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Risk Shifts in Australia:

Implications of the Financial Crisis

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Abstract

'Risk' has become a central theme in 21st-century policy thinking. In particular, there has been considerable discussion of the 'Great Risk Shift', that is, the process by which the burden of risk has been shifted away from governments and employers and on to workers and households. The financial crisis that began in 2007 has fundamentally transformed the problem of social and economic risk management. The outcomes remain hard to discern, but the central ideas of economic liberalism, dominant since the mid-1970s have clearly failed.

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Introduction

Risk' has become a central theme in 21st-century policy thinking. In particular, there has been considerable discussion of the 'Great Risk Shift', that is, the process by which the burden of risk has been shifted away from governments and employers and on to workers and households. The financial crisis that began in 2007 has fundamentally transformed the problem of social and economic risk management. The outcomes remain hard to discern, but the central ideas of economic liberalism, dominant since the mid-1970s have clearly failed.

This paper begins with a brief discussion of theoretical views of risk and inequality, a historical survey of the role of government as a risk manager, and consideration of the revival of economic liberalism since the 1970s. The next section of the paper covers the same issues with a detailed focus on Australia. Finally, the implications of the financial crisis are considered.

Background

Theory

Changes in theoretical understanding of risk and uncertainty have had important implications for our understanding of social justice and the role of government. The development of expected utility theory by von Neumann and Morgenstern (1944), along with models of subjective probability (de Finetti, 1931; Savage 1954) made it possible to undertake formal analysis of risky choices, considered as acts yielding different outcomes in different possible states of nature.

There is a natural analogy between risky distributions of income or goods over possible states of nature and unequal distributions of income or goods between individuals. Harsanyi (1953) treats the two situations as being part of

the same problem and derives (expected) utilitarianism as the optimal social response. Rawls (1971), rejecting expected utility in favour of a maximin rule derived the 'difference principle; as the basis of his theory of justice.

Moving from abstract political philosophy to more immediate policy choices, the use of formal risk analysis to evaluate alternative policy choices has become increasingly important, both for benefit-cost evaluation of particular public policy projects and for evaluation of the overall performance of public policy.

More recently, the limits of formal risk analysis have been the subject of increasing attention. A central point in this analysis has been the observation, reflected in Donald Rumsfeld's famous remark about 'unknown unknowns' that we can never be aware of all possible risks. Both popular works such as Taleb's (2007) *The Black Swan* and formal decision-theoretic analyses of (Halpern and Rego 2006, Heifetz, Meier and Schipper 2006, Grant and Quiggin 2006) have addressed the problem of managing risk in the presence of unforeseen contingencies.

The role of the state

The interpretation of the welfare state in terms of risk and uncertainty may be illustrated by considering some of its core functions. For some of these functions, such as various forms of social insurance, the risk management function has always been emphasised. However, concern with risk has traditionally been a subsidiary theme.

For instance, the public provision of retirement income and of services like health or education have commonly been justified with reference to notions of redistribution, public goods and the provision of basic needs. However, these interventions may equally be supported in terms of risk management.

Giddens (2002) p. 25 observes,

> the welfare state, whose development can be traced back to the Elizabethan poor laws in England, is essentially a

> risk management system. It is designed to protect against hazards that were once treated as at the disposition of the gods - sickness, disablement, job loss and old age.

A risk-based analysis may be extended to encompass more general programs of income redistribution. In a risk-based view, redistribution may be seen as providing insurance against a particular kind of risk, namely the risk of being born poor, socially dislocated and without access to human and social capital.

Moss (2002) surveys two centuries of American history, in which he presents the state as 'the ultimate risk manager'. Moss distinguishes three phases of public risk management in the United States. Although the United States is atypical in important respects, Moss's three-phase model provides a useful framework for discussion.

Moss' first phase, 'security for business', encompasses innovations such as limited liability and bankruptcy laws, introduced in the period before 1900. Moss's second phase, 'security for workers', was produced by the shift from an economy dominated by agricultural smallholdings to a manufacturing-based economy in which most households depended on wage employment. Historically the phase includes Progressive initiatives such as workers' compensation and the core programs of the New Deal like unemployment insurance and social security.

The third phase, 'security for all', began after World War II and includes such diverse initiatives as consumer protection laws, environmental protection and public disaster relief. These may be seen as responses to the 'risk society' (Beck 1992). Risks of environmental degradation and natural disaster are inherently social in their nature, and the success or failure of a society in responding to these risks is a measure of the capacity and responsiveness of its government.

The great risk shift

In the last quarter of the 20th century, there was a reaction against the welfare state, associated with the movements variously known as 'Thatcherism' in the United Kingdom, 'Reaganism' in the United States, 'economic rationalism' in Australian and the Washington consensus in developing countries. Since most of these terms have (or have acquired) pejorative connotations, I will use the more neutral description '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.

The rise of economic liberalism was driven by, and helped to drive, a massive expansion in the size, scope and international integration of financial markets, which began when the economic crises of the early 1970s derailed the system of fixed exchange rates and Keynesian macroeconomic management established at the Bretton Woods conference in 1944. As financial markets became more and more complex and sophisticated, the view that risk was best managed through financial transactions rather than through social insurance

became dominant. It was widely argued that the transformations of economic and social structures associated with the increased importance of risk rendered social democracy obsolete. It would inevitably be replaced, it was argued, by the emergence of a new global turbo-capitalism (Luttwak 1999).

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 financialised capitalism that now appears to be approaching its end. Hacker (2006) describes this process as the 'Great Risk Shift'.

Australia and the Great Risk Shift

The development of social risk management in Australia, and the reactions against it followed a path broadly similar to that in other developed countries. It is useful to consider Australia as a specific example of this process, with its own distinctive features.

In focusing on Australian experience, it is important to avoid the exceptionalism that characterises much discussion, in which Australia is presented as an anomalous special case. A useful corrective to such thinking is the observation that exceptionalism is anything but exceptional. Every country has its own narrative in which its experience is presented as special. In fact, there are typically two such narratives in competition: one in which the country concerned is presented as a beacon of light to the rest of the world and another in which economic and social problems experienced throughout the world are presented as unique failures due to particular social institutions.

The Australian Settlement

Exceptionalism, in its negative form was particularly popular in the wake of the collapse of the postwar boom. Henderson (1990) and Kelly (1992) were the most prominent Australian contributors to the literature which focused on

institutions associated with the formation of the Australian Federation in and shortly after 1901.

Kelly coined the term 'The Australian Settlement' as a description of the particular institutions under which capitalism achieved broadly based social support in Australia. Kelly's list of crucial institutions (industry protection, Arbitration, State paternalism, White Australia and Imperial Benevolence) reflects the context in which the term was introduced, that of a polemic against the Australian Settlement and in favour of the reform program of the 1980s supported, in different forms by both major institutions. The same is true of Henderson's 'Federation trifecta' (protection, arbitration and White Australia).

Both Kelly and Henderson use the racism of the White Australia policy (formally abandoned in the 1940s, and replaced with a firmly non-discriminatory policy by the early 1970s) as a rhetorical stick to beat the policy institutions (tariff protection, arbitration and public ownership) they sought to dismantle. Despite Kelly's reference to State paternalism, neither he nor Henderson pay any attention to Australia's early development of risk management institutions such as old age pensions (introduced in 1908 under powers given to the Commonwealth at Federation in 1901).

Nevertheless, the Federation settlement did reflect distinctive features of Australian public policy that endured for most of the 20th century, though with declining importance over time. The most important was reliance on employment at high wages, under secure conditions, as the primary method of social risk management. The 'New Protection' deal under which tariff protection for employers was tied to arbitrated minimum wages was the defining feature of Australian economic policy in the period before World War II.

Kelly and Henderson fail to recognise the extent to which Australian institutions were transformed during the thirty years of full employment that followed World War II. Reliance on tariff protection to secure employment, having failed utterly during the Depression, was replaced by a focus on

Keynesian macroeconomic management (Smyth 1998). The same period saw a substantial expansion of social insurance.

Although the postwar reforms were broadly consistent with the emergence of social-democratic welfare states elsewhere in the world, they retained some distinctively Australian traits consistent with the earlier employment-based approach. The continued importance of arbitration, and of work-related benefits such as sick leave led Castles and Mitchell (1994) to describe postwar Australia as a 'wage-earners welfare state', a description that may usefully be compared with Moss' characterisation of the New Deal reforms in the US as 'security for workers',

The Hawke-Keating government

The Hawke-Keating government took office after a decade of economic crises, during which crucial underpinnings of the postwar settlement collapsed. Keynesian macroeconomic management had failed to maintain full employment and the Bretton Woods system of fixed exchange rates had collapsed.

The government's decision, announced on 9 December 2003, that the Australian dollar would be allowed to float freely was critical in determining its policy direction. It placed Hawke and Keating firmly on the side of the movement towards liberalised and globalised financial systems that swept the world from the late 1970s onwards, and did not meet a substantial check in the emergence of global financial crisis in 2007.

Throughout its thirteen years in office, the Hawke-Keating government maintained policies that tended to expand the role of financial markets and diminish that of governments. Reversing Labor's longstanding support for public ownership (even today still enshrined in the party's objective of 'the democratic socialisation of industry, production, distribution and exchange'), the government privatised public enterprises such as the Commonwealth Bank and Qantas and corporatised those that remained, most notably converting Telecom

Australia into Telstra. The government phased out import quotas and greatly reduced tariff protection. It promoted deregulation in the airline industry and the rural sector and sought to expose public sector activities to competition.

These policies, part of a broader program of microeconomic reform, eliminated most of what remained of the Federation settlement. The general tendency was to reduce security of employment, particularly for older male workers who had previously been insulated from the economic disruption of the 1970s. A common theme in policy discussions of the time was the view that the resulting 'cold shower' would force previously protected workers, and their employers, to become more efficient.

Even as it abandoned policies based on security of employment, however, the Hawke-Keating government adopted a range of measures to 'refurbish' the welfare state, avoiding the radical retrenchment undertaken in New Zealand and the United Kingdom in the same period (Castles and Shirley 1996). Many of the policy changes introduced in this process may be interpreted as attempts to strengthen the risk management capacity of the welfare state.

The most important single example was the introduction of Medicare, the national health insurance scheme[1]. Medicare was funded in part by a hypothecated levy on income, collected along with income tax. However, the total cost of the scheme ($18.3 billion in 2007-08 significantly exceeds the revenue from the levy).

Along with the Pharmaceutical Benefits Scheme, introduced by the Chifley Labor government in 1948, Medicare provides Australians with effective security against the risk of either incurring large medical costs or being unable to obtain adequate medical treatment. By contrast, in the United States, health care costs are a major cause of personal bankruptcy, and the proportion of people

[1] An earlier scheme, called Medibank, had been introduced in the last days of the Whitlam Labor government, but had been wound back, to the point of effective abolition under the succeeding Fraser Liberal-National government.

without health insurance has risen greatly in recent years.[2]

Another major step in the direction of social risk management was the move towards universal access to superannuation. Prior to the election of the Hawke-Keating government, the retirement income system had been divided broadly along class (or, more precisely, status) lines. Salaried (mainly white-collar) workers generally had access to employer-funded defined-benefit superannuation schemes. Retirement benefits were calculated on the basis of a formula yielding a fraction (determined by the number of years of service) of salary at retirement. Superannuation contributions attracted a range of tax concessions. Wage (mainly blue-collar) workers relied on the old-age pension or on personal savings.

The removal of means tests on income and assets for eligibility for the pension by the Whitlam and Fraser governments (fn: Fraser removed the asset test in 1976, but later reintroduced an income test applied only to increases in the pensions) meant a step towards universalism as regards the pension. However, since little was done to expand access to superannuation, the effect was to reinforce existing inequities.

The Hawke-Keating government reintroduced income and assets test for the old age pension and encouraged the inclusion of superannuation contributions in awards, given in place of wage increases. In 1991, having earlier rejected the option of a National Superannuation Scheme, the government introduced the Superannuation Guarantee Levy (Parliamentary Library 2008).

Medicare and the Superannuation Guarantee Levy were closely tied to the biggest single initiative of the Hawke-Keating government, the Accord on Prices and Incomes. Despite initial hopes (reflected in the name) for a tripartite agreement including business, and embracing prices and non-wage incomes, the Accord in practice was an evolving agreement between the Commonwealth Government and the Australian Council of Trade Unions (ACTU).

[2] President-elect Barack Obama has proposed a national policy to address this problem.

The central element of the Accord was an agreement by the ACTU to support arbitrated national increases in wages that implied a decline in the wage share of national income, and to discourage member unions from seeking additional wage increases, in return for commitments by the government to increase the 'social wage', through measures such as the introduction of Medicare and the expansion of superannuation.

The Howard government

The Howard government oversaw a significant shift in risk away from employers and governments and on to workers and households. However, its policies displayed numerous contradictions, and the change in the burden of risk was less extreme than in the US.

For most of its first three terms in office, the economic policies of the Howard government were characterised by drift. Howard and his Treasurer , Peter Costello, were happy to take the credit for a long period of relative economic prosperity. They put forward economic reforms on a purely opportunistic basis, as and when the political climate demanded the appearance of action rather than stability. On other occasions, as with 'nation-building' infrastructure exercises, they harked back the developmentalist ideas of the 1950s and 1960s.

There was a significant change after the 2004 election, which unexpectedly delivered the government a Senate majority. Although Howard had warned against hubris and even noted that the public was disenchanted with economic rationalism, the apparent opportunity to deal a death blow to the remnants of the Australian labour market settlement proved irresistible.

More than any previous government, the Howard government was openly hostile to the very existence of trade unions, and indeed to the whole idea of wage employment regulated by awards or collective agreements of any kind. The ideal labour market model favoured by the government was based on contract employment and, to the greatest extent possible, employment at will.

The government's view was expressed in the *WorkChoices* legislation introduced after the 2004 election. *WorkChoices* was a radical extension of the earlier *Workplace Relations Act*. Despite having its sails trimmed to fit prevailing electoral winds and the necessity of passing the Senate, the *Workplace Relations Act* had produced a significant shift in the balance of power in the workplace. With the obstacle of the Senate removed, and the (over) confidence generated by four successive election victories, *WorkChoices* pushed this process much further.

One of the clearest instances of shifting risk was the government's removal of protection against unfair dismissal for employees in business with less than 100 employees. This was a substantial extension of previous legislation (rejected in the Senate) where the proposed limit was 20 employees, and Treasurer Costello foreshadowed the complete elimination of protection against unfair dismissal.

The political heat surrounding the issue of unfair dismissal reflects the fact that an employment contract contains many implicit terms and commitments. Once both parties have committed to the relationship, each has the opportunity to cheat on these commitments. How this works out depends on institutional rules, the state of the labour market and similar factors. Whatever the rules there are likely to be numerous instances where employers or employees feel that they have been treated unfairly. Hence, the central policy question is: who should bear the risk?

In relation to unfair dismissal, as in most other issues, *WorkChoices* embodied the view that workers should bear more risk and employers less. Strikingly, this view over-rode notions of freedom of contract: it was illegal, under *WorkChoices* for unions and employers to agree on protections against unfair dismissal in excess of those provided by law.

The risk shift from employers to workers was accompanied by a similar shift in relation to retirement income. Treasurer Costello, who had long expressed

a desire to leave his mark on his portfolio by reforming the retirement income system, was able to announce what he called "The largest ever reform to superannuation”. This was the culmination of a process in which the system of defined-benefit schemes where investments were selected by fund managers and risk was ultimately borne by employers were replaced by defined-contribution schemes, in which members selected their own investment strategy.

In addition to reducing taxes on superannuation investments and relaxing means tests for access to old age pensions, the reform package included a once-off opportunity to make extra contributions to superannuation, with a cut-off date of June 30, 2007. A widespread rush to sell assets or borrow money to meet the deadline was reported.

As it turned out, this initiative was very poorly timed. Although the stock market maintained its rising trend for a few months after the deadline, the emergence of the global credit crisis produced a severe downturn. After reaching a peak of 6684 in November 2007 the ASX 200 index fell by over 40 per cent, reaching a low (so far) of 3217 in November 2008. Superannuation investments which placed a high weight on Australian or international shares suffered similar losses.

Where to from here?

The prospects for the future have changed radically in the past year as a result of the continuing financial crisis. The pace of events, particularly since the crisis turned into a near-meltdown of the financial system from September 2008, has been so fast as to make any assessment hazardous. Nevertheless it is safe to predict that that social institutions for the management of risk will change radically as a result of the crisis and that there will be no return to the financial and regulatory system as it existed prior to the crisis.

At least so far, the shift in political attitudes and policy outcomes has been markedly in the direction of more government intervention, amounting, in

many cases, to nationalisation. This outcome is unsurprising, given the spectacular failure of financial markets. But previous crisis since the 1970s, such as the stock market crash of 1987 have also exhibited evidence of financial markets. These crises were followed by expansion, not contraction, of financial markets and by a further retreat from regulation.

The difference this time around is twofold. First, the scale of financial market failure is massively greater. Second, it has taken place in the context of a more general reaction against economic liberalism, and increasing support for the institutions of the welfare state. Thus, the reaction to the failure of lightly regulated financial markets has been to adopt regulatory measures previously considered unthinkable and not, as might have been the case a decade ago, to remove any regulatory controls that remained.

The resilience of the welfare state

In the early 21st century, social democracy proved more resilient than its critics expected, and than some of its supporters feared. The main institutions of the welfare state, including public health, education and social security systems remained intact, despite continuous pressure for 'reform'. The persistence of the welfare state surprised many observers, given the decline of many of the mass institutions that supported it (most obviously trade unions), and the emergence of an increasingly diverse and individualistic society.

The experience of the Bush Administration illustrates some elements of this resistance. Under the Clinton Administration, and particularly in the period of the Republican Party's "Contract with America" issued after the 1994 Congressional elections, there were substantial cuts in welfare. Bush came to office committed to the privatisation of the Social Security System, effectively replacing a public defined-benefit system with a private, choice-based defined-contribution. Even with Republican majorities in both Houses of Congress the Administration could not muster adequate public support for this proposal.

Worse, from the viewpoint of economic liberals, the Administration felt compelled to introduce a subsidy program for prescription drugs, analogous to the Australian PBS though confined to older people, and very poorly designed.

Similarly, in Australia, the Howard government met vigorous resistance to attempts to dismantle welfare state institutions such as Medicare, and ultimately conceded that 'There is a desire on the part of the community for an investment in infrastructure and human resources and I think there has been a shift in attitude in the community on this, even among the most ardent economic rationalists' (Howard 2004).

A focus on shared risk may help to explain this resilience. Many discussions of social democracy focus on notions of community that derive ultimately from membership of some specific group, and therefore appear vulnerable to social change that breaks down the boundaries between groups.

By contrast, consideration of the risks we all face, and a view of society as a set of institutions through which we jointly manage those risks, may have less immediate emotional appeal than specific claims about community. But it can be supported by reasoned ethical judgements that are consistent with diversity and individualism.

The financial crisis

The financial and economic crisis that began in 2007 is still in its early stages. A wide range of financial markets have closed, apparently for good. A notable example is the markets for collateralised debt obligations, derivative securities most commonly based on mortgages. Around $500 billion in CDOs were issued in each of 2006 and 2007. By the third quarter of 2008, the rate of issuance had fallen by more than 90 per cent (SIFMA estimates $9.752 billion for Q3 2008) and ratings agency Moody's Investors Service declared the products 'extinct'.

Similarly the volume of mortgage related securities from private sources (that is, excluding the now-nationalised agencies Fannie Mae and Freddie Mac) fell from a peak annual rate of $773 billion in 2006 to a monthly rate of $1.2 billion in August 2008. In effect, the mortgage securitisation industry in the United States has been fully nationalised.

Along with financial markets, a large number of financial institutions, including whole sectors of the industry have disappeared. The first sector to disappear was that of non-bank mortgage origination of which the most notable was Countrywide, absorbed by the Bank of America in early 2008. Other sectors including 'monoline' bond insurance followed.

So far, the most striking event has been the disappearance of the Wall Street investment banks, with Lehman Brothers going bankrupt, Bear Stearns and Merrill forced to merge and the survivors, Goldman Sachs and Morgan Stanley converting themselves to commercial banks in order to secure government protection.

But this is only the beginning of the restructuring of the financial sector. With a handful of exceptions, major commercial banks have been kept afloat by government policies ranging from easy access to credit to direct injections of capital. The latest such bailout was the rescue of Citigroup (on some measures the world's largest bank) announced on 24 November 2008. But it is already evident that these half measures are inadequate. If, as is generally agreed, Citigroup is too big to fail, it must be nationalised, either by the US government acting along or by a consortium of national governments. And, where Citigroup leads, many others will follow.

But this is only the opening stage of the financial market crisis. The global recession that is already underway will force governments to exert more influence over banks, seeking simultaneously to reduce the cost of bailouts due to past unsound lending and to promote sufficient new lending to allow recovery from recession. This will entail the conversion of existing public equity holdings

in banks into direct ownership control, supplemented by more stringent external regulation of remaining privately-owned financial institutions.

Implications for economic liberalism and risk management

The financial crisis poses fundamental challenges the central idea of economic liberalism: that risk of all kinds is best managed by allowing individuals and households to contract freely in financial markets that emerge to manage those risk.

The most immediate challenge arises from the fact the very existence of many financial markets and financial institutions is under threat, and those that survive are likely to depend heavily on government guarantees with the associated restrictions and regulations.

Given time, such regulation could potentially be unwound, and much policy discussion is based on the premise that this is likely to happen.

However, the crisis has also exposed the weakness of crucial theoretical claims on which economic liberalism relies. These claims are all linked, in one way or another, to the efficient markets hypothesis. the efficient markets hypothesis says that the prices generated by capital markets represent the best possible estimate of the values of the underlying assets.

The hypothesis comes in three forms.

The weak version (which stands up well, though not perfectly, to empirical testing) says that it is impossible to predict future movements in asset prices on the basis of past movements, in the manner supposedly done by sharemarket chartists. While most of what is described by chartists as 'technical analysis' is mere mumbo-jumbo, there is some evidence of longer-term reversion to mean values that may violate the weak form of the EMH.

The strong version, which gained some credence during the financial bubble era says that asset prices represent the best possible estimate taking account of all information, both public and private. It was this claim that lay

behind the proposal for 'terrorism futures' put forward, and quickly abandoned a couple of years ago. It seems unlikely that strong-form EMH is going to be taken seriously in the foreseeable future, given the magnitude of asset pricing failures revealed by the crisis.

For policy purposes, the important issue is the "semi-strong" version which says that asset prices are at least as good as any estimate that can be made on the basis of publicly available information. It follows, in the absence of distorting taxes or other market failures that the best way to allocate scarce capital and other resources is to seek to maximise the market value of the associated assets. Another way of presenting the semi-strong EMH is to say whether or not markets are perfectly efficient, they're better than any other possible capital allocation method, or at least, better than any practically feasible alternative.

In the light of the experience of the last decade the semi-strong EMH appears indefensible. The massive misallocation of capital that produced the current crisis follows closely on the dot-com boom and bust, in which around one trillion dollars was invested in projects that yielded little or no commercial return, such as schemes to home-deliver pet food ordered over the Internet. In fact, the low interest rate environment that fed the real estate bubble was the product of policy measures designed to mitigate the impact of the bursting of the dot-com bubble. This in turn followed the rescue of hedge fund Long Term Capital Management in 1998 and a series of financial crises affecting emerging markets in Asia, Russia and Mexico among others.

Capital was misallocated between as well as within countries. On any plausible model of international resource allocation, rich countries like the United States should be net lenders. Yet for more than a decade the US has been the world's largest borrower, and consumption by US households has been

financed by the savings of much poorer countries like China.[3] The unsustainability

The EMH also has implications for labour market outcomes. The massive growth in inequality observed in the US (and, to a lesser extent, other developed countries) has been driven, in large measure, by huge increases in salaries, bonuses and other incomes in the financial sector. These increases have flowed through, to some extent to broader groups of professionals and managers, while wages for less educated workers have stagnated. According to the EMH, high incomes for financial sector workers must reflect the social value of their activities in risk management and capital allocation. It is now clear, on the contrary, that the financial sector has paid massive rewards for unsound speculative investments, with the risk of failure being concealed and, ultimately, shifted back to governments and society as a whole.

In summary, there is now no reason to give any credibility to the view that financial markets provide individuals and households with effective tools for risk management. Rather, in aggregate, the unrestrained growth of financial markets has proved, as on many past occasions to be a source of instability and not a stabilising factor.

The future of social risk management

With the spectacular failure of financial markets as risk managers, the need for a return to active social risk management is obvious. But the way in which this will unfold is far less clear. At present, policy is being made on the run, as a series of improvised responses are put forward in an effort to avoid total collapse of the financial system and mitigate the severity of the global recession that is already under way.

In the longer term, however, governments will need to respond to an environment that has changed radically. Even after the recession, it seems

[3]A similar argument applies to Australia, also a large net borrower, though it may be qualified to the extent that capital flows are used to finance capital intensive resource projects. In fact, however much of Australia's overseas borrowing has been used to finance domestic consumption.

unlikely that the relative economic stability of the period since the early 1990s will return. The retirement income system, based heavily on individual investment accounts, will require radical restructuring. And hopes that financial markets would play a crucial role in addressing growing risks in areas as diverse as climate change and health care now appear misplaced.

Meeting these challenges will require a substantial reconsideration of the role of government. Ever since the fiscal crisis of the 1970s, governments have been made acutely aware of the limits on state capacity. Economic liberals have responded with privatisation and radical retrenchment of the role of government. Modernising social democrats have sought to use scarce state capacity more efficiently, using indirect influence through regulated markets to secure improved outcomes while avoiding large increases in public expenditure and taxation.

It seems unlikely that these approaches will prove adequate to meet the demands we are now facing. The public sector share of national income must increase substantially. The need for an increase in public expenditure, as a response to the crisis and recession is obvious and in the short term it is appropriate for government deficits to grow.

In the long term, however, revenue needs to match expenditure. Governments have two main sources of additional revenue: taxation and earnings generated by publicly owned assets. While neither will be easy to come by in the short term, the long run picture is brighter.

As regards taxation, there has been a huge reduction in the tax payable by high income earners in recent decades. This reduction has been justified by the claim that only by providing incentives to this group can strong economic growth be maintained. It is now clear that this argument has been greatly overstated in economic terms. Furthermore the political climate is rapidly becoming more favourable to redistribution, arguably more so than at any time since the immediate aftermath of World War II.

In addition, it seems likely that investors will continue to demand the security of government bonds for years or even decades to come. In the wake of the crash of 2008, claims that stockmarket investments always return good profits in the medium term can no longer be sustained. Only those willing to hold investments for 20 years or more can reasonably expect higher returns on stocks than on bonds. The result of this reassessment will the maintenance of low real interest rates on government borrowing. Hence, the share of the economy for which public ownership is cost-effective will expand.

Concluding comments

In a situation where seemingly safe institutions, and the assumptions they embody, are dissolving daily, it is impossible to present detailed blueprints for the future. Nevertheless, it is clear that the institutions and economic systems that generated the great risk shift of the late 20th century have failed. Space is now opening up for an effective social response.

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