbench has the courage to exercise it. Joyce is a bit wet to be a member of the Howard Government, a Catholic social justice type. He has his populist streak, but he's smart and knows how far to push it. He won't be crossing the floor very often, but he'll be winning his fair share of concessions and getting constant publicity. He's lifted the profile of the Nats in the bush; done them a favour. He's not hugely popular with other backbenchers, but that's mainly envy of someone with more initiative. Anyhow, my particular point is that, with a fractious backbench, Howard would believe that the less time he gave his troops to think about the finer points of his measures, the less trouble he'll have getting them through.

The Labor leadership

Things aren't terribly flash on the Labor side of the aisle. Kim Beazley is competent and likeable, but not inspiring. Labor may be ahead in the polls thanks to WorkChoices, but that doesn't prove much and isn't likely to last once the fuss dies down. Don't forget that Howard has been well behind in the polls in each of his terms, only to pull back in front when it mattered. As for the boost from IR, Beazley could easily find himself caught the way he was with the GST before the 2001 election. He thought the unpopularity of the tax meant he was on a winner, only to find that everyone had calmed down - and been calmed down by bribes from Howard - by the time the election arrived.

You don't get the feeling his troops are terribly happy with his leadership, but there'll be no challenge because no one in the shadow cabinet looks a better bet. Remember, however, that should Howard retire, Beazley will be a much closer match for Costello. In with a real chance, I would have thought.

Monetary policy

Before we get down to it, there are some housekeeping matters to note. On the Reserve board, Frank Lowy will need to be replaced after his term expired last week, and Don McGauchie will be re-appointed when his first term expires at the end of March. I think we can be confident Lowy's successor won't have being a generous Liberal Party donor as his only qualification. One dud is enough. Ian Macfarlane's term ends in mid-September. On past precedent his successor should be announced about a month before hand. As deputy governor, Glenn Stevens is in poll position but, though I know of no reason to doubt he'll get the nod, there are no guarantees.

My text for today is: the Reserve stays quick on its feet, so so should you. Why? Because Stuff Happens. I think most people have got the right fix on the outlook for monetary policy in 2006. Growth is expected to be 'solid' (code for unspectacular), though just how solid remains to be seen. But with underlying inflation likely to drift up towards the top of the target and headline inflation likely to stay at the top of the target, 'policy will need to be responsive to any sign that demand and inflation pressures are stronger than currently expected'. The Reserve keeps hearing from the firms it speaks to that they're experiencing cost pressures - that they're operating close to full capacity, with shortages of labour - so it's got its hand on the lever ready to tighten when it sees things moving out of line. It will be looking not just at wages - wage pressure is there, though so far it's coming through pretty gradually - but also for signs of pricing power, such as too many firms using petrol prices as an excuse for a disproportionate price rise. So at this stage I won't be surprised if we see further tightening next year. If so, the Reserve would do another 25 basis points, then sit back to see the response, then do a little more if it thought it needed.

The Reserve's not likely to be inhibited in any needed tightening by worries about the deflating housing bubble. After two years in which house prices nationwide have been flat rather than falling, with the misalignment getting smaller, it's more relaxed. It's true that household interest payments are a higher proportion of disposable income than they were at their peak in 1989, and are still rising, but they're rising not because of sharp rises in interest rates, rather because people are still borrowing quite strongly. From its peak rate of 20 per cent, housing credit is still growing by 11 per cent a year. That's hardly a sign of distress. If anything, it's a sign mortgage rates are still too low rather than too high and too tight.

The worry has always been that, during this period in which the economy is vulnerable because households are so laden with debt, we might be hit by some exogenous shock that caused a downturn in growth and a rise in unemployment. The knock-on effect from that could be nasty. But shocks are, by definition, unexpected. And you don't fail to do what you should do - keep inflation pressure in check - just because of what <u>might</u> happen. You do what you have to do, then worry about how to respond to the shock if it happens.

All this implies that, at present, you wouldn't expect to see rates being cut next year. If a year from today rates were lower, they would have gone higher in the meantime.

But all I've said represents merely how the future looks 'at present'. The safest prediction I can make is that, before we've got too far into next year, the future will look quite different from the way it looks now. That's what I mean about the Reserve staying quick on its feet. It responds to the incoming data, and is quite prepared to change its view - and its policy - as the evidence evolves.

I observed at this show some years ago that ex-bank business economists were better at second-guessing the Reserve than ex-Treasury economists. Peter Horn said to me later than he thought he knew why that was. The trouble with Treasury is that it has detailed published forecasts, which it's only able to revise once in a year. This means it feels obliged to defend its forecasts until such time as it's able to revise them. It faces a temptation to interpret incoming data in the light of its forecast rather than vice versa. The Reserve, by contrast, doesn't really publish its detailed forecasts, and so doesn't hesitate to revise them as often as the weight of evidence dictates. It doesn't have any institutional ego attached to its forecasts. You can see that in the way Ian Macfarlane explains to the parliamentary hearing why his predictions of six months earlier didn't work out. He does it without a hint of embarrassment. I think the Reserve's pretty humble about the low probability of getting forecasts right.

So that's what I mean about it staying quick on its feet. And this year's been an instructive year in that respect because the Reserve went through four distinct changes of view in the space of 10 months.

The first change came at the February meeting and was signalled in the February SoMP. Everything seemed to be on hold when Glenn Stevens spoke to the ABE dinner this time last year, but by the February meeting we were quite worried about inflation with the economy running out of capacity. What had happened in the interim? The signs of sharply rising costs in the December quarter PPI, I suspect. At the February meeting it was felt the public needed to be got ready for a tightening, which came after the March meeting.

Many people would say the second change of view came at the April meeting, when it was decided not to tighten again. I guess you can blame me for that. But it had never been intended to do two in row and the decision not to tighten further came actually came a month or two later.

The third change came in the Big Mac's appearance before the parliamentary committee in August. The point he meant to make was just that the Reserve had abandoned its tightening bias, that in the SoMP released earlier that week 'we refrained from making the point we have been making for the past year or so about it "being unlikely that there would be no further rises in the course of the expansion".' In our present estimation, he said, 'there is no longer a more than 50 per cent possibility of [a tightening] happening'. But then he went on to say something a bit different, that 'when we look further into the future, we no longer see a clear probability of it moving in one direction rather than the other'. And that's where he inadvertently gave people a bum steer. Understandably, many people went away with the notion of a 50 per cent chance of tightening and a 50 per cent chance of easing. In truth, the probability scheme in the Reserve head would have been 20 per cent tightening, 20 per cent easing and 60 per cent no change.

So the fourth change of view for the year came with the November SoMP, when the Reserve restored its tightening bias. It <u>could</u> have reverted to saying it was unlikely there would be no further rises in the course of the expansion, but it didn't - not because it wasn't true, but because, as we discussed last year, that formula was devised to cope with the election campaign, to warn the public that it reserved the right to raise rates after the election and to discourage the parties from making promises about stopping rates rising. In that, of course, it was only partially successful. But though it hasn't resurrected that formula, be in no doubt that the bias to tighten is back.

One last point. We began this year with a major change of tune between the December meeting and the February meeting. If you think back, you realise the same thing has happened over many Christmas breaks. When the Reserve gets back from summer holidays towards the end of January and views things with a new eye, it often doesn't pick up where it left off. Why does this happen? I can think of two mechanical reasons to explain why view-changes are more likely over the summer break than between meetings during the year: there's double the amount of new data because of the missed January meeting, and the summer period also includes one of the year's four releases of inflation data. I don't think that's enough to explain the phenomenon. Maybe the fresh eyes do make a difference. But my advice to you is simple: stay quick on your feet and always keep an eye out for another over-Christmas view-change.