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An agenda for social democracy

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Summary and highlights

The aim of this paper is to restate the case for social democracy and to propose a policy agenda in response to the global financial crisis. The crisis is not a temporary aberration, to be followed by a return to the 'normality' of the late 20th century, dominated by the ideology of economic liberalism. Rather the economic and social system that emerges from the global financial crisis will be radically transformed. Social democrats face both new opportunities for reform, and new challenges and constraints resulting from the collapse of the economic order of the last three decades.

* Social democrats have long stressed the argument that we have the capacity to share and manage risks more effectively as a society than as individuals. In the light of the financial crisis, only social democratic policies can provide individuals and families with security to manage the risk and uncertainty of a market economy

* The global financial crisis represents a failure of both the policies of financial deregulation pursued since the 1970s and of its primary theoretical justification, the efficient markets hypothesis.

* A reconstructed financial sector must be based on a tightly controlled system of 'narrow banking' providing essential financial services to households and business. Banking must be clearly separated from speculative financial activity. Speculative financial enterprises must bear the full risk associated with their activities, without any public guarantee or support.

* The inevitable contraction of the financial sector creates both the need and the opportunity for an expansion in the provision of non-financial human services, such as health and education.

* The financial crisis has undermined the case for the privatisation of public infrastructure and implies an end to 'innovative' financing methods such as public-private partnerships

* The failure of economic liberalism does not imply a wholesale return to the ideas and policies of the postwar social democratic era. Social democrats must learn from the mistakes of that era and retain what was valuable in economic liberalism, including a commitment to sound fiscal policy and a rejection of protectionist restrictions on trade in goods and services.

An agenda for social democracy

After decades of frequently dispiriting defensive struggles, social democrats find themselves faced with unexpected opportunities and problems arising from the unexpected collapse of their principal adversaries.

The global financial sector, which had long overawed national governments with threats of ratings downgrades and capital flight, and dazzled the world with the immense wealth it generated, has suddenly become a collection of desperate and widely-despised mendicants, bailed out at the expense of ordinary citizens.[1]

The ideology of economic liberalism[2], based on the supposed efficiency and optimality of capital markets, has proved unable to generate a coherent response to a crisis its advocates failed to predict or to recognise until it was far too late. As Kevin Rudd recently observed in *The Monthly*, social democrats have been left, as in the wake of previous market failures, to clean up the mess (Rudd 2009). While critics such as Costa (2009) have pointed to a range of real or perceived inconsistencies in Rudd's argument, no coherent alternative to the government's interventionist response has been offered.

Thus far, however, social democrats have focused almost exclusively on managing the immediate financial and macroeconomic crisis. The problems of stabilising national and international banking systems, and of providing the most effective possible stimulus to the economy at both national and global levels are both difficult and important. It is already evident, however, that this crisis is not a temporary aberration. Its resolution will not be followed by a return to the 'normality' of the late 20th century. The economic and social

[1] Unsurprisingly perhaps, dependence on the public purse has barely dented the massive flow of salaries, bonuses, options and perks which, we are told, is necessary if the sector is to keep on delivering the results it has produced so far.

[2] A variety of terms including 'neoliberalism', 'Thatcherism' and the 'Washington Consensus' have been used to describe the ideological viewpoint, characterized by advocacy of privatization and free-market economic policies, that was dominant from the 1970s until recently. Because these terms are widely viewed as pejorative, the more neutral 'economic liberal' will be used here.

system that emerges from the global financial crisis will be radically transformed, and the policy decisions made in the course of the crisis will help to determine the nature of that transformation.

It is important, therefore, to consider how the financial crisis has changed the range of possibilities open to us. Social democrats in particular, face both new opportunities for reform, and new challenges and constraints resulting from the collapse of the economic order of the last three decades. The aim of this paper is to restate the case for social democracy and to propose a policy agenda in response to the global financial crisis.

1. The new case for social democracy

The resilience of social democratic institutions and values in the face of a concerted attack from advocates of free-market reform has been striking. The time is now ripe for a shift from the defensive position of the last thirty years, in which social democrats struggled mainly to protect the achievements of the past. In the circumstances of the global financial crisis, the most natural way to restate the case for social democracy is in terms of risk and insecurity, as in Quiggin (2007).

Governments of all political persuasions are being forced to deal with a sudden and drastic increase in risk and insecurity generated by the collapse of the global financial sector. But only a social democratic analysis provides any coherent basis for a response.

The alternative, economic liberal, vision of a society in which the problems of risk, insecurity and public good provision are dealt with by a combination of markets and contracts has proved unsustainable. Financial markets, which were supposed to supplant the social democratic state, are now calling on that same state for protection. Bankruptcy, the first state intervention to deal with failed contracts, is now being called upon on an unprecedented scale, and many other rescue measures are needed.

Social democrats have long stressed the argument that we have the capacity to share and manage risks more effectively as a society than as individuals. The set of policies traditionally associated with social democracy may be regarded as responses to a range of risks facing individuals, from health risks to uncertain life chances.

Risk and inequality are closely linked. On the one hand, the greater the risks faced by individuals in the course of their life, including the risk associated with differences in initial opportunities, the more unequal society is likely to be. On the other hand, as the financial crisis has shown, radical inequality in outcomes, such as that associated with massive rewards to financial traders, encourages a search for opportunities to capture the benefits of risky actions while shifting the costs of such actions onto others, or onto society as a whole.

A social democratic response to the crisis must begin by reasserting the crucial role of the state in risk management. If individuals are to have security of employment, income and wealth, governments must establish the necessary legal and economic framework and enforce its rules. The fact that government is the ultimate risk manager both justifies and necessitates action to mitigate the grotesque inequalities in both opportunities and outcomes that characterise unrestrained capitalism and were increasingly resurgent in the era of economic liberalism.

The interpretation of social democratic as a collective social response to risk and uncertainty may be illustrated by considering some of the core functions of the welfare state, such as health care and education.

The necessity of public financing may be traced to the risks associated with health in both the short term and long term. In the short term, we can't know for sure if or when we will get sick. In the long term, markets cannot manage the risk associated with the fact that some people will have chronically worse health than others.

The problems with market provision of health care are well known. In the absence of public intervention or insurance, health care expenses for even moderately serious illnesses and injuries are so large and uncertain as to be beyond the capacity of most individuals and households to manage through ordinary methods such as drawing on savings. In the United States, for example, an average day in hospital can cost $US1,500 (around $AUD2,000). Even a short stay in hospital can exhaust the liquid financial resources of the average household.

These problems have been exacerbated by the financial crisis, which has brought the US system of employer-provided health insurance to the brink of collapse. The Obama Administration is moving towards a social democratic solution, in which government acts as the ultimate guarantor of access to affordable health care. It remains to be seen whether Obama will be successful in overcoming the powerful lobbies opposed to reform, but the inevitability of a social democratic solution is widely accepted.

As with health, education is both the subject and source of risk concerning lifetime outcomes. On the one hand, as children start school, or as teenagers enter university, there is a lot of uncertainty about the outcomes. Some will do well and go on to highly paid jobs, while others will do poorly and face the prospect of insecure, badly paid work. But this uncertainty is not uniform. Students from wealthy backgrounds with highly educated parents face better odds than those whose parents have low incomes and less education.

As a result, any system relying primarily on private financing and provision of education is likely to be inefficient and inequitable. Students from poor backgrounds will have limited access to loans to support education, and will face less favourable borrowing terms and more limited opportunities.

As with health care, the financial crisis has resulted in the near-collapse of many of the quasi-market solutions adopted in the United States such as loan schemes for college tuition.

Reframing inequality in the context of risk

The issue of the distribution and redistribution of income has long been a central concern of democratic political systems. In the 20th century, particularly on the Left, the issue of income distribution was viewed primarily in terms of economic and social class, usually with a focus on the organised working class. As class boundaries have blurred and unions have declined in power and influence, the effectiveness of class-based arguments for redistribution have declined.

People's lifetime incomes are inevitably affected by their family backgrounds. Children from dysfunctional families face greater risks of unemployment, poverty and so on than those from stable, socially integrated families.

There is no inevitability about this relationship. People from poor and unstable family backgrounds can prosper, and those with a more favourable start in life may fail. From a risk perspective, however, the fact that everyone has a chance to do well does not alter the fundamental injustice of a society where people face radically different life chances.

The problem of unequal life chances has commonly been framed in terms of a contrast between equality of opportunity and equality of outcome. In this framing, equality of opportunity is the idea that everyone should have an equal chance at the prizes society has to offer, regardless of family background. Equality of opportunity is distinguished from equality of outcome, that is, the idea that society should not be divided into groups of winners and losers, even if the contest for those positions is in some sense fair.

In reality, though, no such distinction is sustainable in the long run. Without active intervention, inequality is cumulative over time. In a society with highly unequal outcomes, those who do well in an initially equal race will have the resources to ensure a head start for their children, in the form of private schooling, capital for business investment, richer social networks and so on. Hence, equal opportunity cannot be sustained for long in the presence of highly unequal outcomes.

This point is illustrated by the experience of the United States. In the 19th century the United States genuinely was a land of opportunity, with rates of social mobility far greater than those in Europe. By the late 20th century, Americans born into low income families were less likely to escape poverty than their counterparts in other developed countries (Goodin et al. 1999).

The Great Risk Shift

In the last quarter of the 20th century, there was a reaction against the welfare state, and an associated increase in risk and insecurity, driven by economic liberalism. Economic liberals criticised the welfare state as a costly, inefficient and ultimately inequitable drag on economic performance. One influential way of framing this critique was the claim that by socialising the risks faced by individuals and households, the welfare state necessarily reduced incentives to pursue risky opportunities. Hence, it was argued that reductions in welfare benefits would reduce welfare dependence and create a more enterprising society.

Economic liberalism affected not only the explicit institutions of the welfare state like social welfare benefits, but also the implicit contracts between workers and employers, under which employers would seek to preserve jobs, except in circumstances where the viability of their business was threatened, and to reward the loyalty of long-term employees through the maintenance of career paths. From the 1980s onwards, businesses routinely dismissed employees in large numbers, not as a last resort, but as a preferred method of making already substantial profits even larger.

With the advantage of hindsight, it is evident that the transfer of risk from government and business to workers and households was the most significant outcome of the era of capitalism, dominated by the global financial sector, that now appears to be approaching its end. Hacker (2006) describes this transfer as the 'Great Risk Shift'.

The way forward

The analysis above provides a framework in which the broad outlines of policy responses to the financial crisis, and its likely aftermath can be developed.

2. Expenditure, taxes and fiscal policy

Fiscal policy (taxing and spending) is the central business of government. There are two main issues in fiscal policy. The first concerns the macroeconomic effects of changes in the budget balance. The second concerns the scale and scope of public expenditure and the taxation system needed to finance such expenditure.

Under the Keynesian system of macroeconomic management dominant from World War II to the early 1970s, active fiscal policy was used to manage the economy. In periods of weak demand, temporary budget deficits associated with measures such as increased public expenditure, transfer payments or tax cuts were used to stimulate the economy. Conversely, in periods of strong demand, taxes were increased and public expenditure cut to reduce inflationary pressure.

During the era of economic liberalism, monetary policy based on inflation targeting was the primary tool of macroeconomic management. But monetary policy has proved largely ineffectual in response to the global financial crisis. Even after US interest rates were reduced to zero, the downturn in the economy continued and even accelerated.

As in Japan during the 1990s, the situation is most appropriately analysed as a Keynesian liquidity trap, where reductions in interest rates have no effect. In such a situation, monetary policy must be replaced by expansionary fiscal policy. Even in Australia, where some scope for expansionary monetary policy remains, two rounds of fiscal stimulus have been implemented and more will almost certainly be required.

Active fiscal policy is not simply an emergency measure. It is likely to play an important role into the future. Stimulatory policies entailing temporary deficits should be combined with measures designed to ensure the sustainability of fiscal policy. Broadly speaking, such measures must provide for medium term balance between revenues and current expenditures, and for capital expenditure policies that generate growth of public sector assets, debts and net worth broadly in line with national income.

By the time a global recovery is firmly established, the net worth of the public sector will have declined substantially as a result of a series of budget deficits. Deficits arise automatically during recessions as a result of lower tax revenue and higher payments for unemployment and other social welfare benefits. In addition to these automatic effects, substantial fiscal stimulus in the form of increased public expenditure and temporary cash transfers will be required to soften the impact of the crisis.

To service, and gradually reduce, increased public debt it is necessary for the government to plan for budget surpluses in the post-recession period. Some of the shift towards surplus may be achieved through reductions in spending on programs designed to provide a fiscal stimulus, or to maintain employment levels in a declining economy. However, given a sustained increase in the risk aversion of private investors, a similarly sustained increase in the scope of government activity is likely to be necessary. It follows that the necessary surpluses can only be produced by an increase in government revenue as a share of national income.

Even more important in the long run will be the need to determine an appropriate balance between the public and private sectors. The crucial social democratic idea here is that of the mixed economy, based on the observation that neither public nor private provision of goods and services is uniformly superior.

The theoretical program of economic liberalism is based on a claim (made in stronger or weaker forms as the rhetorical and political demands of the occasion demanded) that markets outperform governments in all but a handful of economic activities, and that the reduction of the public sector to a 'minimal state' is economically desirable. The resulting policy program for the last thirty years has been an attempt to roll back the growth of the state, both in terms of the range of activities undertaken and of the share in national income of taxation and government expenditure.

The drive to contract the range of activities undertaken by the state has had some limited successes, notably in relation to the privatisation of public enterprises, but has generally failed with respect to core welfare state activities such as health and education. As regards the size of government relative to national income, the strenuous efforts of economic liberals have been counterbalanced by the growth in demand for publicly provided services, with the result that the share of government in national income has remained broadly stable since the 1970s.

The failure of economic liberalism and the global financial crisis has created a need for a substantially enhanced role for government. This expanded role has a number of dimensions.

First, it is likely that weak labour market conditions will continue for some years to come. This will necessitate continued direct employment creation in the public sector, particularly in the labour-intensive community services sector.

Second, as discussed below, the idea of delivering public services through public-private partnerships appears to be dead, at least for the foreseeable future, and in its current form. This will entail acceptance by governments of responsibilities they have sought to outsource to the private sector.

Third, the end of easy credit means that the structure of demand is likely to change, away from debt-financed consumer durables and housing and towards services. Given the central role of the public sector in providing a range of services, this must imply an increase in the relative demand for public sector outputs.

Finally, the risk premium associated with private investment is likely to remain high for years to come. This necessitates a reversal in the decline of public investment over recent decades. In this context, public investment must be taken to include investment in human capital (health and education) and natural capital (preservation of environmental assets) as well as physical capital such as infrastructure investments.

Some of these needs have been apparent for some years, while others have become more urgent as a result of the financial crisis. Until recently, debate on topics of this kind was stymied by the apparent impossibility of raising taxes explicitly, or of raising the share of national income collected as tax revenue.

The 'tax revolt' of the 1970s engendered in politicians a seemingly permanent fear of raising taxes. The Hawke–Keating Labor government's Trilogy commitments of 1984 included a promise not to increase the tax share of GDP, and similar commitments have been made by the Rudd government.

Even after the tax revolt was replaced by a public preference for improved services, financial markets demanded restraint in the size of government, and pushed for the privatisation of public enterprises, a policy which, not coincidentally, generated massive flows of fee income for the financial sector.

In addition, the globalisation of financial markets and markets for skilled labour encouraged international tax competition. Countries such as Ireland and the Baltic States sought to attract investment with low corporate tax rates. Marginal rates of tax on high income earners were cut almost everywhere.

Finally, international tax avoidance and evasion flourished in the late 20th century, as countries from Switzerland and Liechtenstein to the Cayman Islands and banks such as UBS and Stanford International offered their clients a range of 'wealth management' services.

Fortunately, many of the obstacles to an increase in taxation revenue have been removed as a result of the failure of economic liberalism. The anti-government sentiment that drove the 'tax revolts' of the 1970s, dissipated slowly over subsequent decades as the need for improved public services became steadily more apparent (Grant 2004).

The power and prestige of the financial sector has collapsed. The ratings agencies in particular have been discredited by their promiscuous allocation of AAA ratings to innovative private securities such as Collateralised Deposit Obligations (CDOs). Thousands of these securities, presented as being investments as safe as US or Australian government bonds, have gone into default, with bondholders receiving little or nothing. Meanwhile, the banks, as massive recipients of government aid, are in no position to object to higher government spending (though that has not stopped some of them).

Further although no country has escaped the global financial crisis, countries that have relied heavily on attracting inflows of capital and skilled labour through low tax rates have fared particularly badly. The absence of a well-developed welfare state, an inevitable result of a low-tax policy, has produced massive social unrest and the collapse of a number of governments, from Iceland to Latvia. Workers attracted to these countries have been returning home in large numbers, particularly because many have no access to social security systems in their former host countries. It seems unlikely that competition from low-tax entrants to the global market will be problem in the near future.

Finally, in a particularly encouraging development, the days of tax havens appear to be numbered. The EU is moving to end all bank secrecy, and to demand co-operation from the leading European havens. Among the banks that have facilitated tax evasion, Stanford has been exposed as a Ponzi scheme[3] and UBS is facing a string of criminal and civil actions aimed at forcing it to expose tax-dodgers. Wealthy individuals and corporations that hope to hide their money in a secret Swiss account, or in a Caribbean island, will have to think more carefully in future.

These developments mean that governments, including the Australian government, face both the need, and the opportunity, to increase tax revenues substantially. To some extent, as discussed below, increases in revenue can be derived from the income generated by publicly owned assets. However, the majority of any increase in revenue must be raised through higher taxation.

The two main sources of tax revenue are sales taxes (primarily the GST) and taxes on personal and corporate income. The obstacles to an increase in the GST rate of 10 per cent are formidable. The agreement under which the GST was introduced requires all states to agree to any change in the rate. The Commonwealth Parliament could amend the legislation to remove this requirement, effectively repudiating the agreement, but the likelihood of securing a Senate majority for such a course of action appears minimal. Hence,

[3] That is, a financial fraud in which the deposits of later investors are used to pay high returns to early investors.

the primary focus for increasing tax revenue must be on personal and corporate income taxes.

Although Australia has avoided the massive increases in inequality seen in other English speaking countries, the era of economic liberalism has been characterised by a sharp increase in the share of income going to the the richest members of the community, those in the top 1 per cent of the income distribution. Their share of total income almost doubled between 1980 and 2000 (Atkinson and Leigh 2007), from 4.8 per cent to 8.8 per cent and increased further in the final years of the bubble economy.

The financial crisis has affected some high income earners, particularly those employed in the financial sector, or whose wealth was invested in the sharemarket. However, this has not been enough to offset years of growing inequality, especially as households in the middle and lower quintiles of the income distribution have also been affected by the decline in the value of superannuation assets.

Changes in the distribution of market income over recent decades were amplified by changes in tax policy, including the abolition of the top marginal tax rate of 66 per cent, the introduction of dividend imputation, the halving of capital gains tax, the abandonment of measures to reduce tax avoidance through trusts and companies, and the flattening of tax scales under the Howard government. All of these measures disproportionately benefitted the rich.

The Rudd government has taken an important first step in dropping the 'aspiration' to scrap the top marginal rate of taxation by 2013-14.

Restoration of stable and sustainable levels of public assets, debts and income will require considerably more painful steps. Given the collapse of forward estimates of government revenue, maintaining fiscal sustainability requires the abandonment of the second stage of the tax cuts proposed by the Howard government, and copied by Rudd Labor during the 2007 election campaign. Even at the time, these promises were irresponsible, since they took no account of possible adverse shocks. Now that the shocks have turned out worse than anything contemplated in forecasts at the time, the tax cuts must be abandoned. They should be replaced with temporary cuts in taxes and increases in once-off transfers, directed at those in the lower half of the income distribution.

Even at the time they were first promised, the tax cuts were bad policy and many economists called on the Rudd government to abandon them in its first budget. The decision to implement the first stage of the tax cuts was, however, justified, since the alternative would have been to accelerate the corrosion of faith in government processes associated with a pattern of continuing promises. At that point, nothing had changed since the election to justify repudiating a promise.

Now, however, everything has changed. Yet despite the disappearance of the projected surpluses that were expected to pay for the the tax cuts, and of any possible economic rationale for aiding high income earners, the government is still promising to proceed with the tax cuts promised in the utterly different world of 2007. If fiscal policy is to be sustainable, permanent tax cuts must be off the agenda for the foreseeable future. The surpluses out of which the tax cuts were to be paid have vanished. A substantial part of the tax cut was compensation for anticipated bracket creep, on the basis of anticipated inflation that is no longer likely to occur.

In real terms, the tax cuts are larger, and more unaffordable, than when they were promised, even as the real capacity of the government to finance any tax cut has diminished. To keep this promise, the government will have to break many others, abandoning core commitments like the 'Education Revolution'.

The tax cuts proposed by the Howard government, and copied by the Labor opposition during the 2007 campaign were permanent and were targeted towards those in the top half of the income distribution.[4] The proposed tax cuts for July 2009 offer a paltry $3 a week to anyone with an income under $80 000, and nothing at all for those under $34 000. The biggest proportional benefit accrues at individual incomes of $180 000 a year. Such regressive tax cuts will do little good in the short run, either to boost consumption, or to repair the balance sheets of middle and lower-income households.

A Keynesian tax cut should be temporary and targeted at those below median incomes, who are mostly likely to spend it, and, if they save it, most likely to need the money to balance their household budgets. The "temporary" aspect of the stimulus is crucial. Once the financial crisis is over, higher taxes will be needed for a long time, both to service and repay debt and to finance the permanently larger role for government inevitable in the light of the collapse of the financial sector. Having reaped most of the benefits of the era of economic liberalism, it is appropriate that those in the top 10 per cent of the income distribution, and particularly those in the top 1 per cent, should make the largest proportional contribution.

The extent to which tax revenue needs to be increased will depend on a wide range of factors, including the level of public debt needed to finance economic stimulus and infrastructure programs. It seems likely that additional public debt of 20 to 30 per cent of national income will be incurred. Taking account of the need to service and pay down this debt, and to finance a sustained increase in public expenditure, it seems likely that the tax share of national income would need to rise by around 5 percentage points, or from 30 to 35 per cent. This would still leave Australia a relatively low-tax country, especially as tax rates can be expected to rise globally.

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[4] Under the conventions of Australian politics, this group is normally referred to as "middle-income earners", but this is no time for polite fictions.

3. Financial sector regulation

Radical changes in financial sector regulation have already taken place in Australia and elsewhere as a result of the financial crisis. Guarantees of bank deposits have been introduced or greatly expanded in all major economies. Partial or complete nationalisation of failing institutions, with the resulting assumption of risk by the public, has been widespread.

However, these policies have been introduced as emergency measures, with the implicit (and sometimes explicit) premise that they will be ended when normal (pre-crisis) conditions are restored. This premise is untenable. By the time the crisis is over, the financial sector will be radically transformed, and will require a radically different mode of regulation.

The starting point for a stable regulatory regime must be a reversal of the burden of proof in relation to financial innovation. The prevailing rule has been to allow, and indeed encourage, financial innovations unless they can be shown to represent a threat to financial stability. Given an unlimited public guarantee for the liabilities of these institutions such a rule is a guaranteed, and proven, recipe for disaster, offering huge rewards to any innovation that increases both risks (ultimately borne by the public) and returns (captured by the innovators).

Post-crisis financial regulation must begin with a clearly defined set of institutions (such as banks and insurance companies) offering a set of well-tested financial instruments with explicit public guarantees for clients, and a public guarantee of solvency, with nationalisation as a last-resort option. Financial innovations must be treated with caution, and allowed only on the basis of a clear understanding of their effects on systemic risk.

In this context, it is crucial to maintain sharp boundaries between publicly guaranteed institutions and unprotected financial institutions such as hedge funds, finance companies, stockbroking firms and mutual funds. Institutions in the latter category must not be allowed to present a threat of systemic failure that might precipitate a public sector rescue, whether direct (as in the recent crisis) or indirect (as in the 1998 bailout of Long Term Capital Management). A number of measures are required to ensure this.

First, ownership links between protected and unprotected financial institutions must be absolutely prohibited, to avoid the risk that failure of an unregulated subsidiary will necessitate a rescue of the parent, or that an unregulated parent could seek to expose a bank subsidiary to excessive risk. Long before the current crisis, these dangers were illustrated by Australian experience with bank-owned finance companies, most notably the rescue, by the Reserve Bank, of the Bank of Adelaide in the 1970s.

Second, banks should not market unregulated financial products such as share investments and hedge funds.

Third, the provision of bank credit to unregulated financial enterprises should be limited to levels that ensure that even large-scale failure in this sector cannot threaten the solvency of the regulated system.

In the resulting system of 'narrow banking', the financial sector would become, in effect, an infrastructure service, like electricity or telecommunications. While the provision of financial services might be undertaken by either public or private enterprises, governments would accept a clear responsibility for the stability of the financial infrastructure.

Global financial architecture

One of the most striking developments of the late 20th century was the explosion in the volume, speed and complexity of international financial transactions, and the resulting breakdown of effective regulatory control over the global financial system. The speed with which this process has gone into reverse since the onset of the financial crisis has been equally striking.

Transactions in the global foreign exchange market, once confined to financing trade flows, peaked at around $4 trillion per day in mid-2008. At that pace, two days of foreign exchange trading would be sufficient to finance an entire year's trade flows. The growth of private credit reached an annualised rate of $10 trillion at the same time.

Since then the market has collapsed. Although data on foreign exchange markets is slow to arrive, it seems clear that volumes and liquidity have declined sharply.

According to the International Monetary Fund (2009), private sector credit growth has fallen 90 per cent, and 'Emerging bond markets virtually shut down for a period of time in the fourth quarter' .

Although rescue measures by governments have restored some credit flows, the long term tendency is towards reversal of financial globalisation. Banks that have been bailed out or nationalised are being encouraged, and sometimes forced, to sell off overseas assets and focus on their home market. Public policy is simply reinforcing the pressures of the market.

In one of many similar examples, the Rudd government has been forced to intervene in the market for motor vehicle finance and, on a larger scale, in the commercial property finance market, in response to the withdrawal of foreign lenders from the market.

By the time financial markets have been stabilised, the global financial system that prevailed a year ago will have contracted rapidly, with many markets and institutions disappearing altogether. The challenge facing governments and regulators will be to construct a new global financial system and a regulatory architecture strong enough to prevent a recurrence of the bubble and meltdown that has largely destroyed the existing unregulated system.

The first objective must be to ensure that exchange rate movements reflect the economic fundamentals of trade and long-term capital flows, rather than the vicissitudes of financial markets. The most promising candidate here is the idea, long-advocated and long-resisted, of a small tax on financial transactions, commonly called a Tobin tax. The idea was first put forward by James Tobin (1978), and discussed further in a volume edited by ul Haq, Kaul and Grunberg (1996).

A tax at a rate of 0.1 per cent would be insignificant in relation to the transactions costs associated with international trade or long-term investments. On the other hand, daily transactions of $3 trillion would yield revenue of $30 billion per day, or nearly $1 trillion per year. Since this amount exceeds the total profits of the financial sector (profits that are likely to be much smaller in future) an effective Tobin tax would imply a drastic reduction in the volume of short-term financial flows. It follows that the revenue from a Tobin tax, while significant, would not be sufficient to replace the main existing sources of taxation, such as income tax.

The large literature on Tobin taxes has identified some problems with the simple proposal for a tax on international financial transactions. First, it is possible to replicate spot transactions on foreign exchange markets with combinations of forward, futures and swap transactions. To make a Tobin tax effective, it would have to be applied to all financial transactions, including domestic transactions. During the bubble era, when the few remaining taxes on domestic financial transactions were being scrapped to facilitate the growth of the financial sector, this was seen as a fatal objection. It has become apparent, however, that the destabilising effects of explosive growth in the volume of financial transactions are much the same, whether the transactions are domestic or international.

The fact that a Tobin tax on international financial transactions would be integrated with taxes on domestic transactions suggests that, in all probability, revenue would be collected and retained by national governments. However, suggestions that at least some of the revenue could be used to fund global projects such as the international development goals of UNCTAD remains worthy of consideration.

The second problem is that the tax would require global co-operation, since otherwise financial market activity would migrate to jurisdictions that did not apply the tax. Although this will remain a problem in the post-crisis world, it is likely to be much less severe than indicated by earlier discussions. The number of separate jurisdictions that would need to agree has been substantially diminished by the emergence of the euro.

As part of the resolution of the crisis, it seems inevitable that most remaining European currencies, with the possible exception of the British pound, will disappear, and that a Europe-wide regulatory system will emerge. The number of separate jurisdictions with well-developed financial systems is therefore likely to be very small, with the European Union, United States and Japan being overwhelmingly dominant.

As in the case of tax evasion, the problem of 'offshore' financial centres, such as Caribbean island states, is unlikely to be a serious stumbling block. The free market dogmas that prevented effective action to preserve the effectiveness of financial regulation in the late 20th century have lost much of their force. A Tobin tax on transactions among complying jurisdictions may have to be supplemented by a punitive tax, at a rate of, say 10 per cent, on transactions with non-compliant jurisdictions. This would effectively ensure that non-compliant jurisdictions were excluded from global financial markets, though the penalty would be modest as regards trade and long-term investment flows.

Another important regulatory adjustment will be the end of the system by which prudential regulation has been, in effect, outsourced to ratings agencies such as Standard & Poor's and Moody's. Agency ratings have been enshrined in regulation, for example through official investment guidelines that require regulated entities to invest in assets with a high rating (AAA in some cases, investment grade in others) or provide those responsible for making bad investment decisions with a 'safe harbour' against claims of negligence if the assets in question carried a high rating. For these purposes at least, an international, publicly-backed non-profit system of assessing and rating investments is required.

It is to early to determine the form a new global financial architecture will take. Much depends on the extent to which existing financial institutions are transformed by the crisis. However, it is possible to draw one fundamental conclusion from the crisis. From the breakdown of the Bretton Woods system of fixed exchange rates[5] to the present, domestic financial regulation has operated subject to the constraints imposed by unregulated global financial markets. This balance must be reversed. Global financial markets must be controlled and regulated so that they do not threaten the integrity of domestic regulation.

4. Human services and employment

The provision of human services such as health, education and social services has always played a central role in social democratic policies. Even at the height of economic liberalism, when public enterprises were privatised *en masse*, assaults on core social-democratic institutions such as Medicare and the Pharmaceutical Benefits Scheme failed, and the push for a market-driven approach to education met vigorous resistance. The resilience of these and other

[5] The 'Bretton Woods' system is named after the location of a conference held in 1944 to plan the reconstruction of the global economic system after World War II. The conference established the World Bank and International Monetary Fund and introduced measures to remove or reduce restrictions on trade in goods and services while maintaining tight control over financial flows.

components of the social-democratic welfare state was the main reason for the failure of free-market 'reforms' to reverse the growth in the share of national income allocated to public expenditure.

Human services are central to the social democratic vision for a number of reasons. First, as already noted, the universal provision of these services is at least as important as direct income redistribution in ameliorating the risks and inequalities inherent in a capitalist society. Second, market provision of these services has repeatedly proved inadequate and unsatisfactory. Finally, public funding and provision of human services is an expression of social solidarity against the atomism and self-seeking that is at the core of economic liberalism.

The provision of human services will be even more important in the wake of the financial crisis. The growth of the sector has been constrained by the dominance of small-government ideology, resulting in a substantial imbalance between private consumption and human services. Most Australians say they would prefer improved services to tax cuts, but governments of both parties have offered tax cuts anyway.

Equally importantly, labour demand from the private sector is declining fast as a result of the crisis and is likely to remain weak for years to come. The finance and business services sector, a major employer of skilled workers, is likely to contract permanently. The human services sector is among the most labour-intensive areas of the economy. Expanding provision of these services will make a major contribution to the restoration of full employment.

The limited responses announced by the Rudd government so far will not be adequate to respond to the current crisis. Consideration of active labour market measures aimed at minimising the impact of any economic contraction must begin now if growth in long-term unemployment is to be avoided.

There are three main classes of active labour market policy: training, wage subsidies and direct job creation. The choice between them depends, in part, on timing.

Most of the time, training is the best way of making people more employable. To some extent this is also true when a recession or slowdown is looming. If the labour market is weak, the option of staying in school, or of going back to university or TAFE to enhance your qualifications is more attractive. It is safe to predict that demand for tertiary education places is going to be higher for the next year or more. The need for the promised education revolution has never been greater.

On the other hand, training programs directed at those who are already unemployed are of little use in recessions. When few employers are hiring, those who do so can pick and choose from a pool of experienced and qualified candidates. A training course of a few months, the kind of thing usually associated with active labour market policy, is unlikely to move an unemployed person to the front of the queue.

The choice between wage subsidies for hiring unemployed workers and direct job creation is more complex. Job creation gets a bad name from silly projects exemplified by the (apparently apocryphal) case of 'painting rocks white', so they tend to be a last resort. But the alternative of wage subsidies is least effective during the initial contraction phase of a recession, when employers are cutting back or freezing their staff numbers.

It is precisely at this time when some well-timed projects could do a lot of good. In this respect the assistance to local governments incorporated in the stimulus package looks like a good idea.

Finally, while there are good reasons for governments to pick up the private sector slack as regards infrastructure investment, it's important to remember that the days of large gangs of workers swinging picks and shovels are long gone. Physical infrastructure projects have many potential merits, but large-scale job creation is not among them.

5. Infrastructure

For much of the last decade, infrastructure policies have focused on the idea of public–private partnerships, in the specific form referred to by the acronym PPP. The term 'PPP' is misleading, since, just about any form of economic activity involves both public sector and private sector contributions of some kind. The public sector contributes the basic legal and property rights structure within which all private sector activity takes place and much of the physical infrastructure on which economic activity depends. The private sector contributes a vast range of goods and services necessary to any kind of economic activity, public or private. The question is not whether to engage in partnership but what form that partnership should take.

In the standard PPP model, assets are owned by private consortia, the profitability of which depend on high levels of debt. This model is no longer viable and the flow of new PPP projects has ceased since the crisis began. The end of the PPP model that has prevailed for the last decade does not, however, mean the end of partnerships between the public and private sector.

The experience of the PPP era suggests that the optimal arrangement for most public projects will involve private sector firms tendering for construction at a fixed price, with transfer of ownership to the public sector on completion. The contract may also involve maintenance for a fixed period after completion to ensure high quality of construction work. The operational activities of public sector assets such as schools and hospitals should be under public control, but many inputs will be provided by private sector enterprises through contracts, tenders or market purchases.

One common, though rarely acknowledged, motivation for the use of a PPP project has been the desire of governments to avoid levying user charges for public infrastructure assets such as roads. The spurious transfer of ownership to a private firm has made it possible to conceal the reality that governments are in fact levying such charges.

In the post-crisis environment, such evasions will no longer be possible. Governments will need to increase revenue substantially to meet the costs of their expanded role, and to service the debt associated with the large deficits and capital expenditures required to resolve the crisis. In these circumstances, it will be necessary to apply user charges for public assets such as roads. The required charges should reflect the social cost of road congestion, and the need for a continuing return on capital assets, and should not be related to the construction costs of recent additions to the road network.

Similarly, governments should seek to earn socially appropriate returns to public investments in network infrastructure assets such as electricity and telecommunications networks, ports and so on. The large scale privatisation of such assets is likely to be reversed in coming years as heavily geared asset owners default on their debts and private buyers are unwilling to invest except at fire-sale prices.

The experience of the PPP era shows that many different structures for the provision of goods and services, ranging from private corporations to direct government provision are possible and may be appropriate in different situations. Possible alternatives include statutory authorities, government business enterprises, not-for-profit corporations and a range of structures combining public and private contributions.

6. What's left of economic liberalism ?

The decade of financial crises that began in the late 1990s has demonstrated the falsity of many of the assumptions underlying economic liberalism, and, in particular, of claims about the microeconomic and macroeconomic superiority of free markets. Nevertheless economic liberals were correct in pointing out some of the policy mistakes made under the postwar social democratic settlement. It is important that a resurgent social democracy should avoid repeating those mistakes.

First, the experience of the 1970s and 1980s demonstrated the dangers of chronic budget deficits. However, the response most commonly advocated by economic liberals at the time, that of a requirement for budget balance on an annual basis, would exacerbate business cycles and preclude any serious response to the current crisis.

Second, the breakdown of the Bretton Woods system and the painful period of economic disruption that followed it gave a clear demonstration of the economic costs of inflation. Attempts in the 1960s to exploit a trade-off between unemployment and inflation, accepting higher inflation in return for lower unemployment, proved unsuccessful. As workers, firms and households became use to high levels of inflation, reductions in unemployment proved temporary, but inflation was firmly embedded in the system. Only after long years of high unemployment and the severe recession of the early 1990s was low inflation restored.

Third, economic liberals extended the move towards freer trade in goods and services that began with the Bretton Woods conference in 1944, and the establishment of the Global Agreement on Trade and Tariffs. With some relatively minor exceptions (such as attempts to undermine environmental protections and trade union rights in the name of free trade) the growth in trade in goods and services has been overwhelmingly beneficial, unlike the disproportionate expansion in financial flows. A new international settlement must encourage trade and ensure that global financial markets facilitate trade and investment, rather than destabilising them.

These lessons will be of particular importance when the economy emerges from the current crisis. They are important precisely because the crisis will generate both large and sustained budget deficits and a need for monetary policies focused on fighting deflation rather than inflation. It is important to recognise that while budget deficits and fiscal expansion are necessary responses to severe economic downturns, governments should maintain budget balance over the course of the economic cycle and should aim at positive levels of net worth. Similarly, while modest rates of inflation may be beneficial in the short run, a long run target rate of 2 to 3 per cent remains desirable.

Concluding comments

In the face of a global crisis of their own making, the advocates of economic liberalism have had nothing to offer. Even with respect to the relatively narrow issue of salvaging the banking system, the responses have ranged from reluctant acquiescence in a range of rescue measures to vociferous opposition to 'bailouts', without any analysis of the resulting large-scale financial bankruptcies or suggestions of possible responses. Consideration of the broader issues raised by the collapse of the economic order that has prevailed for the last thirty years has been almost non-existent.

It is therefore, up to social democrats to develop and guide both the response to the immediate crisis and the reconstruction of a social and economic order sufficiently robust to avoid such crises in the future. This paper has raised a variety of suggestions in relation to economic policy.

The global financial crisis will have long-term effects going far beyond finance and economics. There is already a reaction against the consumption culture that has become steadily more extreme over recent decades, as the restraining influences of Depression-era frugality and the anti-materialist idealism of the 1960s faded away. At this stage, the reaction is superficial and unlikely to be maintained in the event of a rapid return to pre-crisis conditions. But such a return is improbable. Even when economic growth and employment recover, the effects of the crisis on wealth and debt levels, and on access to consumer credit are likely to persist for many years.

Going beyond specific policies, the failure of financial regulation leading up to the crisis is likely to lead to a re-evaluation of 'light-handed' and 'incentive-based' regulation in all areas of public policy. Similarly, ideas such as New Public Sector Management, promoted largely on the basis of the supposed superiority of private sector methods, will need to be re-examined.

In an environment as uncertain as that of the present, any attempt at forecasting future developments and proposing responses is inevitably going to be erroneous in important respects. But the task must be attempted, and the broad outlines of a social-democratic response can already be discerned.

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