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Economists air extreme views at stimulus inquiry

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CANBERRA, Sept 21 AAP

September 21 2009, 6:06PM

Senators heard both sides of the economic divide at an inquiry on Monday to determine whether the federal government's economic stimulus has worked and whether it should continue.

Quizzing several academic economists, the inquiry heard that the stimulus was a waste of money, that the recession was a normal part of the business cycle and should have been left for the free market to resolve.

It was also argued that the human tragedy would have been far worse without the billions of dollars stimulus, regardless of whether it results in higher interest rates and higher taxes.

Indeed, one economist believed more money should be spent on lifting the unemployment benefit to stimulate the economy further.

Prime Minister Kevin Rudd told CNN from New York where he is attending the United Nations General Assembly, before heading to G20 Leaders Meeting Pittsburgh later this week, that calls for an immediate withdrawal of stimulus from the global economy were "misplaced".

The Australian Greens had called for the inquiry to take a sounding on the impact of the stimulus measures, that continue to pump money into the economy through infrastructure spending.

Greens leader Bob Brown said the Senate economics references committee had made a "mistake" by not having Treasury secretary Ken Henry and Reserve Bank of Australia (RBA) governor Glenn Stevens front the committee until next week in Sydney.

"We should be hearing them first and then getting the economists to comment on them afterwards," he told reporters in Canberra.

Senator Brown was also "surprised" by one economist's observation that the market should have been left to work through the recession, which was just part of the normal business cycle.

"It's the failure of the market that has led to the necessity for a stimulus package," Senator Brown said.

Executive director of the independent think tank, the Australia Institute, Dr Richard Denniss, told the hearing the government should be commended for its stimulus initiatives, and that while it was unfortunate that some money might have been mis-spent, it was "probably unavoidable".

He argued there was a case for "more stimulus, not less" that should be aimed at raising unemployment benefit that would be quickly spent.

Dr Andrew Leigh of the Australian National University believes the stimulus should continue given the great deal of uncertainty over the unemployment outlook, describing fiscal policy as an "ocean liner which takes a lot of time to turn".

Professor Tony Makin of the Griffith University said the stimulus may have helped the retail sector, but interest rates will rise which will hit private investment and be a negative for growth.

A rising Australian dollar because of rising interest rates will also hurt jobs in the manufacturing sector.

Two economists from the Royal Melbourne Institute of Technology (RMIT) believed the stimulus had been a waste of money.

Professor Sinclair Davidson believed the reason that the Australian economy had fared better than others was more to do with economic reforms undertaken over the past 25 years.

Professor Steven Kates said interest rates should have been lowered further and taxes cut rather than spending "an unbelievable amount of money".

He calculated that the government had spent $1.5 million of taxpayers money saving each job.

By Colin Brinsden, Economics Correspondent

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September 22, 2009 9:21 AM AEST

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PM with Mark Colvin
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Economic stimulus package under senate scrutiny

Danny Morgan reported this story on Monday, September 21, 2009 18:18:00

MARK COLVIN: Kevin Rudd's trip to the United States also includes discussions with world leaders on the next phase of the global economic crisis.

At the same time, in Canberra, some of Australia's leading economists are dissecting his $42 billion stimulus package.

They're appearing at a Senate inquiry set up to evaluate the Government's strategy and advise on whether it should continue.

The Government hopes that the inquiry will vindicate its response to last year's collapse in world financial markets.

The Opposition is looking for signs that the package is too big and needs to be wound back ahead of time.

Danny Morgan reports.

DANNY MORGAN: In an interview on cable news giant CNN in New York overnight Kevin Rudd was invited to explain what the world could learn from his Government's handling of Australia's miracle economy.

He was initially bashful.

KEVIN RUDD: I'm never in the business of preaching to anybody.

DANNY MORGAN: But the Prime Minister soon warmed up, and pointed out that the key to Australia's success has been early intervention with an economic stimulus package.

KEVIN RUDD: As a result of that, and our heavy emphasis also on infrastructure investment through that stimulus, we have managed to be the only economy across the OECD in the last 12 months to have generated positive growth.

Of the major advanced economies the only one to stay out of recession so far.

The second lowest unemployment the lowest debt the lowest deficit.

DANNY MORGAN: Back in Canberra, RMIT economics professor Steven Kates, was challenging that view in front of Senate's economics committee.

The committee is examining whether the Government should wind back its $42 billion dollar stimulus package in light of economic data showing Australia's economy is faring much better than anticipated.

Professor Kates says the Government got it wrong from the start.

STEVEN KATES: You should not have this blanket expenditure as a stimulus, four per cent of GDP which is an unbelievable amount of money.

That will not create growth and in fact wastes resources so comprehensively in ways that will they are destroying our savings.

They are going to push up interest rates, they are going to push up taxation in future and may yet push up our inflation rate.

DANNY MORGAN: Professor Kates concedes the package has saved some jobs, but has questioned the cost.

STEVEN KATES: I think in the short term, it, it.... the unemployment rate might have gone to 6.1 instead of 5.8 had there not been a stimulus.

I think it has saved jobs, but I think that the cost of saving those jobs has been so disproportionate to any of the good that it will do that I think it is a tremendous policy mistake to have done this.

DANNY MORGAN: Australian National University economics professor Andrew Leigh takes a different view.

He argues that a large amount of extra Government spending was needed to prevent the long-term problems caused by an increase in unemployment.

ANDREW LEIGH: I think it's important to bear in mind how slowly economies tend to recover from recession.

The unemployment rate of the late 80s wasn't again achieved until the late 1990s and that scarring cost of unemployment is pretty substantial.

I left school in 1990 just as the economy was hitting the skids and that was a terrible time for young kids to leave school so I think it is important where government can, to try and smooth the economic cycle.

DANNY MORGAN: Dr Leigh says there is evidence the stimulus package may have been too big, but believes that's not such a bad thing.

ANDREW LEIGH: I think that's the side of error that I would prefer to be on and you can... what monetary policy is for is this kind of short term fine tuning.

It's not clear to me we would want to massively scale back the fiscal stimulus.

DANNY MORGAN: Instead, he says there are compelling reasons for the Government to allow the stimulus package to run its course.

ANDREW LEIGH: I think when government's promise to do things it's a bad look to then break their promises.

But the second is this question of fine tuning, we are sufficiently uncertain as to what the path out of the downturn will be that I think it makes sense just to let fiscal policy roll and let monetary policy which takes affect much faster do the fine tuning.

DANNY MORGAN: Back in New York, Kevin Rudd is urging world leaders not to wind back their stimulus packages prematurely.

He says the focus should be on making sure stimulus is withdrawn in a coordinated fashion.

And that leaders work to make sure they never face such dire economic conditions in the future.

KEVIN RUDD: How do we craft a long term economic growth strategy which is sustainable for the world no longer dependent on these massive financial imbalances, huge debt driven consumption on the one hand out of surplus economies on the other?

We need a new sustainable growth model for the future otherwise we may be looking at the prospect of flat global growth in for a while to come.

MARK COLVIN: Kevin Rudd ending that report from Danny Morgan.

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Senate told stimulus 'a waste of money'

September 21, 2009 - 2:04PM

An academic believes the federal government's approach to tackling the global financial crisis has been a waste of money, and that the recession was part of the business cycle, a Senate inquiry has heard.

The Senate is hearing from a number of academics on Monday to examine the impact of the government's series of stimulus measures since October 2008 and whether economic circumstances warrant changes to the initiatives.

Professor Steven Kates from the Royal Melbourne Institute of Technology (RMIT) backed the government's measures to support the banking system, but said interest rates should have been lowered further and taxation lowered.

"But one thing you shouldn't do, you should not have this blanket expenditure as a stimulus - four per cent of GDP (gross domestic product) is an unbelievable amount of money," Prof Kates told the Senate Economics References Committee.

"That will not create growth and, in fact, wastes resources so comprehensively.

"They are destroying our savings, they are going to push up interest rates, they are going to push taxation in the future, and may push up our inflation rate."

He calculated that unemployment would have 6.1 per cent now rather 5.8 per cent, calculating that the government has spent $1.5 million savings each job.

Labor senator Doug Cameron said Prof Kates' comments had certainly embedded in his mind that you should never let an "academic economist run the economy".

"Why have the IMF, the OECD, the ILO, the treasuries of every advanced economy, the Treasury in Australia, the business economists around the world, why have they got it so wrong and yet you in your ivory tower at RMIT have got it so right?" Senator Cameron said.

Prof Kates said the response to the crisis had been based on Keynesian economics that backs government intervention to stabilise growth during a downturn in a business cycle.

"The use of Keynesian economics has been one of the great catastrophes for economic theory in the west," Prof Kates said.

Dr Andrew Leigh, of the Australian National University, believes the stimulus should continue as fiscal policy is not suited to suddenly changing course.

"It's an ocean liner which takes a lot of time to turn," Dr Leigh said.

"Monetary policy is our best tool for dealing with quick changes. And there is still a great deal of uncertainty over what unemployment is going to be next year and the year after.

"Were we to see another downturn just after turning off the tap, it would be hard to get the fiscal spending back on because of these long lags involved in construction projects."

Opposition finance spokeswoman Senator Helen Coonan asked whether there was a "tipping point" where it becomes more costly to consumers and taxpayers to keep the stimulus going.

"Particularly when they are going to cop it in the neck with reduced expenditure, higher taxes and certainly interest rates," she said.

Dr Leigh said it would be different if the stimulus measure was 10 times larger.

"If we were, rather than talking about a $42 billion package, talking about a $420 billion package, I would quite happily say we should break faith with the voters and should turn things off because of the huge debt load that it would impose," he said.

But he didn't believe the debt being created by the pack was "terribly large" and said it was manageable in the medium term.

"There are two kinds of mistakes we could have made in this. We could have done too little or too much," he said.

"It seems the human costs of doing too little are pretty large in terms of the scarring impacts of unemployment."

He said the cost of doing too much would be the "deadweight burden" of the taxation involved returning the budget to a stable position and higher interest rates.

This story was found at: ***http://news.brisbanetimes.com.au/breaking-news-national/senate-told-stimulus-a-waste-of-money-20090921-fx70.html***

Printed August 27, 2009 01:24am AEST

Resources keep recovery going, figures show

David Uren, Economics correspondent | August 27, 2009

Article from: The Australian

THE resources industry is coming to the aid of the economy, delivering a big boost to the heavy construction industry just when other work appeared to be drying up.

The construction industry is operating at record levels in Western Australia, South Australia and Victoria, raising hopes that next week's national accounts may show the pace of economic growth has accelerated further since the surprisingly strong 0.4 per cent increase in the March quarter.

Construction figures released by the Australian Bureau of Statistics yesterday show that the housing and commercial property construction industries are still in a deep slump. However, resource and infrastructure projects raised the value of engineering-related construction by 5.6 per cent in the June quarter, with the total now 22.7 per cent ahead of its level a year ago.

"There was such a big stockpile of work still to be done because of the resources boom until the middle of last year that it will keep supporting growth in the economy," Commonwealth Bank chief economist Michael Blythe said yesterday.

He said new projects such as the Gorgon gas field and BHP Billiton's proposed Olympic Dam mine would add to the stockpile of work.

The strength of engineering construction is consistent with a Reserve Bank business liaison program that suggested companies were rethinking their planned cuts to investment because the downturn had not been as severe as feared.

Total construction in Western Australia rose 11.3 per cent in the June quarter, while there was a 12per cent rise in South Australia. Although construction has been weakening in Queensland, falling 4.4 per cent in the June quarter, it remains the biggest market for the industry, with work done totalling $8.7 billion in the June quarter.

The construction industry dipped just 0.1 per cent in the June quarter, much less than the 4 per cent fall being canvassed by private sector economists. The strength of construction in the resource and infrastructure sectors is offsetting the collapse in the commercial building industry, and the continuing weakness in private housing.

The value of commercial building dived 11 per cent in the June quarter and is now 18.6 per cent below its level of a year ago.

The value of private housing construction fell 1.8 per cent last quarter and is down 7.8 per cent from its peak last year.

There is not yet any evidence of the government's stimulus spending on housing or schools. However, the 22.9 per cent growth in public sector spending on construction over the past year contrasts with a rise of just 1per cent in the private sector.

Research published yesterday by the Australian National University's Andrew Leigh showed the government's cash handouts were at least twice as effective as similar measures in the US.

The study indicated that, at a minimum, 40 per cent of the government's $12bn in cash handouts between March and May this year were spent within three months. This compared with about 20per cent for the tax rebates given to US consumers in 2007 and last year.

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Aussies spend stimulus, Yanks save: poll

Stephen Johnson
August 26, 2009 - 1:54PM

Advertisement

Australians are more likely than Americans to spend their stimulus payments, a study has found.

Stronger consumer confidence in Australia was the reason, Australian National University (ANU) researcher Andrew Leigh said.

"The more confident people are about the state of the economy, the more willing they are to spend rather than save the stimulus payments," Professor Leigh told AAP on Wednesday.

The telephone poll of 800 Australians who received a cash handout, taken in June, found 40 per cent of the stimulus bonus had been spent.

By now, the majority of that money would have gone into the economy, Professor Leigh added.

The Australian government's second stimulus package, unveiled in February, gave $900 handouts to low and middle-income earners as part of a $23 billion outlay.

The study compared it with the former US Bush administration's tax rebates, given out in mid-2008 to counter deteriorating economic conditions.

Individual Americans were given $US600 ($A719) handouts, while married couples were allocated $US1,200 ($A1,438).

The ANU study found Australians were twice as likely to have spent the bonuses.

"Americans in 2008 were much more pessimistic about their economy than Australians in 2009," Professor Leigh said.

Unlike the US, Australia has so far avoided a technical recession.

Australia's jobless rate of 5.8 per cent is also much lower than the US figure of 9.4 per cent.

The study also found Australian Labor voters were more likely to have spent their stimulus than coalition supporters.

A comparison was not made with the Obama administration's $US787 billion ($A942.91 billion) stimulus program, announced in February, because not enough data has been collected.

But the study compared the Rudd government's stimulus package with another tax rebate program of the Bush administration in 2001.

This story was found at: ***http://news.smh.com.au/breaking-news-national/aussies-spend-stimulus-yanks-save-poll-20090826-ez5k.html***

COMMONWEALTH OF AUSTRALIA

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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Government economic stimulus initiatives

MONDAY, 21 SEPTEMBER 2009

CANBERRA

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SENATE ECONOMICS

REFERENCES COMMITTEE

Monday, 21 September 2009

Members: Senator Eggleston *(Chair)*, Senator Hurley *(Deputy Chair)*, Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Bob Brown, Cameron, Coonan, Eggleston, Hurley, Ryan and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

The economic stimulus initiatives announced by the Government since October 2008.

The Senate requests the committee:

(a) to invite the Secretary of the Treasury, accompanied by any other officials he considers appropriate, to appear before the committee, on or after the morning of Monday, 14 September 2009, for the purpose of giving evidence on the matter;

(b) to invite the Reserve Bank Governor, Mr Glenn Stevens, and other independent pre-eminent economists to appear before the committee, on a date to be determined by the committee, for the purpose of giving evidence on the matter; and

(c) to hold public meetings to take evidence from those witnesses, in the form of a full update on the economic stimulus initiatives, which addresses:

  (i) the efficacy of the spending measures to date,

  (ii) the anticipated costs and benefits of continuing the spending measures,

  (iii) consequent change in the stimulus 'roll out' that ought to be entertained given the changed economic circumstances,

  (iv) anticipated impact of the stimulus spending on future interest rate movements and taxpayer liabilities,

  (v) an evaluation of the environmental impacts of the spending to date, and

  (vi) other related matters.

WITNESSES

DAVIDSON, Professor Sinclair, RMIT University and Institute of Public Affairs.....38
DENNISS, Dr Richard, Executive Director, The Australia Institute.....57
KATES, Dr Steven Ian, Private capacity.....2
LEIGH, Professor Andrew Keith, Private capacity.....18
MAKIN, Professor Tony, Private capacity.....71

Committee met at 9.35 pm

CHAIR (Senator Eggleston)—I declare open this first public hearing of the Senate Economics Reference Committee inquiry into the government's economic stimulus package. Next Monday we will be hearing from the Secretary of the Treasury and the Governor of the Reserve Bank and from some business organisations. Today's hearing is primarily with academic economists. These are public hearings, although the committee may agree to a request to have evidence in camera or may determine that certain evidence should be heard in camera. I remind witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage witnesses on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to the committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time.

[9.37 am]

KATES, Dr Steven Ian, Private capacity

CHAIR—Professor Steven Kates, welcome. Professor, would you like to make an opening statement?

Dr Kates—Yes, I would, thank you. I would like to thank the committee for inviting me to speak to them on what I think is one of the most important issues of public policy in Australia today. The standard theory of recession is wrong. That is my conclusion from a number of years of research on these issues. The use of Keynesian demand side theories to restore growth to economies in recession is misconceived. Only the natural strength of the market economy is strong enough to overcome the changes caused by Keynesian stimulus to allow the economy to recover. So in my view Keynesian stimulus, as we have had here in Australia and in America and elsewhere, is actually an obstacle to returning to economic growth and full employment rather than being any kind of assistance.

I have prepared a background paper which I have distributed to the committee and I would just like to go through some elements of that before we have questions. This submission provides both theoretical and empirical evidence that public spending and deficit financing cause positive damage to an economy. In particular it looks at the effects of the stimulus package that have been undertaken in Australia between the end of 2008 and the third quarter of 2009. This submission is broken into five separate sections. Firstly, the state of the national economy demonstrates that the Australian economy has been, and is, in recession. Even using the technical definition, the actions of the government have not prevented the economy from entering recession.

Secondly, I would like to note the impossibility of quantifying the effect of a stimulus showing that the conclusions based on projections from a Keynesian model cannot be used to demonstrate that the economy would have been worse off had no Keynesian stimulus been applied. Thirdly, I would like to number the aspects of the harm that will be done because of the stimulus. These include: noting that there is no justification for the introduction of a stimulus other than its effects on employment, and those effects have been minimal at best; distortions in the structural production, which occurs as a result of stimulus, which directs the economy into an unproductive activities; the loss in real economic growth because the stimulus measures have competed resources away from productive enterprises; a loss in long-term economic growth, which will depress the rise in real incomes and lower living standards; the effect on interest rates, which have remained higher than they otherwise would have been and will rise sooner than they otherwise need to have done; the effect on taxation, which will need to rise to a greater extent than it otherwise would have needed to rise in order to repay the costs of the stimulus; and, lastly, the potential effect on inflation which may become an important medium-term and long-term economic issue as the recovery gathers momentum.

My fourth point is that the fundamental structural flaws in Keynesian economics wrongly argue that increases in unproductive forms of public spending and budget deficits are capable of generating economic growth. And my fifth point will be that a discussion of theory of the cycle

makes it clear that economies are subject to periods of rapid growth and periods of recession and therefore the overreaction to the downturn at the beginning of this year has been wrong. We have not had the need for this kind of stimulus to be taken because the business cycle would actually have covered most of the change that we need to have anyway.

I take you to a number of features on this table. On page 2 I have a table on the state of the national economy. That first table shows the trend growth in real GDP. I have just above that a quotation from the ABS, which is found in the national accounting publication, which points out that the trend data are the most accurate and the most useful means to use in examining economic activity and for providing policy advice. You will see that the growth in GDP was negative growth in the September quarter and the December quarter 2008, and while I agree that the downturn in the September quarter is small, as in $14 million, $14 million one way or the other should not be the determining factor in whether Australia is in recession. The fact that we have had a rise in GDP over that four-quarter period of 0.3 per cent should be all that it takes to demonstrate that we have been in recession, whether you call it technical or not. But if we are going to use the two-quarter consecutive falls as the measure and as the determining factor, then on the proper measure of what has been happening in the Australian economy, the Australian economy has indeed been in recession. We have had those two consecutive quarters of negative growth, which occurred in September and December 2008.

I then point to the data on page 3, which is on the market sector GDP. It will be seen there that market sector GDP, which is the closest proxy we have to the private sector, has shown three consecutive quarters of falling GDP and in fact, if anything, the decline has been accelerating across the year. The decline has been 2.0 per cent. The table at the bottom of page 3 shows real net disposable income per capita. Again what we find is an accelerating decline in the level of real national net disposable income per capita. Across the year we find that there has been a fall in per capita income of 5.0 per cent.

On page 4 I discuss the national net savings and the savings ratio. It will be seen that there has been a massive fall in the level of national savings. The fact that people are spending their stimulus money should not be surprising given the fact that savings have fallen, as the table shows, by 49.4 per cent across the year. The data on hours worked in the economy show those for both the total economy and the market sector. On both of these figures there has been a decline in the level of hours worked. For the total economy the figure has been 2.1 per cent across the four quarters and for the market sector it is 2.8 per cent, which is a quite significant fall in the level of hours worked.

On page 5 I have included an article I wrote for the *Australian* which was published last week, on Monday, in which I pointed out, using the seasonally adjusted data, that there has been a decline in two of the three measures in the level of GDP. On both of those two measures, the income measure and the production measure, the fall in GDP has occurred in two consecutive quarters—the very definition that we use for a recession, if we wish to use a technical definition. Only the expenditure data, which is the Keynesian ‘C plus I plus G plus X minus M’ definition of GDP calculation, show an increase. The reason we have had an increase in GDP is because the expenditure measure, which is where you would expect a stimulus to show up, has been boosted by 2.9 per cent across the year while the other two measures have actually fallen.

I would now like to go to table 9. I should say I am going to the second section in doing so, which is the section on the impossibility of quantifying the effects of the stimulus. Unfortunately, the heading shows up just as a single line on the bottom of page 7, which I apologise for. The real issue is: what would have happened had no stimulus package occurred? What the Treasury and, I suspect, the government have been stating is that things would have been worse had there not been a stimulus package. The point that I think is very important to make is that the very basis for providing the stimulus has been on Treasury modelling, so the very model they use to show that a stimulus would be a good idea is the one they are using to validate the fact that the stimulus actually provided some positive effects on the economy.

In actual fact, of course, you cannot use that model to demonstrate that the Keynesian stimulus has done good when it cannot actually be seen in the data. The model will of course show that the stimulus has provided a benefit and that, had there not been a stimulus, the economic circumstances would have been worse because that is exactly what those Keynesian models are designed to show. They are designed to build in the fact that a stimulus will actually lead to higher levels of GDP and faster economic growth and greater employment. If you do not accept the model itself then there is actually no evidence, and I would submit that the Keynesian model cannot be used to demonstrate that a Keynesian stimulus has a positive effect on the economy.

I turn to the chart on page 9, which shows a set of figures that have been put together by the Innocent Bystanders blog in the United States. This is about the American stimulus package. What you will see is the grey line, the lighter line, which shows that, had there been no stimulus, that is where the unemployment rate would have reached. There is then the second line which is what the Obama administration said will happen if there is a stimulus put into the American economy. Then the little dots show what has actually happened, the actual rates of unemployment in the United States. It can be seen clearly that the unemployment rate in the United States has been far higher than it was to be not only had there been a stimulus but even had there been no stimulus. So on just this evidence—although I would not push this at all—one could say that the stimulus has actually had the negative effect that I would have expected it to have.

I will just quickly go through the issues under section 3, which is the harm done by the stimulus. The supposed effect of the stimulus is going to be unemployment. There is almost no serious argument to say that the areas of expenditure that have been chosen for stimulus will actually lead to high rates of economic growth. They are in many, if not most, respects just forms of expenditure without genuine benefit in a cost-benefit sense. We will certainly chew up a lot of our resources but there is very little likelihood, certainly inside the next 10 years, of those expenditures actually helping to boost the economy. Unless one believes that spending on anything at all will cause growth, one cannot actually think of those particular expenditures leading to value-adding activity.

Senator COONAN—It will not have any impact on long-term productivity?

Dr Kates—That is right; on value-adding, long-term productivity. The table I put together on page 11 is an estimate of what the stimulus package will cost per addition to employment or reduction in unemployment. If you take the second line there are, according to ABS statistics, 11,439,000 persons in the labour force at the moment. The unemployment level right now is 668,700 and the unemployment rate is 5.8 per cent. Had the unemployment rate been 5.9 per

cent, the number of unemployed would be 674,901 and the addition to unemployment would be 6,201. Based on that, given that we spent $43 billion on the stimulus package, if the unemployment rate has been shaved by 0.1 per cent, the actual cost per addition to the labour force per new employee, the reduction in unemployment, would be per unemployed person $6,934,365, which is an exorbitant amount. I would think the best you really could say that the stimulus package has done is that the unemployment rate might have reached, perhaps, 6.1 per cent—which is kind of my estimate—and to me that would me that per addition in employment to reduction in unemployment has cost $1½ million per employed person.

The 'Effect on the structure of production', on page 12, is one of those things that is a problem with Keynesian economics in that it sticks to final demand rather than recognising that there are actual channels through which production takes place. The supply chains that are being set up because of the stimulus package are actually, in most respects, unproductive supply chains. They are leading towards the production of things which are not going to create a net value-adding activity in a strained economy. Therefore we are actually creating a longer term problem by creating supply chains that will actually not be productive in the longer term.

The 'Misdirected production' I discuss on page 13. The central point I would make there is that the core Keynesian belief that the man would drive the economy in productive directions could not be more mistaken. The man does not create the value; only value-adding production creates value. Buying things is not a way to create value. The Keynesian aggregate demand belief that spending is the road to recovery and the road to economic growth is, I think, obviously wrong.

Section (d) is 'Growth and real incomes'. Resources are used wastefully and I believe the bulk of the resources that have gone into the stimulus package have been used wastefully and reduce the ability of the economy to improve real incomes. There is also no inbuilt mechanism that I can see that will enable value-adding activities to take place. The resources have been taken away from those activities that could have added to our economic strength, instead they have been frittered away on things that will not.

Section (e) is 'The effect on interest rates and other production costs'. The interest rates are already likely to go up in an economy which shows 0.3 per cent economic growth. The stimulus package is taking our savings and using them to the extent that those savings could have been used elsewhere for more productive purposes. They have gone into the government's stimulus package. We will end up with higher taxation as a result. The dead certainty is that over the years, with the deficit rising the way it is, there will be a need for taxation to rise to get that money back.

Lastly, section (f), which mistakenly shows (e), is 'The potential effect on inflation' which is a medium-term effect, may well end up being the greatest single cost should that inflationary spiral actually break out. The rise in house prices and even in the share market at the moment is some kind of indication to me where those funds are going. People are putting them somewhere. If that kind of expenditure and that kind of increase in the price level takes place in the economy generally, we will be looking at an inflationary environment which will take many, many years to wind back, as we discovered in the 1970s and then into 1980s and again into the 1990s, just how long and how hard and how expensive it is to wind back inflation.

CHAIR—Professor Kates, if I could just interrupt you. We only have an hour, so is it possible for the rest of your comments to be covered in questions from senators? Since this is Senator Bob Brown's referral we will ask Dr Brown to open the questioning.

Senator BOB BROWN—Thank you, Professor Kates. The committee has arranged to have Treasury appear last, next Monday: what questions would you like most to see this committee ask Treasury?

Dr Kates—I would like you to put them on the spot to see whether they actually think the particular elements that go into the stimulus package will, themselves, be value-adding and whether they actually think that they will, on the run, create growth, help increase real incomes and improve living standards? If you have an investment in the private sector, even though there is some delay, there is always going to be some expansion in an economy and in its ability to satisfy consumer demands. My expectation with all of the expenditures that have been made through the stimulus is that none of them will actually create any growth in economic activity. It will not create a strong economy and it will not build our ability to produce nor to raise real incomes. If you can ask the secretary that, and also ask him how he thinks these expenditures will lead to an improvement in the economy, given the effect on industries and given the effect on taxation down the line—that would be a very useful contribution.

Senator BOB BROWN—There are two things here. One is the growth scenario that you are seeking, but a recession is of course going in the opposite direction. Do you think government has any role to try to minimise the economy from going into negative territory?

Dr Kates—Yes, absolutely, it really does need to do that. There are many things that I would have recommended. The actions the government took right at the beginning to stabilise the banking sector were extremely important, and no-one could disagree with those. I thought that made an important contribution because it settled what could have been a very destabilising series of circumstances. Beyond that, the kinds of actions that really do work are actions that go to profitability. What we are doing now, in a sense, is saying that we have to raise profitability but we are going to first channel it through the consumption expenditures of individuals or give them money to spend on various aspects, and that the stimulus will occur once removed.

In a sense that stimulus will only occur when someone buys real goods and services so that rather than being an expenditure that says, 'Here is more money in the hands of business,' it is only in exchange for actual product. Had they gone down the road of, say, finding ways to reduce taxes—payroll taxes and other kinds of taxes related to business—which would have a direct effect on business profitability and on cash flow then the reaction within the business community would have been a lot stronger. Not only would employment have been protected in the way that the stimulus was intended but it would be much more general. In fact, a higher profitability for business and higher cash flows would actually have led to, I believe, an actual improvement in the level of economic activity relative to what we have seen here.

Senator BOB BROWN—How do you account for the fact—and I am using a generality here—that business in general has welcomed the stimulus package, if that is the case?

Dr Kates—I do not really expect the business community to be filled with economic expertise in the same way.

Senator BOB BROWN—Really?

Dr Kates—The whole issue of these kinds of expenditures began because business thinks it is a great idea at any time for the government to spend more money. From a business perspective, what they see is that what gives them growth is somebody spending money and buying their goods—that is how it looks to a businessperson. The old concept was that a recession is when people stop buying and that is how it appears to business, so what you must do is reverse that process and get people to buy again. When you look at these things more deeply and in the proper way of how an economy works in a macro sense, spending money on valueless objects cannot give you momentum and growth.

Senator BOB BROWN—So what did you mean then, if business is not seeing this in a proper sense, by saying that only the natural strengths of the market are enough to have the economy recover? What are those said natural strengths that you are talking about if business does not recognise them?

Dr Kates—As far as business is concerned, they are always happy to have somebody spend money with them, but getting the government to just spend money out of taxpayers' funds is easy and it looks easy. To actually have to find markets, to innovate, to build your business is difficult. This looks like a shortcut but from a national economic perspective it is pointless. It is actually pointless to be spending money on goods and services that do not create value. If you are a lumber manufacturer—

Senator BOB BROWN—If I may just interrupt there—what do you think about the public health and education system?

Dr Kates—Public health?

Senator BOB BROWN—There is very large government expenditure on public health and the public education system.

Dr Kates—I am not making a point against government spending as such. There is a major role for government spending in all kinds of areas. We could debate any of the individual items but with health, for example, I think there is a public policy role. The point about such things as public health is that people debated for years on end how to do this properly. We have ended up with what I think is a really first-rate system in Australia. When I look at the American debate, I am astonished at how well we have done here relatively speaking.

I have no objection to public spending on things that really do add value. They can only be determined, I believe, by serious consideration of issues and feedback mechanisms that look at what is happening and then try to improve on them. What we have had with the stimulus was an attempt just to jump in and spend on anything. I think both the insulation package and the expenditure on schools—while one can think it is important to have these things—have not been properly considered. They are not good public policy. They are, I think, a mistake and almost every dollar of it is a waste.

Senator BOB BROWN—If I can come back again to the natural strength of the market, isn't it the market that created the problem?

Dr Kates—I will answer this in two ways. The last section of this paper is on the business cycle. Business cycles are things that just happen. It is part of economic growth and economies will go up and down in some kind of cyclical way so that, rather than having a Keynesian approach and believing that economies can sink and then stay sunk, what really matters is to recognise that there is cyclical activity and there will be downturns on occasion. The second part of this is that the—

Senator BOB BROWN—I am sorry, but this is quite central to what we are talking about—

Dr Kates—No, I was going to answer that.

Senator BOB BROWN—Do you think that the government has no role in that cyclical activity and in trying to, for example, minimise the downward part of the cycle? Do you think it should be let go?

Dr Kates—No. I did not say that at all. What I did say is that there are many things you should do, including lowering interest rates and lowering taxation, but of all the things you should not do, you should not have this blanket expenditure as a stimulus of four per cent GDP, which is an unbelievable amount of money. That will not create growth and in fact will waste the resources so comprehensively in ways that will destroy our savings, will push up interest rates, will push up taxation in future and may push up our inflation rate. This is not the way—

Senator BOB BROWN—But, again, isn't that due to the recession occurring, the global downturn?

Dr Kates—No.

Senator BOB BROWN—You are saying this is due to the stimulus rather than the fact that the market failed to prevent a global recession?

Dr Kates—Recessions are going to happen. When I think just of my time in Australia, there was one in '75. There was another one in '82. There was another one in '92. We sort of had one in 2000-01—and now we are having one in 2009 which is much worse than all the others. These things happen. This one has been made worse, and the thing that is quite clear is that it began in the housing market in the United States. The housing market in the United States pushed financial institutions into lending to those who had no genuine ability to repay the debt. Those mortgages, which were already toxic, as they described them, were then bundled together.

Senator BOB BROWN—But that is the market.

Dr Kates—No. The first part was not the market, with respect.

Senator BOB BROWN—So you do not think the stimulus package has saved any jobs?

Dr Kates—I think in the short term the unemployment rate might have gone to 6.1 per cent instead of 5.8 per cent had there not been a stimulus. I think it has saved jobs. But I think that the cost of saving those jobs has been so disproportionate to any of the good that it will do that it is a tremendous policy mistake to have done this. We can see now that everything has calmed down

and we are moving towards a platform from which growth can occur. But within that we now have this unbelievably large debt that we are going to have to repay and we have higher interest rates than we otherwise would have had.

CHAIR—It is quite clear from what you have said that you do not think the package has avoided Australia falling into recession, and you have given your views on reliance on the market and private sector to restore the economy. Do you really believe that deep cuts to personal and corporate taxation and a balanced budget would have been a preferable approach to this crisis? I see that you also say in your article that we should be concentrating on returning the economy to structural balance. Could you comment on those points?

Dr Kates—On the first issue, about tax cuts: the approach that would have been most beneficial would have been to focus your tax cuts in ways that would immediately have had an impact on cash flow. That is why I think the notions of using the payroll tax system might have been the optimum. To also get to small business, there are other taxes that particularly affect small businesses and would have been immediately felt by them had those taxes or imposts been lowered. So to have actually achieved the kind of outcome that I think would have been preferable and given us stronger growth and a much stronger platform, the reductions in taxation and imposts on business, particularly small business, would have had a much larger effect than the actual expenditure, which was very localised and, as the data show, have not had any particularly large effect on the economy. You can always say it could have been worse, but I think it is pretty bad as it is.

On the second issue, of structural balance: what I mean here is that, if we are going to have recovery, that recovery will come through private-sector businesses again generating their own growth. The important thing here is that the supply chains are related, so you not only will have growth in final demand at some level but the actual supply chains within the economy that are feedstock into those businesses will also be growing.

Having the kinds of structural imbalances that the stimulus has—which mean that, ultimately, it will have to be wound back; you cannot continue with these forms of expenditure—means that all the structural aspects that go into these expenditures will also have to be wound back. Had we instead opted for an approach that went towards raising the profitability of private-sector businesses, then the actual structures that we put in place, the supply chains, would themselves have been productive because they would have been feeding into the ability of firms to actually produce what other people are willing to buy. In that way, rather than being a structure that has to be wound back as the stimulus is withdrawn, this would have been a structure that would have become a permanent feature of the Australian economy and contributed to growth.

Senator HURLEY—You have outlined a theoretical framework to allow the private sector to basically take over any stimulus and the government to maintain more of a hands-off approach. It has, as far as I know anyway, been adopted by no other country, and it kind of advocates tax cuts rather than payments to pensioners and families, with consequent effects on unemployment and the retail industry and infrastructure in this country. Isn't that a huge risk for this government to take? There is the argument you have made about whether or not we have avoided recession. But we have kept this country on an even keel. We have kept unemployment relatively low; retail sales have surprised everyone; and, even though you are sceptical about business response to that, that has still kept this country on a fairly even keel and at least has the benefits of

infrastructure, which should continue into the future. How can you suggest that we abandon that for a policy debate that might have continued on for months and taken us well into a recession?

Dr Kates—I would say to begin with that there is no true evidence that this thing has worked in any way at all. The American downturn is actually three overlapping downturns. They had their housing downturn. They then had a banking downturn which was fed out of the housing market. Then finally there was the collapse of the car industry. So you had in the United States three things, not one of which really has occurred here. Our housing market and prices, rather than being in any kind of freefall, have never fallen during this downturn. There might have been a blip but now they are going back up.

The banking system was not caught up in the kind of problem that they have had in the United States. All banks have been caught to some extent, but ours were not caught to the same extent and of course we do not have the problem with the car industry that they have in the United States. What is happening in Australia is a far less intense downturn than they have had in the United States. Americans have much greater problems to deal with. They are using the same approach with, I think, very bad results. You say that no-one else is doing this. I do point out that New Zealand is doing this, I do not know whether that counts—

Senator HURLEY—No stimulus—you are saying that New Zealand is not using a stimulus?

Dr Kates—As far as I understand. I may be wrong but I understand that New Zealand did not do it for any point of principle; they did it because they could not afford it, which is a very good reason not to do it. In fact, we cannot afford it either. My major point is that the basis for all of these stimulus packages across the world is the use of Keynesian economic theory. Keynesian economic theory builds on the Great Depression. I think you have an article that I published that has been distributed to you. Keynes published his book in 1936 and everybody still says—I just read something the other day—that Keynes saved the capitalist system when in fact the Great Depression reached its bottommost point in 1933. By the time that book was published in 1936 the Great Depression was over in every part of the world except the United States which had used a Keynesian approach. Keynesian economics will cloud anyone's mind if they want to understand how economies work.

Senator HURLEY—Could not the argument be that in Australia the recession has not been as bad as in America for a number of reasons, including the government regulation of our banking sector? Could you not also say that one of the reasons it has not been so bad is that the government acted very early? It did not sit around and do long, extensive policy debates on the theoretical benefits of Keynesian economics. It actually went in there very early on and stimulated the economy by giving money to pensioners and to families.

Dr Kates—You can say that. I just do not say that. I will go back to what happened here in 1996. The Howard government came into government in 1996. The first thing they did during what was actually a mild downturn was that they balanced the budget and they cut public spending. I remember being uniquely, amongst all the economists I knew, supportive of that policy. To me, cutting public spending was an absolute positive to the economy where for everybody else it was negative—there were petitions circulating and the rest. The outcome was that by the time the Asian financial crisis struck in 1997 rather than Australia being in a bad position, we were in a strong position. We rode through that with five-plus per cent growth.

We are now in the opposite position. Here we were with an economy which has until now had no debt and was, as these things go, very strongly placed and we have taken on debt. We have actually reversed the processes of 1996 and the effect, I think, is just what I would expect. We have had 0.3 per cent economic growth. You can argue that it would have been minus 0.5 per cent or something else but, as far as I can tell, the stimulus has not done us any good. There are a handful of jobs that have continued at the cost, I might think, of others that are just invisible because they have never been created in the first place.

Senator HURLEY—I do not quite agree with your cavalier attitude—

Dr Kates—I can imagine, yes.

Senator HURLEY—towards unemployment and throwing people into unemployment, but I will pass over to Senator Cameron to finish off.

CHAIR—We are actually going to go to Senator Ryan, because we have 10 minutes each and you have had your—

Senator HURLEY—Five.

CHAIR—Have you? I have got you down as 10. If that is the case, all right, but perhaps in the interests of alternating we might go first to Senator Ryan.

Senator RYAN—Dr Kates, you have mentioned on a number of occasions your concern with the Keynesian fiscal stimulus approach. We have not had a chance to absorb all of your submission as much as we would like but I was wondering if you could further explain what you perceived as the risk of interest rates and monetary policy moving in a different direction to an expansionary fiscal policy through these stimulus measures over the coming months. It is mentioned in your submission or in one of the other submissions that there is an expectation that interest rates will increase towards the end of this year, so do you have anything to say about the risk of the two arms of government economic policy moving in different directions and whether there are any lessons from the past about that?

Dr Kates—It is not, in my view, that they have moved in opposite directions; it is that the rise in interest rates must follow upon the rise in public spending. The fiscal stimulus, however you want to characterise it, takes Australian savings and uses it for government purposes—that is what happens. It is based on the idea that there are all these savings that exist out there during a recession that are not being utilised: that is the Keynesian notion and it is the Keynesian flaw. However you think about it, this stimulus money is coming out of Australian savings. It may well be forced savings or it may be just part of some pool of savings that exists already, but the fact that it is coming out of savings means that as the economy expands there are less savings available for private sector borrowers and even for government borrowers and therefore they are not working in opposite directions, this is what must happen. Irrespective of whether the Reserve Bank itself chooses to raise rates, rates will go up because we have taken our national pool of savings and we have spent them on whatever the items in the stimulus package are.

When businesses turn to try to expand their own activities they will go to financial institutions and those financial institutions, in trying to get their hands on savings, will have to raise the cost

of funds. They have to raise the cost of funds to bring the funds in and therefore they will have to pass that increased cost of funds on to those businesses who come to borrow. Therefore, if we are going to have the stimulus and we are going to expand the economy, which is what we hope to do, interest rates will of necessity have to rise as part of that process.

Senator RYAN—Just to clarify part of your earlier comments in relation to business investment generally being directed to productive activities and the higher cost of funds for business to access capital to invest in future activities, would you characterise the stimulus being funded by debt as taking away from future savings as well as current savings because of the need to have an increased tax burden later on?

Dr Kates—Yes.

Senator RYAN—Does that pose the problem that we are taking away future savings as much as savings for today which you have just outlined?

Dr Kates—That is true in ways that you could write books about. The stimulus package takes savings away immediately and therefore there is less available for private sector value-adding activities. The absence of these value-adding activities for business in the medium and longer term means that we are actually going to have less real growth. The stimulus money is being spent on goods and services that will give you no economic momentum. An equivalent expenditure by private sector businesses would give you a stronger capital base, which would be something that would lift the economy and therefore create more savings in the future. The fact that we have actually diverted our savings into non-productive, non-value-adding activities means that we will not generate those savings and we will not generate faster growth and therefore we will be less well off as a result, both in the medium term and in the longer term.

Senator RYAN—When you say 'non value adding', as opposed to, say, business investment that would be value adding over the medium and longer term, are you referring there to these particular stimulus programs effectively not adding to productivity, labour or capital as opposed to business investment which generally does add in such a way? So these measures would have no positive gain or, indeed, a negative impact on future productivity?

Dr Kates—Again, to respond to what Senator Hurley said, economies across the world are driven by these Keynesian notions of demand and therefore from an economist's point of view—and it is an infection that goes across the entire profession—the idea of spending money, of itself, is growth generating and creates and underpins an increase in the level of economic activity. Demand does not create growth. It does not generate increased output. It does not create value. It is only the supply side economy but does that; it is never the demand side of the economy that does that.

We have a private sector and we encourage the capitalist approach to economic activity because it is a trial-and-error system in which those who are able to create profitable industries and businesses survive and those that do not disappear. We have diverted funds from those industries into the hands of government chosen projects which on no accounting whatsoever have been shown to create value, that is, to create economic growth and to build the kinds of assets that will lead to a stronger economy in the future, higher real incomes, higher output and

higher investment. These activities will do none of those and therefore we are just throwing our savings into the sea.

Senator RYAN—Just one final question, Dr Kates, and you may or may not be able to answer this. I recall the 1980s, and there was focus through much of the 80s under a Labor government on reining in government deficits, allowing the private sector to invest in future productive activities, giving business a greater profit share of the economy, and that was solidified by what you mentioned in particular in 1996 with the budget being brought back into surplus. Would you see this current stimulus package and the arguments underpinning it as representing a dramatic change from where Australia has been since the mid-1980s and that sort of philosophy or those sorts of arguments underpinning the government approach to its budgetary policy?

Dr Kates—Yes, I do. I remember that period very well. The Australian economy went through 'banana republics' and all the rest and in 1987, I think it was, we balanced the budget—1986-87. This had such a strong upwards impact on the Australian economy that everybody got spooked by it, unfortunately, and everybody began describing the Australian economy as 'overheating'. I do not know whether you remember this yourself, but we had fantastic growth, I think based on the balanced budget of 1986, 87 or 88, which led to a tremendous upturn in the Australian economy. I think it was unfortunately killed off by Reserve Bank action which is simply did not accept the fact that we could have sustainable growth at that rate without inflation.

The present policy is the reverse of that. Rather than recognising the value of balanced budgets and a strong economic foundation, it has gone in the opposite direction and, as I see it, it somehow believes that the government is able to lead the economic growth rate and is able to pull us out of recession by its own expenditures. I think that is the reverse of what we saw in the 1980s and I think that the problems will be manifest over the medium term.

Senator RYAN—Would it be fair to characterise some of the problems that are being seen in the United States and European countries that are often compared with Australia, and have been recently, to what have been decades of substantial and massive public sector deficits? Would you see that as a significant driver of the problems they are facing, along with any current travails or banking system issues that we have seen in more recent times?

Dr Kates—I used to say during the last decade or so that we have had this extraordinary economic growth but my worry is no-one will have learned from it. We actually will have seen how brilliantly getting rid of the deficit and running budget surpluses work for an economy. I would talk to other economists about it, and they still saw this really important role for governments in driving the economy forward. In Europe and particularly the UK, which I am very well aware of, they have tried to drive their economy through public spending, and it is in a shambles. Using public sector activity to drive your economy forward is so inferior to relying on private sector activity that there is no comparison. In Australia, despite our distance and despite the fact that we are so far from the countries with which we trade and the rest, we are still able to compete and have this brilliant growth in economic activity and in real incomes because we have tended to rely more on the private sector than our overseas competitors. To the extent that we have done that, we have actually created economic growth and prosperity. Had we tried the European approach to things, that would not have occurred in this country.

Senator CAMERON—One thing you have certainly embedded in my mind is that we should never let an academic economist run the economy. You draw my mind to what Keynes said back in 1931:

If economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid.

You have reminded me of that quote this morning with your dismissal of the human cost of an economic downturn. You say it is so great that John Howard cut the budget, but you do not talk about the pain and suffering of people who could not get to a dentist or could not get into a hospital. The theoretical arguments that you are bringing up just beggar belief. The question I have for you is: why have the IMF, the OECD, the ILO, the treasuries of every advanced economy, the Treasury in Australia and business economists around the world got it so wrong, and yet you in your ivory tower at RMIT have got it so right? Why are you a voice in the wilderness for the correct approach?

Dr Kates—I will start with a quote of my own from John Maynard Keynes:

Madmen in authority—

are basing their decisions on—

… academic scribblers of a few years back.

Keynes is now that academic scribbler of a few years back, 1936.

Senator CAMERON—So who has it right? Friedman?

Dr Kates—I correspond with Friedman.

Senator CAMERON—You are with Friedman, are you?

Dr Kates—We have had very interesting conversations, but we disagreed in the end. I wrote this book, *Say's law and the Keynesian revolution*—

Senator CAMERON—This is not the ABC, but no ads.

Dr Kates—No, I am just pointing it out to you. The book came out in 1998—

Senator CAMERON—Look, you can run your ad for your book later.

CHAIR—Senator Cameron, let the witness answer the question. You have asked him a question so let him give his answer. You cannot direct his answer.

Senator CAMERON—The question is why he has got it so right and governments around the world have got it so wrong.

CHAIR—The professor is answering that issue.

Senator BUSHBY—Let him answer it.

CHAIR—Just give him the space to answer it.

Dr Kates—I was just going to read one of the comments on the back of the book, that is all. This is from one of the original reviewers back in 1998. He said:

If Steven Kates is right about Maynard Keynes then Keynes was very wrong about Say's Law - as understood and employed by most mainstream economists up to the writing of The General Theory itself. And not simply was Keynes wrong about the classics but in making legitimate the concept of aggregate demand failure ... the consequence of Mr Keynes has been ruinous for theory and policy alike.

Senator CAMERON—Who was that? Hayek?

Dr Kates—No. I have someone else who has written about it who says:

A work of true scholarship and thought-provoking content. You may disagree with Kates, but you cannot easily dismiss him

Senator CAMERON—I think I would dismiss a lot of your arguments this morning.

Dr Kates—This is a 'convincing and authoritative account'.

Senator BUSHBY—A quote about your economic qualifications.

Senator CAMERON—Don't you talk about economic activity as a Liberal government. Give us a break. What a joke!

Senator BUSHBY—Attacking economic academics is a bit of a joke, I think.

CHAIR—Order! We will not have cross-conversations. Do you have any other questions, Senator Cameron? We can go to Senator Coonan, who may have a clearer view of where we should be going?

Senator CAMERON—What are you saying? She has a clearer view on where we should be going?

CHAIR—She may have, I said.

Senator CAMERON—Are you being biased towards me again.

CHAIR—Not at all. I just simply asked whether you had another question.

Senator CAMERON—Professor Kates, what do you say on the analysis of the Chairman of the Financial Stability Board, Mario Draghi, when he said that the 'key issue is to break the

negative feedback loop between the financial system and the real economy'. If government does nothing, how do you break that negative financial feedback loop?

Dr Kates—That moves into different areas about the financial system, which does need close examination. But the stimulus package is not part of that process. You are not going to fix the financial system by squandering money on things that do not create value. Where the financial system needs fixing is probably well beyond my own areas of expertise, but there is no doubt that the financial system, rather than being a problem per se, is part of the reason that we have economic growth, ultimately, in our economy. Financial systems are important to creating growth. I have always thought that John Law in the early 1700s created the Mississippi Bubble in France, which put back the issuance of paper money by something like more than a century because of the effect that paper money had had at that stage in France.

Senator CAMERON—I do not need this theoretical analysis. What I am asking you is how you break the negative feedback loop, which is so important for investment, jobs and business activity. If you say that government plays no part, how do you do it?

Dr Kates—I did not say that government plays no part. I do not say that. I do not say that government plays no part at any aspect of the economy. Governments have a role in spending, they have a role in regulating and they have a role in administrating. What I am saying, though, is that if you are going squander money unproductively on various elements of the stimulus package you will end up with a slower economy and lower incomes. If you are worried about the poor and the unemployed, I take you back to the effect on the labour market of the stimulus packages back in the 1930s in the United States. The Roosevelt administration led to unemployment remaining high, uniquely, in the United States. In 1938 I think the unemployment rate was at 14, 15 or 19 per cent.

Senator CAMERON—So you are basically saying that the ILO, the OECD, the IMF and the treasuries of most advanced economics have got it wrong and that you have got it right; is that what you are saying?

Dr Kates—I have written a book on this, and that is my point: I do say that they have it wrong.

Senator CAMERON—So the answer is yes, is it?

Dr Kates—I do say they have it wrong. The use of Keynesian economics has been one of the great catastrophes for economic theory in the West.

Senator CAMERON—Everybody else is wrong and you are right.

CHAIR—You must know the feeling, Senator Cameron.

Senator COONAN—I would like to raise a point of order. That is not a conclusion that follows from the witness's answer. Could you move on to the next question.

Senator CAMERON—It is my conclusion.

Senator COONAN—It might be yours, but it is not supported by the evidence.

Senator CAMERON—It is a reasonable conclusion. Why will expenditure on education, social housing, transport infrastructure and energy efficient homes not lead to improved productivity in the future? We are putting in the Hunter Expressway, which will be positive in terms of increased capacity. We are improving the Pacific Highway and the Ipswich Motorway just to get people to and from work. There is the regional rail express in Victoria, the Gawler rail line modernisation in South Australia, the Noarlunga to Seaford rail extension in South Australia, the Gold Coast light rail in Queensland, the east-west rail tunnel in Victoria and the Bruce Highway.

Senator COONAN—On a point of order, this inquiry and the background paper do not include the infrastructure package. The witness was confining his answer to the $42 billion stimulus package so far as I understand his evidence to date. I think that point needs to be made for the purposes of the question that Senator Cameron is addressing to him.

CHAIR—Let us give the witness an opportunity to answer this question from Senator Cameron about public expenditure on infrastructure.

Senator CAMERON—What analysis and modelling have you done that says that none of these projects will lead to long-term productivity improvements within Australia? It seems to me to defy common sense.

CHAIR—You have asked your question, Senator Cameron, now let the witness answer.

Dr Kates—My concern is that you have not done the analysis, that these were just expenditures made in haste without any of the kinds of safety measures that you would normally want to take on a government outlay. We are talking about $43 billion—an immense amount of money. Even to this day, there has not been any effort to demonstrate that these will create value for the economy.

Senator CAMERON—Did you make the same point when the Howard government was going to invest $10.4 billion in the Murray-Darling Basin without any analysis?

Senator COONAN—That is a rhetorical question.

Senator CAMERON—It is not a rhetorical question. It is exposing your hypocrisy; that is what it is doing.

CHAIR—Senator Cameron, you have asked your question. The professor has answered it. We will now move to Senator Coonan.

Senator RYAN—On a point of order, Dr Kates has been remarkably polite this morning and one senator in particular is continuing with interjections and assertions. I would ask you, Chair, to insist on appropriate behaviour and some decent manners in the conduct of this hearing.

Senator CAMERON—Do not lecture me about manners.

Senator RYAN—You are the guilty speaker, Senator Cameron.

CHAIR—It is a general requirement that witnesses at Senate inquiries should be treated with respect, listened to in silence and given an opportunity to answer. I think we should all bear that in mind.

Senator COONAN—Professor, I take you to one part of your evidence this morning. You appear to be asserting that make-work activities or activities that do not have any long-term productive capacity for the economy are not, in your view, to be encouraged, and nor can they be justified. Is that a fair statement?

Dr Kates—Yes, that would be the general conclusion I would reach.

Senator COONAN—This inquiry is not only looking at the overall stimulus packages—and there are some $95 billion worth of announced stimulus packages, not just the $42 billion. My understanding from an answer that I got from the Assistant Treasurer to a question on notice is that, of the package of $42 billion, some $20.5 billion has been distributed, and the implication is that the balance of the $42 billion may not have yet been spent. There may be commitments in relation to it, but it may not yet have been spent. Do you think that there is justification in looking at not going ahead with that expenditure or winding it back, if it is contractually and legally possible?

Dr Kates—Yes. I think that the less of that money that is spent the better it will be for the Australian economy. The expenditure is actually a negative feature of the level of economic activity in Australia. It will distort our productive potential and it will reduce our long-term ability to raise living standards and create jobs. To the extent that it can be wound back and greater attention paid to encouraging private sector activity, I think that would be all to the good of the economy.

Senator COONAN—Could you give some weighting to or give the committee some evaluation of the importance to the economy of us having negative net debt in 1996—in other words, the state of the economy when it was handed over, all debt having been paid down by 2007?

Dr Kates—I missed that last part; I am sorry.

Senator COONAN—By 2007 there was negative net debt in this country so, for the purposes of being able to look at the downturn in our economy, there was some money in the bank: there was a budget surplus of some $22 billion; there was about $43 billion in the bank. What value did that have for the present government in being able to handle the downturn?

Dr Kates—I think we were the only economy in the world with no debt at that time. Having those sorts of features, such as the negative net debt, gave the Australian economy a strength that I think very few other economies had. We are on one of the most solid foundations of any economy just because of that. We relied on the private sector, we relied on business examining the costs and benefits of what they were doing with a view to profitability, and the outcome has been that we are one of the best placed economies in the world because of that. We are therefore in a very major sense running down our capital. We had this solid foundation and we are now

chipping away at it with these expenditures. It kept interest rates lower; therefore we could borrow at lower rates. It kept tax revenues higher; therefore we were able to spend more money and stay in surplus. On all of those features, we have allowed the current government to spend money that it otherwise could not have done. The $43 billion, therefore, has been put on top of a structure that began from a position of immense strength. My fear is that once that $43 billion is spent we will no longer have that kind of strength that we once did and we will not be able to make changes and increase expenditures in other areas when serious needs arise in the future.

CHAIR—Thank you, Professor Kates. We will conclude at that point. Thank you for appearing and thank you for your answers.

Dr Kates—Thank you to the committee for allowing me to present.

[10.50 am]

LEIGH, Professor Andrew Keith, Private capacity

CHAIR—Welcome. I invite you to make an opening statement.

Prof. Leigh—Thank you for inviting me to give evidence today. My focus is going to be not on the entire remit of what your committee has been asked to determine, but principally on looking at the impact of the expenditure delivered from March to May 2009 through the so-called Nation Building and Jobs Plan. I will try to specifically talk to you about the evidence that I am aware of on the marginal propensity to consume, as economists call it—or as everyone else would simply put it: what share of the money got spent.

In broad terms there are three ways in which academic economists have tried to answer this question. The first is to look at aggregate spending or aggregate savings data. There is a large amount of literature in US economics coming out of the 1975 US tax rebates, which has essentially looked at these monthly or quarterly figures and tried to tease out what is going on. This is a pretty hard ask. In some sense, you should think about this as a sporting analogy. You want to know the impact of putting a new player out there on the field, but you are playing a team you have never played before that is better in the second half than you are. You put that player out in the field and then you are going to have a look at the final score to work out how effective that player was. It is pretty hard to sort the wheat from the chaff in this style of analysis.

The second way in which economists try to work out the impact of the share of a bonus payment that gets spent is to directly measure expenditure of recipient and non-recipient households. Ideally you want a set of non-recipient households who look exactly like the recipient households. You do not want to compare rich and poor households, for example, because they may have different spending patterns. What these US studies have been able to exploit is the fact that in 2001 and 2008, the US bonus payments were rolled out essentially on a random basis. They used the second last digit of taxpayers' social security numbers, and that determined when you got the cheques. This is terrific from a methodological point of view, because it really allows us to compare a set of households who are exactly the same but for the fact that one has a different social security number than the other.

The leading study using this method, and in my view the leading study in the literature, is a paper in the 2006 *American Economic Review* by David Johnson, Jonathan Parker and Nicholas Souleles. They have the consumer expenditure survey and they add a set of extra questions to that. Their estimate from that, if they just focus on non-durable goods, is they get a marginal propensity to consume, a spending share, of about 37 per cent in the quarter of receipt and about 69 per cent if you take into account the first two quarters of receipt. One of the co-authors on that study, Jonathan Parker, has written another as yet unpublished paper with Christian Broda where they try to do something similar using AC Nielsen Homescan data for the 2008 bonus payments. They get slightly larger numbers for the US 2008 payments: about 0.6 in the first quarter and about one in the second quarter. Other studies have used this random variation, but looked at credit card payments. Methodologically, you can think of this as being like you want to

know the impact of a new player and you get to have a whole lot of different games in which you just toss a coin and decide whether or not to send the new player out onto the field. It is a much more precise way of working out what is going on.

A third method is to ask people what they did with the money. Economists are typically a little wary about going and just asking people what they did. We tend to think that so-called 'stated preference' is inferior to revealed preference. People might forget, or they might have systematic biases. Typically we would rather measure what they do rather than what they say, but it is a simple and straightforward approach. The leading two studies here are by Matthew Shapiro and Joel Slemrod. They ask a question—basically a 'What did you do with the money' type question—of US households following the 2001 and 2008 rebates. They get an estimate that about a fifth of US households say they spent the money, and the rest either say they saved it or used it to pay off debt.

My contribution in Australia has simply been to replicate the Shapiro-Slemrod study using data from a June 2009 ANU poll in which we simply asked respondents, 'Thinking of the money you received from the household stimulus package, did you spend it, use it to pay bills, save it or invest it?' The investments we get from that suggest a much higher spending rate than the United States. When we collapse the categories down, 40½ per cent of our recipient respondents said they spent it, 24 per cent said they saved it, 35½ per cent said they used it to pay off debt. That then suggests that about 40 per cent of the money got spent, and this is just a first-quarter estimate. You would expect this is a lower bound of the total share of the 2009 rebates that made their way into the economy. If you believe the studies which have used the direct expenditure approach, it could well be that three-quarters of the money got spent. There is a Westpac study which does something similar with a slightly different question. They get a bigger number than we do, they get 70 per cent of the money being spent, but it is consistent with my study in the sense that they are getting much bigger estimates than you see in the United States.

I am happy to go into variation across households, if you like, in questions. The three things that might be worth highlighting are that households were more worried about government debt were less likely to pay the money. This makes sense. To an extent, the theory is helpful in this area, but I do not think theory really answers many of these questions. It does suggest that people who think that a government that is paying your bonus this year is a government that is going to raise your taxes next year are the kinds of people who are less likely to go out and spend the money. Households where they are worried about personal unemployment or about another member of the household being unemployed are also less likely to spend the money. And the ANU poll for other reasons included a question asking respondents how they intended to vote had an election be held. It turns out that has a huge effect. People who said they were going to vote Labor were much more likely to spend the money than people who said they would vote Liberal or National.

You might be worried here that this is just reverse causality, that perhaps the kinds of people who spent the money were also the kinds of people who like the incumbent government. But there may be a feeling that rusted on Labor voters are doing what the government has told them to, and in that sense is rolling out the money. This has zero policy relevance. It is not as though we would ever design policies which were targeted in the way in which people said they would vote, but it is an interesting finding—to me at least—in trying to understand some of the human

dynamics as to what goes on and think about how we would design these optimal packages in the future. I am happy to take questions.

Senator BOB BROWN—The previous witness said, yes, the spending was there, but it is not value-added spending. What is your comment on that?

Prof. Leigh—The purpose of the spending is not to improve the productive infrastructure of the nation but simply to avoid a downturn. So if you believe the Treasury estimates, these payments reduced unemployment by about two percentage points relative to what it would have been in the absence of the payments. The notion here is that what you are trying to do is to smooth the cycle. This is not a strategy that would work in the long run.

Senator BOB BROWN—And do you believe the Treasury estimates? I guess that is a real central point for our committee—that is, how do you think Treasury's analysis of the stimulus package can be seen?

Prof. Leigh—It certainly seemed reasonable to me based on the available data. The margins of error around these estimates are all pretty large. You have seen that just in what I have told you. I get a number of 40 per cent; Westpac gets a number of 60 per cent. They could easily be out, but they seem to be in the ballpark.

Senator BOB BROWN—Overall, what is your view of the stimulus package and its effectiveness?

Prof. Leigh—In terms of reducing unemployment relative to what it otherwise would have been, I think that it was an effective package. What is interesting for me as an academic is to think about why Australians were more ready to spend than Americans. One of the reasons for that could well be that the downturn here has been much less severe than it was in the US. If you look, say, from the middle of 2007 to now, the US unemployment rate has basically gone from five to 10 per cent; ours has gone from four to six per cent. So one of the reasons that Australians were more ready to spend the money was, I think, perhaps because the economy was looking a little better.

Senator BOB BROWN—You are looking there presumably at the $900 cheques that went out?

Prof. Leigh—I am indeed. My focus is on the 2009 payments. The Westpac survey is sufficiently vaguely worded that it could pick up the December payments as well, but the ANU poll has focused on the 2009 payments.

Senator BOB BROWN—Do you think that there is a prospect of a so-called 'double-dip', another downturn in the way the world is going?

Prof. Leigh—I think this is a terrible time to be an economic forecaster, Senator!

Senator BOB BROWN—I agree.

Prof. Leigh—Economic forecasters have egg on their faces and I would do my best not to join them.

Senator BOB BROWN—The next question I was going to ask—and this is as difficult as the last one, I know—is: do you think another stimulus package is warranted?

Prof. Leigh—I certainly have not heard any call for it at the moment. There are two kinds of mistakes you can make as a policymaker in this context: you can do too much or you can do too little. The case that we have done too much is at the moment stronger than the case that we have done too little. But I think that that is the side of error that I would prefer to be on. What monetary policy is for is this kind of short-term finetuning. It is not clear to me that we would want to massively scale back the fiscal stimulus. I think that the right thing to do as an economic policymaker would be to let it to roll out and probably not do any more at this stage and, if the economy recovers rapidly, let monetary policy do its job.

Senator BOB BROWN—So you wouldn't put the brake on that rollout?

Prof. Leigh—There are two reasons I would not put a brake on. One is that I think that when governments promise to do things it is a bad look if they then break their promise. The second is this question of finetuning. We are sufficiently uncertain as to what the path out of the downturn will be that I think it makes sense just to let fiscal policy role and let monetary policy, which takes effect much faster, do the finetuning.

Senator BOB BROWN—Do you see the prospect of increased taxes coming down the line?

Prof. Leigh—I think that it is inevitable that these payments have to be paid for in some sense, but how the fiscal tightening is done is a matter entirely for policy. You could do it through expenditure cuts or tax increases.

Senator BOB BROWN—Have you got any best idea as to where those tax increases should be applied?

Prof. Leigh—I would probably focus first on middle-class welfare. That seems to be a logical area to focus on, but one that is politically difficult, and you can see why a government facing a 2010 election would not want to cut back on payments that go to the median voter.

Senator BOB BROWN—What about resource taxes?

Prof. Leigh—I have certainly argued in favour of a more comprehensive system of resource rent taxation in the past.

Senator BOB BROWN—And finally, if you were in our position, what question would you most like to ask Treasury when they appear before us?

Prof. Leigh—I think this issue over too much or too little is an important one. The other aspect of that is the estimates of what economists call the 'deadweight cost of taxation'. So if you simply tax me a dollar and then give me a dollar in benefits, it is not true that the world is as well-off as it was beforehand. We have lost some revenue because the higher taxes have

decreased the incentive to work. My best read of the evidence is that that may be 20c in the dollar. But it would be interesting to know what estimates of that look like, because that policy parameter matters for just about every government decision including its fiscal stimulus.

Senator BUSHBY—Thank you, Dr Leigh. I am interested in your survey that you have conducted. That survey relates to the $12 billion that was spent between March and May—is that right?

Prof. Leigh—In retrospect we should have worded question so it specifically focused on the 2009 payments.

Senator BUSHBY—So the 2009 payments started being sent out in March and over the next six or so weeks?

Prof. Leigh—That is correct. So the Centrelink payments I think were delivered in March and the ATO payments from April to May. We should have worded the question so we asked specifically about those. We think most of our respondents were referring to it. But that is not in the question.

Senator BUSHBY—So that is $12 billion that was received by Australians through that period between March and May?

Prof. Leigh—Yes.

Senator BUSHBY—So when would that be likely to show up in the accounts? The impact of that 40 per cent that your survey showed was being spent—in which quarter would that be likely to show up in the accounts?

Prof. Leigh—This is a pretty big discrepancy in the literature. The survey type approach suggests that there is not a big kick-up from the first to the second quarter. The expenditure approach does find a big kick-up. The *American Economic Review* study I referred to before has 0.37 marginal propensity to consume in the first quarter, and 0.69 by the second quarter—almost as much in the second quarter as the first. We have just got a first-quarter response. I think it is a lower bound but I cannot tell you how much lower than the truth.

Senator BUSHBY—But if you asked people whether they spent that money, and 40 per cent said yes, then presumably they were talking about spending it immediately or very soon after receipt of it, even though some may spend it in the quarter that follows—is that what you are really saying there: the propensity to consume being a kick-up in the second quarter meaning that they might delay spending but still be spending?

Prof. Leigh—Indeed. So if I tell you I have used it to pay off debt then I may well be saying, 'I paid off the credit card this month so I could go on a binge in a couple of months.'

Senator BUSHBY—And rack it back up again.

Prof. Leigh—What we would like is an expenditure approach that gets it back. That would be a much nicer way of evaluating—

Senator BUSHBY—But, in terms of your 40 per cent, that would show up in the first quarter?

Prof. Leigh—Our 40 per cent is purely a first-quarter effect. It is getting respondents somewhere between one and three months after they received the cheques.

Senator BUSHBY—So 40 per cent of $12 billion is roughly how much?

Prof. Leigh—I have a calculator here.

Senator BUSHBY—It is 4.8. I just wanted to get Dr Leigh to say that.

Prof. Leigh—Yes, $4.8 billion.

Senator BUSHBY—The seasonally adjusted accounts for June have shown an increase of slightly under $2 billion in terms of the increase in household income spending. So how do you reconcile the fact that your survey shows $4.8 billion has been spent in that quarter and yet the official accounts show that only $2 billion was actually spent by households in addition?

Prof. Leigh—This is the drawback of using the national accounting method. To the extent that expenditure trends are bumping up and down due to the recession, it is going to be hard to tease out from that the causal impact of sending cheques out. So it is entirely possible that you will not see a blip up in the accounts which is precisely the same as the spending share.

Senator BUSHBY—In that context, could it be because, although people may say, 'Yes, I took the stimulus payment I received and went off and bought a brand-new, Taiwanese-made, plasma TV,' they may well have gone off and bought a brand-new, Taiwanese-made, plasma TV anyway, regardless of whether they got that cheque? That may be just substitution for spending that they would have done anyway but, in their minds, because they had that cheque, they went off and spent it. Might the missing $2.8 billion be lost in substitution for spending that they might have done otherwise?

Prof. Leigh—It is entirely possible that households are systematically making mistakes. Certainly, when we look at the expenditure approach, which I think is better than the savings approach, in the US the first-quarter estimates out of those two methodologies are pretty close. That gives me some greater degree of confidence that the survey approach is getting to the truth. But, as you say, there are errors involved in this method. I think the survey method is better than the national accounts method. Ideally, perhaps, if that is all we have, we would take some weighted average of the two.

Senator BUSHBY—If you ask somebody, 'Did you spend your cheque?' they may say, 'Yes I did.' But they might have bought the thing that they spent the stimulus cheque on anyway, and then it is not really showing the impact of the stimulus. It is substituting for something that they might have spent anyway. It is not actually necessarily creating additional demand.

Prof. Leigh—We do learn a little from looking at different question wordings. The US Shapiro-Slemrod survey asks about additional spending. There is a CBS-*New York Times* survey

which asks about how people spent the payment. Those two surveys get fairly close to one another.

Senator BUSHBY—But doesn't it come back to your initial criticism about the survey method in terms of the stated preference being different from an actual preference? If you ask somebody whether it was additional spending they might say yes because in their minds it was, but, nonetheless, the appeal of that new plasma TV might have been so great that they would have bought it anyway.

Prof. Leigh—This method is certainly not perfect. I would never want to argue that.

Senator BUSHBY—Okay. You mentioned that we should keep the fiscal policy going and allow the monetary policy in effect to keep things in check. They are not the actual words you used but that is effectively what you were saying—is that right?

Prof. Leigh—That is a fair summation.

Senator BUSHBY—Does that not mean that, if monetary policy is going to be allowed to be used as a more flexible way of keeping the balance of things in check, you are actually talking about higher rates?

Prof. Leigh—Yes, absolutely. We have a three per cent cash rate now and that is unsustainable in the long term.

Senator BUSHBY—To use the words of the governor, it is actually an 'emergency' level, nonetheless it is a lot higher than what has been observed in comparable countries, certainly in recent times.

Prof. Leigh—Yes, so we have not got to zero, which is positive.

Senator BUSHBY—Theoretically, in terms of using monetary policy as a method of stimulating the economy, we did actually have additional capacity in that regard.

Prof. Leigh—Yes, monetary policy becomes less effective the closer you get to zero.

Senator BUSHBY—Nonetheless, we had additional capacity and that capacity was used elsewhere.

Prof. Leigh—Yes, that is right.

Senator BUSHBY—The bottom line is that by keeping the fiscal policy going and allowing monetary policy to keep the balance right that means increased interest rates.

Prof. Leigh—Yes, absolutely.

Senator BUSHBY—You also say that in the future in terms of addressing the debt created by the current fiscal policy we will be looking at either expenditure cuts or tax increases. Are those the only options?

Prof. Leigh—Certainly from the government's point of view, they seem to be the two main possibilities.

Senator BUSHBY—The bottom line, as a consequence of the current fiscal policy, regardless of the efficacy or otherwise of that, is that in future Australians will be looking at either cuts to expenditure by government or increases in taxes. They are the only options that they face as a result of the current policy decisions.

Prof. Leigh—An inevitable impact of Keynesian fiscal policy is that if you inject money into the economy in bad times then you are going to have to get it back in good times.

Senator BUSHBY—Thank you.

Senator CAMERON—Senator Bushby has criticised my understanding of economics and I plead guilty. I am not an academic economist, though I try my best. I would like to get some comment from you on a paper from Sinclair Davidson and Ashton De Silva. Have you seen it?

Prof. Leigh—I have not seen that paper.

Senator CAMERON—I might take you to some of the points they make in that paper. They come to the exact opposite conclusion to yours in terms of the economic stimulus package. They say they have conducted a small forecasting exercise and that after doing that forecasting exercise, they compared government spending to actual observation and found there is no impact. They argue that they have applied what is called a 'Henderson weighted moving average' in their analysis. They have applied what they call a set of 'surrogate filters'. They had estimated the poly trend and they have conducted a robustness test using the Holt-Winters model. It all sounds very impressive to me, but it comes up with exactly the opposite conclusion to your conclusion. Do you know of any of these things that they are talking about and are they legitimate approaches?

Prof. Leigh—I think I would be disappointed in any colleague who attempted to pick up a research paper of mine and analyse it on the fly within a few seconds. So I am very reluctant to do that to others. I would be happy to give it a considered look and give you my views on it, but it would not be wise for me to do that on the fly.

Senator CAMERON—Could you take it on notice to provide us with a response to that paper?

Prof. Leigh—Certainly.

Senator CAMERON—You said that your system is not perfect and that you would never argue that. There are no perfect systems when you are analysing these types of stimulus are there?

Prof. Leigh—That is correct.

Senator CAMERON—When you say that your system is not perfect, you are saying it is not quite robust in the context of what you are trying to achieve?

Prof. Leigh—I think of this as a pastiche of evidence, that you want to gather little pieces of evidence where you can, put them all together and do your best to see the whole picture.

Senator CAMERON—You also argue that the issue was to do either too much or too little, that that was the key test?

Prof. Leigh—Yes.

Senator CAMERON—One of the arguments that we heard this morning was that maybe we should have done nothing and we should have let the market determine these issues.

Senator COONAN—That was not what was said.

CHAIR—That was not put, Senator Cameron, with respect.

Senator CAMERON—Let me rephrase that.

CHAIR—Yes, you should rephrase it, for accuracy.

Senator CAMERON—What would your response be if there was an argument that we do nothing, that the market would self-correct and that government in the circumstances we were facing after the collapse of Lehman Brothers should do nothing? Would that have been a reasonable option?

Prof. Leigh—Certainly this argument has been made by a number of my colleagues, both here and in the United States. I think it is important to bear in mind how slowly economies tend to recover from recession. The unemployment rate of the late eighties was not again achieved until the late 1990s, and the scarring cost of unemployment is pretty substantial. I left school in 1990, just as the economy was hitting the skids, and that was a terrible time for young kids to leave school. So I think it is important, where government can, to try to smooth the economic cycle and not simply to see this additional two percentage points of unemployment as being a statistic but as being many young people whose livelihoods will be better if they do not spend a scarring period of unemployment early in their careers.

Senator CAMERON—One of the other arguments we heard this morning was that it would be better if we simply reduced taxes to business and let business get on with the job. What is your analysis of that approach?

Prof. Leigh—My favourite primer on multipliers is a Bookings Institution paper by Doug Elmendorf and Jason Furman that you are probably aware of and that I regard as a nice review of the literature. My read of that is that the multipliers are highest for infrastructure, next highest for consumer handouts and lowest for business tax breaks. The impact of business tax breaks on the economy seems to be fairly low.

Senator CAMERON—I am not sure if you were here when I went through some of the government infrastructure initiatives that are taking place as part of the overall stimulus package. Again, the argument has been put that these will not achieve any long-term productivity improvements. Have you any view on that?

Prof. Leigh—The only work I have done on the impact of infrastructure on unemployment was looking at, to use a pejorative term, a pork-barrel program run in the early 2000s which gave us some degree of random variation in road building across Australia. My co-author, Christine Neill, and I found out of that that there seemed to be a reduction in unemployment in the areas where road expenditure was highest. We did not estimate a multiplier but it is consistent with the notion that local infrastructure projects can create jobs rather than simply crowd out, which is the other economic theory.

Senator CAMERON—I want to take it to the next step: not only do they create immediate jobs but they can have an impact on improved productivity in the future through infrastructure such as the capacity of ports or, for instance, the Ipswich Motorway, which I do not travel on very often but I have at peak time when people's capacity to get to and from work could be freed up. Surely these are issues that improve the long-term productivity of the nation.

Prof. Leigh—I think that is why in many of these infrastructure studies we are getting multipliers which are pretty close to one, because the idea is you can both improve infrastructure and have a direct spending impact.

Senator CAMERON—So you do not agree with the argument that the package is not delivering in terms of improving the productive capacity of the country?

Prof. Leigh—That is not my read of the academic literature on this. I do not have fresh academic evidence to present on that point, however. I am simply giving you my summary of what I know others have done.

Senator COONAN—What part of the package were you referring to when you gave that answer?

Prof. Leigh—The infrastructure package.

Senator COONAN—But not the $42 billion stimulus package or the cash splash part of the package? I am just not quite sure what part of the package you were referring to.

Prof. Leigh—I am sorry. My direct research has been on the household handouts component, the $12 billion.

Senator COONAN—That is not what you were referring to when you were talking about productive capacity?

Prof. Leigh—No. I apologise if I was not clear earlier.

Senator CAMERON—Just to be clear, the package was made up of three different elements. One was the short-term fiscal stimulus, the second was trying to get as much short-term infrastructure in place through the schools projects, and the third was the long-term infrastructure. In your mind, would there be cohesion in that approach? Is that a sensible approach?

Prof. Leigh—Certainly the standard wisdom on fiscal stimuluses is that you get a smaller multiplier from household handouts but you can do them quickly. You want a mix of quick, less-effective household handouts and slower but possibly higher multipliers through infrastructure spending.

Senator RYAN—I compliment you on your blog. I am a regular reader.

Prof. Leigh—That is very kind of you, Senator.

Senator RYAN—I missed you when you were away for a few months. You mentioned earlier the deadweight cost of taxes—the churn factor being somewhere near 20c in the dollar—I think that is what you said—depending on the type. With the stimulus package involving substantial deficits—in the sense of extra spending that has been being laid over the top of the budget in the last 18 months—that is obviously going to require an increase in taxes in the future, more so than would otherwise have been the case?

Prof. Leigh—Either increased taxes or lower expenditure.

Senator RYAN—Given that the history of the Commonwealth has been one that has been more likely to increase taxes than decrease expenditure, at least in real terms, do you see any risk in the increased taxes being necessary to either fund the debt or repay the debt—even just funding the interest—with respect to what you said about the deadweight costs? Are we looking at an economic loss against what would otherwise be the case, because we have to have higher taxes in the future than we would have without this package?

Prof. Leigh—That seems perfectly sensible to me. At the moment I am looking at page 8 of Budget Paper No. 4. There is a line showing Treasury estimates post-stimulus and pre-stimulus. You will notice two differences: the pre-stimulus Treasury estimate is that the economy would have dropped more rapidly than in the absence of the package; post-stimulus, the impact is that the economy would have grown more slowly than with the impact of the stimulus. I regard this as essentially conventional wisdom.

Senator RYAN—In February, when this package was reviewed by a Senate committee, with the updated economic and fiscal outlook stimulus package, we heard that there was no modelling undertaken of this package. We heard that from one of the deputy secretaries of Treasury. Wouldn't that make it difficult to ascertain whether or not we are, in net terms, better off or worse off in the medium and longer term without such modelling being undertaken?

Prof. Leigh—It is not clear to me what modelling involves in this context. One way of thinking about this is to simply look at the available evidence on multipliers and think about whether or not the package stacked up in that context. There are large margins of error around these sorts of estimates, so anyone who is confident that they can pinpoint to the last billion dollars what impact this program is going to have is, I think, pulling your leg.

Senator RYAN—I appreciate that. It just strikes me that there has been little discussion of what you referred to as conventional economic wisdom—that running up a larger deficit than would otherwise be the case for a stimulus package in the short term will in fact have a long-term economic cost through the need for what is likely to be increased taxation.

Prof. Leigh—Suppose taxes were raised in 2011 and 2012 to an amount equivalent to the size of the current cash handouts, it then follows that growth will be lower in 2011 and 2012 than would otherwise have been the case. It does not follow that our final ending point is going to be lower than would otherwise have been the case. We have moved resources forward in time, we have had a cash injection in the economy, we have avoided a downturn which would have been steeper, and we paid for that later. Certainly the Treasury estimates I have in front of me have that being, on balance, a good deal.

Senator RYAN—Do you have a view, based upon your research, whether or not the Treasury estimates that have returned to what I believe was 4.5 per cent growth—given the history of economic growth rates over the last 40 years—are realistic, optimistic, pessimistic? They are higher than the trend rate of growth, I suppose, and I was wondering if you had a comment on that.

Prof. Leigh—Nothing based on my research.

Senator RYAN—With respect to the multipliers that are involved in stimulus packages, you have mentioned consumer versus business breaks and the Brookings paper. I was wondering if you could provide the reference to that Brookings Institution paper that talks about multipliers, which would be quite handy. The quality of the spend—the way it is termed in Australia—would therefore be an issue, and Senator Cameron has mentioned the Ipswich Motorway that would presumably have a different sort of multiplier than the home insulation $2 billion pink batts program.

Prof. Leigh—The quality of the spending is certainly integral to this. The old Keynesian argument about burying money down mineshafts is going to be at the bottom of your productive measures. Building an essential road would have a much higher payoff.

Senator RYAN—You have undertaken no research other than the household survey on where the money has gone, where the consumer spending has gone, have you?

Prof. Leigh—I have not. There are some slightly more detailed tabulations in the paper, which I am happy to discuss, but that probably does not take us much further in getting to an MPC.

Senator RYAN—Finally, you mentioned earlier in reference to the Brookings Institutions paper that 'business tax breaks', I think was the phrase you used, were at the bottom when you considered the three consumer/government/spending in terms of the multiplier effect. Wouldn't that be particularly determined about what sort of business tax breaks were involved? For example, a long-term cut in business tax that may facilitate a greater profit share which may facilitate greater investment, as we discussed with our previous witness, was a discussion topic in the 1980s, as opposed to tax breaks for behaviour that would already be undertaken, which some may say may happen more often in the US political system than the Australian one.

Prof. Leigh—Senator, I should have been clearer when I was talking about business tax breaks being at the bottom. My read of that Brookings papers is that they are at the bottom of the hierarchy in terms of immediate bang for buck. In terms of sensible long-run policy measures the calculus may well be entirely different. It is certainly not the case that we would want to run a policy which every year mailed cheques out to Australian households. That would then go to the

bottom for the long-term measures. Perhaps some sort of a business tax reform would look very attractive in the long term. It just does not seem to deliver in terms of boosting the economy in a recession.

Senator RYAN—What short of timelines are we looking at when you say short term versus long term?

Prof. Leigh—Most of these multiplier studies are looking in the first six months; some are looking out to a year. That is what I am thinking of when I am talking about short-term impacts.

Senator RYAN—Should the committee and the parliament be concerned with, even when considering short-term stimulus things such as pink batts and memorial school halls, and considering the impact upon productivity, or is it your view that that is irrelevant in the short term and it is a matter of getting cash out? You mentioned earlier that you do some things at different stages because of the different timing of the spend, so to speak.

Prof. Leigh—That sounds like a question which goes to your terms of reference rather than to something which I can usefully answer. I regard those both as inherently interesting questions, however.

Senator COONAN—I am interested in the extent to which you factored into your research the large fall in interest rates. My question is: do people tend to respond to changes in real interest rates? Do they tend to save more or spend more? What do Treasury and the RBA suggest about the response of spending to changes in interest rates?

Prof. Leigh—There is an interesting question out there as to what expenditure is fiscally equivalent to a one percentage point cut in interest rates. I wanted to have that number to present to you today but I just cannot find a good study which answers it. But it is a key question: how do we think about the magnitude of these two policies. I am sorry not to be able to give you a clearer answer. My quick skim of the literature suggests it is not there.

Senator COONAN—I had a number of questions that related to that topic that might not be fair to continue to ask about if you do not have the basic data. I was going to suggest to you that your estimate did not take into account or ignored the fact that the RBA has reduced interest rates over the past 12 months, and I was going to try to get you to disentangle it.

Prof. Leigh—I am happy to go to that specific question. I think this is an issue which is particularly tough if you are trying to tease the signal out of looking at monthly or quarterly data. You then have to take into account changes in interest rates, changes in consumer confidence and so on and this kind of blip upwards that seemed to happen when we avoided a technical recession and the sort of irony that if you avoid a technical recession in some sense that actually helps the real economy. A survey approach like this is not contaminated by changes in monetary policy because it is going more directly to the instrument—what did you do with the money?

Senator COONAN—But it is a critical question if you are looking at the overall evaluation of the effectiveness or otherwise of this package and certainly its short term and longer-term effects. You really do need to be able to look at all of these factors. You cannot really isolate anything in particular on the broader macro view.

Prof. Leigh—I think it is useful to isolate the causal effect of each policy mechanism to the extent that you are able to. Going as precisely as possible to the variation induced by the household stimulus and that impact on the economy seems a worthy exercise. Lumping everything together does have the problem that you really do not know who to give the credit or the blame to.

Senator COONAN—That is half the problem, is it not? It is very difficult. The government, of course, are claiming that they were the saviours. The argument has been that the economy is a complex beast and there are many factors that have operated to ensure that our economy has withstood, perhaps better than most, the economic vicissitudes that have been visited on us. Given the clear signs of economic recovery and the perhaps imminent likelihood of the Reserve Bank moving to tighten monetary policy, I am interested to know why you would think you would continue the expansionary spending in the fiscal stimulus—because a lot has not yet been spent.

Prof. Leigh—That is certainly true. Firstly, I think it is important for politicians not to break promises. I am saying this as a voter rather than as an economist. Secondly, I think fiscal policy is not very well suited to suddenly changing course. It is an ocean liner which takes a lot of time to turn. Monetary policy is our best tool for dealing with quick changes. There is still a great deal of uncertainty over what unemployment is going to be next year and the year after. Were we to see another downturn just after turning off the tap, it would be hard to get the fiscal spending back on, because of these long lags involved in construction projects.

Senator COONAN—Nevertheless, there must be a tipping point somewhere, is there not, where it becomes more costly to consumers and to taxpayers of keeping the stimulus going, particularly at this rate when they are going to cop it in the neck with either reduced expenditure or higher taxes and certainly higher interest payments?

Prof. Leigh—That is certainly true. If this package were 10 times as large, my answer to you would be different in that context—

Senator COONAN—Which package? I am sorry, I keep asking that.

Prof. Leigh—I am sorry. Rather than talking about a $42 billion package, we were talking about $420 billion package, I would quite happily say that we should break faith with the voters and we should turn things off because of the huge debt load that would impose.

Senator COONAN—But even at $42 billion, it is going to cost an awful lot, is it not?

Prof. Leigh—It is an expensive package. It will certainly leave us with debt levels which are low by our OECD standards, however. The typical household takes on debts which are well above their annual income. Australia's debt will be nowhere its annual income.

Senator COONAN—But is that the test, in all fairness? We started off better than anyone else. We would expect, obviously, that whatever happens we would not be taken back to the field. Our stimulus package, for instance, was the third biggest in the OECD, so you would certainly expect that we would not as an economy be comparably worse off in terms of debt than other economies.

Prof. Leigh—That is certainly true. I guess that, by the household test, I do not think this is a terribly large debt burden to be taking on. It seems manageable in the medium term.

Senator COONAN—But isn't the test whether it is necessary, not comparably how large or otherwise it is? Ultimately you have to come back to the fact that we are not spending for the sake of it, surely? You spend if it is absolutely necessary perhaps—that is one argument. But the critical question now is: with the signs of recovery and all of the other indicators that we have talked about during your testimony, and the fact that taxpayers are really going to cop it with rising interest rates and whatever we need to pay off this debt—and it is more like $95 billion, not $42 billion—wouldn't that give you pause for thought?

Prof. Leigh—I guess there are two kinds of mistakes we could have made in this: we could have done too little or too much.

Senator COONAN—Or just right. That is the question, isn't it?

Prof. Leigh—That is true, although I do not think that would be a mistake. It seems that the human costs of doing too little are pretty large in terms of the scarring impacts of unemployment.

Senator COONAN—And too much.

Prof. Leigh—There are also costs in doing too much, in terms of the deadweight burden of taxation involved in returning to a stable fiscal position.

Senator COONAN—And higher interest rates.

Prof. Leigh—Indeed. So there are costs either way.

Senator COONAN—Where is the tipping point then?

Prof. Leigh—What do you mean by the tipping point?

Senator COONAN—The tipping point at which it becomes more damaging than beneficial. You are making a judgment that somehow or other $95 billion is beneficial. Where does it get to be damaging?

Senator BUSHBY—Have a look in the briefing paper. I think it is about $45 billion, isn't it?

Senator COONAN—It is $95 billion.

Senator BUSHBY—In the briefing paper—

CHAIR—That is what it says.

Prof. Leigh—I will perhaps leave the committee to debate over the magnitudes. Certainly our current economic indicators are better than those that you see in the budget papers. This suggests

that, if policymakers knew what we know now, they would have constructed a smaller package. But it is not clear to me that that is the right test. You want to ask: 'At the time the package was put together, was it of the right magnitude?'and 'Is the error so great at this point that it is worth breaking faith and cutting off the spending?'

Senator COONAN—So you would put more faith in the fact that it was a voters' promise than it being a real macro-economic lever that is at play here?

Prof. Leigh—In terms of thinking about 'Should contracts be cancelled?' that seems to me to be an issue of making a promise to voters.

Senator COONAN—It might have been committed, but no contracts might have been signed. In fact, the information I have is that about $20 billion of the $42 billion has not yet been spent. It may well have been committed in some way, shape or form—I am not in a position to put that to you—but I certainly have, from the Assistant Treasurer, that $20 billion has not actually been spent or expended. Does that change your view?

Prof. Leigh—Not in the broad, no.

Senator COONAN—What about the broader package? That is just the $42 billion.

Prof. Leigh—Which aspects do you have in mind in particular?

Senator COONAN—The stimulus package is a very large one. Of the $95 billion, there is $42 billion. Of the $42 billion—before you even get to the third stage of the stimulus, which we have not really talked about here other than in the broadest of terms; your survey has been all about the cash part of the $42 billion—

Prof. Leigh—Indeed.

Senator COONAN—I am saying: even though the settings are all changing with the economy recovering, is it still your view that you should continue to pump this $22 billion of the $42 billion out?

Prof. Leigh—For the reasons I have stated before, yes.

Senator CAMERON—I just want to go to this issue of whether the package is necessary and to the issue of a 'voter promise'. I will go back to September last year, when Lehman Brothers collapsed and the economy went into meltdown. Wasn't that a reason why governments should act and intervene?

Prof. Leigh—Things certainly looked a lot worse at that stage than they do now; that is right.

Senator CAMERON—And it was perfectly legitimate for government to intervene, as governments all over the world did.

Prof. Leigh—Certainly there was a pretty strong movement. Even those who held out initially, I think, eventually moved ahead with fiscal stimulus packages.

Senator CAMERON—On the issue of withdrawing the package too early—now that we have ranged into this wider debate away from the paper that you have presented—isn't it true that the IMF managing director, Strauss-Kahn, has said that 'unwinding the stimulus too soon runs a real risk of derailing' the economy? Similarly, Timothy Geithner, from the US Treasury, has indicated that we do not want to 'repeat the mistakes of the past'—that is, to withdraw stimulus too early. Gordon Brown, Nicolas Sarkozy and Angela Merkel are arguing that the crisis is not over and that we must implement our stimulus plans. Isn't that all a reasonable analysis from these leaders in the world economy?

Prof. Leigh—It is certainly reasonable. The argument is strongest, I think, in the case of the US, where the unemployment rate is still probably climbing and where it would clearly be unwise to withdraw money now. But these things interact. For the sake of our economy, we certainly would not want them to withdraw their stimulus either.

Senator CAMERON—Yes. There is an argument that no modelling was done. Wasn't it reasonable, following the collapse of Lehman Brothers and the economy going into meltdown, for us to act quickly and decisively with the stimulus package?

Prof. Leigh—There is certainly a benefit to getting money out the door quickly. The criticism that is sometimes made of fiscal policy is that it simply cannot act fast enough. So, if policy makers deliberate for a year before putting in place an infrastructure project which takes two more years to roll out, it is very likely that the money will come too late. A quick response, beginning with household stimulus, seems to be pretty textbook.

Senator CAMERON—We have had a debate about the value of Keynesianism in the current crisis. I do not want to go there, because it seems to me that some economists really get their temperature up when we are talking about Keynesianism. I do not know if you are one.

Prof. Leigh—No.

Senator CAMERON—We have been down that path. But there is not just the economic impact but also the human impact. Do economists ever actually think about the human impact? It seems to me that this morning we had this theoretical debate about Keynesianism and not much talk about how the government stimulus package is helping families through the crisis—putting food on the table, educating the kids, paying for transport, having a decent quality of life and not getting thrown out onto the dole. It seems to me that that is a failure in some economic analysis: it is simply on the numbers and not on the human tragedy that 210,000 extra jobs being lost would create.

Prof. Leigh—It is certainly right to focus hard on unemployment. We know that the best predictor of poverty in Australia is not having a job, so trying to minimise job loss is important in the short term and, as I think we spoke about earlier, the long term. If kids experience a period of unemployment early in their careers, you can see that in their wage trajectory and their occupation later on in their careers. They recover, but not fully. I think that is partly due to the loss of skills, the absence of gaining experience and just the psychological impact of the feeling that you are not worth employing. So, to the extent that policy can ameliorate unemployment, I think that should be a top policy goal.

Senator CAMERON—The IMF, in their article IV report in July, said that even with the debt arising from a stimulus package Australia would be in 'an enviable fiscal position by international standards'. Do you agree with that analysis?

Prof. Leigh—It is certainly true that our debt loads will be low by OECD standards. The discussion we had before about the counterfactual is a reasonable one to have but, when we compare ourselves with our rich world colleagues, the debt burden looks good.

Senator CAMERON—Good. Thanks.

Senator BUSHBY—I have a couple of questions that follow some of the discussions that we have had. Senator Cameron asked about the need for action after the collapse of Lehman Brothers last year, and you gave an answer to that. Is the stimulus package, in terms of its size and structure as implemented by the government at that time, the only option that the government had? Could the government have implemented a package that had a different size or structure and still have achieved similar outcomes to what it was trying to achieve? Could it have implemented other measures, like taxation measures, or allowed monetary policy to be used to a greater extent? There were a range of tools available at the time that could have been utilised and it did not have to be a package of that size with that structure, did it?

Prof. Leigh—Absolutely. When putting these packages together there are a variety of reasonable ways of doing them. You could imagine a package that had more infrastructure spending, which would have had a smaller short-term bang but perhaps a larger long-term impact, or a package that was only household stimulus that went off very quickly but did not have a very large multiplier, or a package of tax rebates rather than direct cheques, which has been the US style. Some have argued that these should have been permanent tax cuts. The difficulty with that is that it does put you into a fiscal position which is pretty hard to unravel unless you are willing to make some hard choices on the expenditure side.

Senator BUSHBY—Nonetheless, the government had options and it has taken only one of those options.

Senator CAMERON—Doing nothing was what you wanted.

Senator BUSHBY—To respond to Senator Cameron's interjection, the point I am making is that to have not implemented this package does not necessarily mean the government had to do nothing.

Prof. Leigh—There are certainly a range of judgment calls to be made in putting these sorts of packages together.

Senator BUSHBY—To defend economists in general, I have got an economics degree—

Senator CAMERON—You are an economist, aren't you?

Senator BUSHBY—I have an economics degree, Senator Cameron, but I don't claim to be an economist. Isn't all economic analysis ultimately about the human impact in the end? That

aspect might not be apparent in the terminology that is used, but it is ultimately all about delivering the best hope of improving incomes for the people involved in that economy.

Prof. Leigh—That is certainly true. We are also thinking about a balance between distributional concerns and equity concerns. Just focusing on GDP growth figures may miss a widening gap between the rich and the poor or a group which is being left behind. But if you are focusing both on distributional and efficiency concerns you are getting to the human impact.

Senator CAMERON—Thank you.

CHAIR—Senator Xenophon, are you on the line?

Senator XENOPHON—Yes, I am here. I would like to ask a couple of questions to Professor Leigh about the delivery of the household payments. It is reported that 40 per cent of households have spent it. Are you saying $4.8 billion of the $12 billion has been spent, or is it an amount less than that in your estimation?

Prof. Leigh—My estimate would be that $4.8 billion is a lower boundary for the two-quarter impact. My best estimate of the one-quarter impact would be $4.8 billion. Over the second quarter you would expect that number to rise somewhat.

Senator XENOPHON—Are you saying that would be more effective than tax rebates when you look at the US statistics?

Prof. Leigh—There are two questions there. The spending rate in Australia was higher than the spending rate for comparable packages in the US. My reading of the evidence is that business tax cuts have a lower pay-off, but I do not think I meant to argue that tax rebates have a greatly different impact.

Senator XENOPHON—I will just go to the delivery of the household payments. In Taiwan's stimulus package they had a voucher system that had to be spent in a certain time. The information I have got is that, within a fairly short period, about 78 per cent of the handouts to households were spent. Would a voucher or debit card system be more effective in ensuring that consumers were spending the money in the economy on goods and services rather than hoarding it?

Prof. Leigh—Certainly a voucher system ensures that all of the money you give out directly gets spent. It does not prevent crowd-out, however. It does not prevent the problem that I use a voucher to buy a product I was going to buy in any case and therefore do not increase my total spending. My guess is that from a policy point of view this is tougher to put together because the required infrastructure is not immediately in place. That would have presumably been a factor bearing on policymakers' minds in Australia.

Senator XENOPHON—Sure, but in a perfect world, if you could have a debit card system so that it is spent on goods and services, you would see a better bang for your buck in terms of the spend?

Prof. Leigh—I suspect so, Senator. If you thought that we were going to be putting these kinds of packages together every five years you could perhaps think about setting up some sort of infrastructure that will allow this to be done quickly. I do not think that anyone thinks that is likely however.

CHAIR—Surely there is nothing wrong with people paying off debt though, which a lot of people did in fact, didn't they?

Prof. Leigh—There is certainly nothing wrong with it, just as there is nothing wrong with people saving the money and putting it on the mortgage, which is what I would have done if you had given me a cheque. But in terms of getting the immediate fiscal stimulus, one wants this money to be spent for the sake of the economy—the old paradox of thrift.

CHAIR—But you could argue that by paying off debt or mortgages that frees up more of their regular income to be spent in the economy.

Prof. Leigh—That is certainly possible. These kinds of crowd-out issues can go either way and it was one of the tricky things of trying to judge with the survey. When I say I 'spent it', am I saying that I spent it and therefore did not spend other money? When I say I 'saved it', am I saying that I saved it so that I could then spend other money? It is pretty tricky and it is the reason I prefer the expenditure approach, but I could not implement it here.

CHAIR—That is an issue in terms of the way your surveys or other surveys are constructed that it does not look for secondary expenditure.

Senator BOB BROWN—You may have noticed that the Greens had most of cheques reduced from $950 to $900 by agreement with the government in return for make work schemes, heritage schemes and so on. Have you got any comment on whether that was a good move?

Prof. Leigh—If we could possibly depersonalise it, I would feel a little better. My read of the literature and active labour market programs is that wage subsidies are more effective than direct job creation schemes. But we do not have a great deal of high-quality evidence on how best to create jobs in the Australian context. It would be nice to have some really rigorous studies and randomised trials that compared wage subsidies, direct job creation and training, which are the three main things we think about doing in a downturn.

Senator BOB BROWN—Do you think in the light of events that reducing the $12 billion or so that went in the so-called 'cash handouts' by $340 million has made any material difference to the outcome?

Prof. Leigh—As a percentage of $12 billion it is fairly small so that you would expect that as the percentage of any outcome it would have a fairly minor deleterious effect.

Senator BOB BROWN—What I am trying to get at though is that you are indicating that maybe we are on the positive side of spending in that the economy is in a better shape than we expected. The logic of what you are saying therefore leads me to be putting the proposition that maybe it was a good thing that some of that money did not go into cash handouts but has gone into longer-term benefits in terms of infrastructure and job creation.

Prof. Leigh—So this is the argument: that we should be applauding anyone who managed to shave off some money in the original package?

Senator BOB BROWN—As it has turned out. I understand your argument that at the time it was right, but with hindsight now I am asking about that.

Prof. Leigh—That does come back to my view on direct job creation programs, and it is a somewhat dim view of the efficacy of those programs. I do not know these particular programs and I do not know whether they have been robustly evaluated. My general read of the literature makes me somewhat cautious on such programs.

Senator RYAN—Looking at the difference and comparing the US to Australia spending figures, which as a percentage figure is roughly 20 versus 40 per cent—and I do not know whether there is any historical comparison other than the ones that you have spoken about and the ones that I have been able to gather from the paper—could those sorts of things also be explained by different national factors? In Australia, for example, there is a larger social safety net. In the United States if you thought you were at risk of unemployment, with a less intense social safety net, you might be more inclined to save. Could those sorts of factors play into explaining part of this difference? Are we comparing, as much you can compare, different sorts of apples?

Prof. Leigh—It is the question I puzzled over most in this paper: why the lower spending rates in Australia than in the US. It is not true that US payments have always got a low spending rate though. The 1964 and 1982 short-term tax cuts had a 50 per cent spending rate. A 1992 change had a 43 per cent spending rate—

Senator RYAN—But they were tax cuts as opposed to rebates, weren't they? That does play into the potential—rebate this year, tax rise next year—

Prof. Leigh—Indeed, that is certainly true of the 1964 and 82. I thought that the 1992 change had a temporary character to it, but my memory is a little hazy on that one. Certainly the arguments you make are plausible, though a little depressing if you are a fiscal policymaker in the US.

CHAIR—Thank you very much, Dr Leigh, for your expanded presentation beyond your surveys. We are waiting for Sinclair Davidson to advise us whether he will be available in person or by teleconference.

Senator RYAN—He has landed in Sydney.

CHAIR—I know that but, if he cannot get up here, we will have to hear him by teleconference.

Proceedings suspended from 11.56 am to 1.12 pm

DAVIDSON, Professor Sinclair, RMIT University and Institute of Public Affairs

Evidence was taken via teleconference—

CHAIR—We will resume proceedings. Welcome, Professor Sinclair Davidson. Would you like to make an opening statement?

Prof. Davidson—Thank you, and I apologise for the change in plan.

CHAIR—I understand that, and we apologise to you for the inconvenience.

Prof. Davidson—You should have before you a 29-page document which sets out a submission. It contains a number of different bits and pieces and studies, which I have undertaken in the last while with my colleague, Ashton de Silva, also of RMIT University, to have a look at the impact that the stimulus package is actually having on the economy. Before I talk through the document, if I could just remind the Senate what I said in February of this year when I was speaking to the inquiry into the stimulus package before it was undertaken—certainly the second stimulus package—I made a number of points. The first point I made was that there was a lot of spending and little actual stimulus and the second point was that this was very poor quality expenditure of taxpayer funding and that fiscal policy has a very poor track record. I think nothing has happened since February to cause me to revise my opinion, and as a matter of fact if we think that the majority of OECD economies have all undertaken massive stimulus packages and, with the exception of Australia, have tended to go into recession, I think we can add this incident to the continued poor track record of fiscal policy timing the economy.

The other point that I made was that this particular stimulus package, or certainly the $42 billion stimulus package, consisted of a great deal of government spending a dollar, any dollar, on any project. Of course we realise that there are going to be teething problems in any particular project but I think the almost daily revelations of extraordinary waste, which the *Australian* has been very good at highlighting, simply goes far beyond teething problems. We have actually seen a very poorly implemented policy of a substantial amount of taxpayer money that has basically, to a large extent I believe, been wasted.

Then to the current inquiry, I have to say that the argument that the stimulus package has worked on face value appears to be extraordinarily powerful. Australia is the only OECD economy that we have data for that has not officially entered into recession. If you have a look in my submission at figure 1 on page 5, we actually see a graph of the size of the stimulus packages that have been unveiled across several economies and then the GDP growth to the June quarter of this particular year.

There we see that there is a single economy that has done particularly well, and that is the Australian economy, with positive growth. All the other economies have got large negative growth. If we look at that diagram, we see that there are about seven economies that have stimulus packages in excess of three per cent of their 2008 GDP. So, if people want to argue that the Australian stimulus package has prevented the Australian economy from going into recession, they would also need to explain why those other economies with similar sized

stimulus packages to ours have not gone into recession. So I think we need to look beyond the stimulus package and to look at other things that could possibly have contributed to the Australian growth which we have seen over the last year or so.

I want to jump over whether this is the greatest crisis since the Great Depression—it certainly is not the greatest crisis since the Great Depression in Australia's sake—and have a look at some of the other arguments that have been made to suggest that the stimulus package has been successful. The argument that we heard a lot of quite early on was that retail sales in Australia had held up very nicely and this was due to the government's first stimulus package in December of last year where they spent $10 billion, of which about $8 billion went in cash handouts. Of the second stimulus package, about $12 billion went in cash handouts. So, all up, we have had about $20 billion in cash handouts. A lot of people argued that the benefit of a cash stimulus was that the money would be quickly spent and we would see the numbers coming through in retail sales.

Unfortunately, the ABS stopped publishing their trend data in November last year. But if we have a look at the figures, we see that the retail sales figures do appear to be quite high. An analysis undertaken by Tony Meer of Deutsche Bank—and reported at Peter Martin's blog and then in the *Age*—tends to suggest that retail sales were far in excess of what we might otherwise have thought. But Ashton and I have undertaken an analysis of the retail sales, and our argument is that, simply by extending the ABS trend data—which they stopped doing in November last year—and putting in another very commonly used trend figure, retail sales trends are not unusual at the moment and retail sales are at about trend. So the argument that retail sales are unusually high and this is due to the government's stimulus package cannot be sustained on that particular type of analysis.

But the other thing that we did—which is a far more powerful test, I suggest to you—is that we undertook a forecasting exercise and we imagined that we were back in May 2008. If you recall, in May 2008, everybody was suggesting that the Australian economy was doing very well. The Reserve Bank were raising rates, they had a tightening policy and people were talking about decoupling and all that sort of stuff. So everybody in May 2008 suggested that the economy was going very, very well. So, if we had stood in May 2008 and tried to forecast retail sales out into the future, what would we have found? If you look at our figure 6 on page 12, you will see the results of that particular exercise. The black line represents actual retail sales, the dotted green line represents our forecast and the red lines represent the upper and lower 95 percentile figures. You will see that, by and large, the actual retail sales is within a 95 per cent confidence band of what we would have expected in May last year—which again suggests to us that retail sales are not that unusually different from what they might otherwise have been if we could forecast this from almost over a year ago.

The other alternate argument is that the government so finely calibrated its stimulus package that it returned sales to what they otherwise might have been. That is an argument but, given the exchange between Senator Joyce and Dr Gruen on 22 October in the *Hansard*, I suggest that is not the case. Senator Joyce asked if there had been any formal modelling undertaken of the stimulus package and Dr Gruen indicated that there had been no modelling. So, to the extent that the stimulus package has actually returned sales to where they would have been, that would be a pure luck argument, and certainly Ashton and I do not believe that to be the case at all.

We have also had a look at unemployment. The argument has been made that if it were not for the stimulus package, unemployment would have gone through the roof. There seems to be a powerful argument for this case. In May of this year the government was forecasting an 8.5 per cent unemployment rate by the end of the financial year and at the moment we are 'only' at 5.8 per cent, which is a level last seen in October 2003, so it would appear that we have done a lot better. But, if we have a look at the overall OECD report, unemployment has not actually risen very much across the entire OECD. There are a couple of standout economies—the United States, Canada and Spain, for example, have all had massive increases in unemployment—but, if you look at figure 7 on page 14 of my submission, you will find that in most of the OECD unemployment has obviously increased, and that is not a sign of success; nonetheless, it has not increased that much. But unemployment has increased quite a lot in Australia compared to other OECD economies, so it is a bit hard to point to the unemployment figure as being an indicator of success.

The other thing that we have done is plotted the size of the stimulus package against the increase in the unemployment rate, and we see that Australia has a very large stimulus package but a very underforecast increase in the unemployment rate. If you look at figure 8 of our analysis, you will see that it would seem that there is a lot more to the performance of the Australian economy than the stimulus package. In recent weeks a variable called 'hours worked' has been considered. If you look at figure 9, which has been shown around the traps quite substantially, you will see that hours worked do seem to have peaked in the middle of 2008 and fallen quite substantially over the last two-year period. Ashton and I plotted that entire time series from July 1985 through to August of this year and put a very simple linear time trend through that number. We found that over the last few years the hours worked has been above trend and over the last year or so has simply reverted back to trend. There is nothing unusual in that to suggest that unemployment would have gone through the roof, that hours worked would have massively exploded or anything along those lines, so again it does not appear that the stimulus package—certainly when we look at unemployment and retail sales—has worked as was advertised.

At the time when the spending packages were announced there was a bit of a debate over whether the packages would be saved or spent. This is quite important because at the time the policy advocates were saying that, if you gave a lot of money to liquidity-constrained individuals, they would very quickly spend the money and this would get money moving through the economy—and the goal of the policy was for money to be spent very quickly. A number of US studies have been done—and there is also now an Australian study by Professor Leigh, who I understand you spoke to this morning—and in these particular studies it looks as if a fair amount of the money was actually spent—it was normally about 40 per cent or so—but that the vast bulk of the money tended to be saved in one form or another. In his study, Professor Leigh found that about 40½ per cent of the money was spent and about 59½ per cent of the money was actually saved. This is in line with US studies, and we know that the stimulus packages in the United States have failed, so we would anticipate that the Australian study would indicate that we had failed as well and that the money was not in fact spent; it was mostly saved. If you have a look at the Australian Bureau of Statistics data at figure 11 on page 20 of my submission, you will see that household final consumption expenditure has tended to trend upwards in a nice smooth line and household disposable income shows a bit of a kink in it where the stimulus package money was received. But there is no corresponding kink in the consumption figure, so basically the money has not really been spent; it has mostly tended to be

saved, which is what we would have expected to have happened if we had some sort of real income hypothesis going along. That is much the same result as you find in the United States.

Finally, on the studies we have done: we have got access to the Oxford economic forecasting model, and we are the only Australian university to have access to this forecasting model. What we have done is to audit the budget assumptions. There was a lot of talk around about May when the budget came down that the government was forecasting too high a GDP rate and was forecasting too quick a decrease in the unemployment rate. So we have relaxed the very unrealistically high assumptions that we believe that the Treasury and the government have made in their modelling and had a look to see what happens to federal debt if we relax those two assumptions. On figure 12 on page 21, we show a historical figure which indicates the net debt of the Commonwealth since 1970 and up until the present, and then forecast out three or four years. We also have the underlying budget cash balance.

If you have a look at the net debt position, you see that net debt very quickly spikes up on a number of occasions but it tends to come down quite slowly. The Commonwealth went into a positive net debt position in the mid-1970s and only returned back to a negative net debt position in the mid-2000s. So for all that period the Commonwealth actually had a positive net debt position.

Public debt has the effect of crowding out private investment and increasing interest rates. So we would have expected Australia to be paying slightly higher interest rates than it would be if it were not for that net debt. Certainly I think a very low, negative net debt position is prudent fiscal policy, and a balanced budget. Again, if we have a look at the budget figures, we see when the budget balance goes into deficit we see a slow recovery from deficit positions. We do not actually see very quick recovery. The historical evidence, we need to suggest, is that the economy recovers slowly from deficit and debt is actually quite difficult to eradicate in total.

I will jump over some of the gory details, but if we have a look at figure 13 on page 23, the government is forecasting that the economy will start growing at 4½ per cent very soon. What we have done there is to actually tabulate annual growth rates in GDP, and we show those instances where the economy has actually grown at more than 4½ per cent or at 4½ per cent, and what we find in recent history is that this is actually quite a rare occurrence. Even if you believe that there is such a thing as the mining boom or the China boom, or whatever you want to call it—which Ashton and I do not believe—even during the so-called unsustainable boom period of the 2000s, the economy was not growing at 4½ per cent. So it is very unlikely that it could do so again.

The government are also forecasting a massive decline in unemployment over the next budget period. In figure 14 we show historical data as to how slowly unemployment declines from peaks. We have all heard the term ‘jobless recovery’ and that term actually exists for good reason. The economy recovers far exceeding the decline in the rate of unemployment. We have actually calculated more plausible decreases in the unemployment rate and, over the government’s forecast period, they suggest that unemployment will be down to 6.5 per cent. We say, ‘If your history is any guide, it would actually be only 7.4 per cent. Luckily, unemployment has not reached that level just yet. Nonetheless, we are auditing the budget papers and we throw the government’s numbers into the Oxford economics model and we solve the equations. If you look on page 28, figure 16, you will see that over the period to 2012-13, we believe that there

will be nearly $40 billion more net debt than the government has actually indicated in their budget papers, using the far more realistic approaches to how fast the economy would grow and how quickly unemployment would decline—which are contained in the budget papers, which are the most up-to-date official forecasts we have of the economy right now. This indicates that net debt per capita, or debt per capita, would not be about $8,500, which the budget papers suggest but would be over $10,000 per Australian. On the current budget settings, the government would actually incur a great deal more debt than they have indicated in the budget papers.

This then brings us to two very important issues. One is the argument that this is the greatest crisis since the Great Depression. That is extraordinarily misleading, especially in the case of Australia. Unemployment during the Great Depression in Australia for trade union members rose to about 29 per cent. Unemployment in Australia today is 5.8 per cent. To be sure, 5.8 per cent is unacceptably high, but it is nowhere near the 29 per cent figure that we experienced in the 1930s. Similarly, the Australian economy fell, GDP fell, for several years from the late 1920s all the way through to the early 1930s, whereas, over the current crisis, we have had one quarter of negative growth—again, nowhere near the kind of economic turbulence which we might have expected. And it is almost the case in the United States that it is not the greatest crisis that they have faced since the Great Depression—that is only true if you exclude the economic downturn in the late 1940s. So it is a fine piece of rhetoric but it is simply not at all economically accurate.

Finally, why has the Australian economy performed well compared to many of the other economies? The first thing to bear in mind is that the subprime crisis and the financial crisis have affected Australia from the outside. Our financial institutions are basically very sound. We have had a deregulated labour market for a while. Over the last 20 years labour markets have been steadily deregulating. We have had a deregulated financial market. So the exchange rates took a hit. The stock exchange took a hit. People reorganised their labour market conditions. The Reserve Bank of Australia lowered interest rates by 4¼ per cent very quickly. So our economic institutions of civil society, the market mechanisms, the government mechanisms, all of these mechanisms, actually worked very well to cushion the Australian economy, and they worked in precisely the way they are supposed to have worked.

So we have done well because we have had 25 years of hard-earned, hard-fought-for economic reforms, and that has cushioned us from the external shock to the economy. This is what economic reform is supposed to deliver. And I want to really emphasise that we have not done well through good luck. We have not done well through China. We have not done well through the mining boom. We have done well through our own efforts to improve our economy and to liberalise our economic conditions. So why we are doing well has nothing to do with factors external to the economy. It is certainly not the government's stimulus package and it is not good luck that we have done well.

CHAIR—Thank you very much. We will now open the meeting up to questions to you from the senators, beginning with Senator Brown who made this reference.

Senator BOB BROWN—Thank you, Professor. You said at the outset that the massive stimulus package has been common to OECD nations and yet they have all, except Australia, gone into recession.

Prof. Davidson—Yes.

Senator BOB BROWN—Isn't it the other way around—that they were all headed into recession and therefore they had a massive stimulus package?

Prof. Davidson—The stimulus package was actually designed to prevent the recession from occurring. So, yes, they realised there was economic trouble and they instituted these massive stimulus packages, and the stimulus packages have failed to prevent recession.

Senator BOB BROWN—And you can titrate that to say that, without the stimulus package, the recession would have been the same—it would not have been any worse; the economies would have been affected in the same way?

Prof. Davidson—I would probably titrate it to say that, over time, if it were not for those stimulus packages those economies would perform better in the long run.

Senator BOB BROWN—Yes, but we are looking at the impact in the short run here as well.

Prof. Davidson—In the short run I would certainly say that those stimulus packages have done nothing to prevent those economies from going into recession. That was the policy objective and, if so, that policy objective has failed.

Senator BOB BROWN—In Australia's case, the performance of the Chinese economy has done nothing as well, you say?

Prof. Davidson—No, I would not say that the performance of the Chinese economy has done nothing. I would say that, if we had not had entrepreneurial foresight, if we had not had people who had put in, who had prospected, who had put in mines, who had ventured their capital in order to sell stuff to the Chinese, we would not have prospered at all. So it is not through luck that we have prospered by selling to the Chinese. You cannot fatten the pig on market day. You actually have to prepare, work, invest and take risks.

Senator BOB BROWN—But you have to have a market as well, don't you?

Prof. Davidson—Yes.

Senator BOB BROWN—You point out that it is not the greatest crisis—there was a deeper one in the early 1940s—since the Great Depression. I just want to hear this again. You say that the stimulus packages around the world have not had an impact on lessening that crisis?

Prof. Davidson—Yes. We need to be clear: the world economy is facing a crisis. The stimulus packages have done nothing to eliminate those crises.

Senator BOB BROWN—Thank you, Professor.

CHAIR—Professor, I would like to ask you a question about the Chinese issue. Surely the fact that, whether we like it or not or whether it was due to entrepreneurship in the past or not, the Chinese economy picked up and they began to buy large amounts of iron ore again, and coal,

I presume, must have made a contribution to our balance of payments in terms of trade and cushioned Australia somewhat through the difficulties the world was experiencing and which we were as well.

Prof. Davidson—Having our trading partners perform well is always good for the Australian economy. But I think to make the argument that the Australian economy is now one of the world's wealthiest economies and that our economy is doing well simply because one of our trading partners is doing well is not entirely convincing. The Japanese are, I think, still bigger trading partners for us than the Chinese. The Americans are still bigger trading partners than the Chinese. I think to 'blame' or to attribute everything that has happened to the Chinese economy is simply not giving sufficient credit to the entrepreneurial behaviour of Australians and, of course, to the economic reform that Australian governments have undertaken over the last generation.

CHAIR—We do respect the entrepreneurial spirit of Australians and we do respect the reforms that were put in place; nevertheless, I would have thought that—regardless of the fact that the Chinese have a large trade largely in manufactured goods with the United States, I think, and with other places—the fact that they have continued to buy our minerals did provide some balance and assistance to the Australian economy.

I see that the IPA is of the view that tax cuts might have been a more effective way of dealing with the crisis, such as it was. Would you explain that point of view to the committee?

Prof. Davidson—First of all, I want to say that the IPA has no formal views on any issue.

CHAIR—My apologies—Alex Robson, then. I notice in one of your documents you refer to that.

Prof. Davidson—Yes. At the February Senate inquiry into the implementation of the stimulus package I made two arguments. The first was that, if the government wished to actually stimulate the economy, and to prevent unemployment from rising and all those good things, they would buy out the payroll tax of the state governments. My view was that state governments are very financially fragile because the Commonwealth has taken all the best taxes for itself and that the state governments, which provide the bulk of services to the Australian people, would actually be quite hard hit by the crisis. So buying out the payroll tax would have the effect of giving money to the state governments and at the same time taking out a disincentive to employment for employers.

Combined with that, I made the argument that there should be a GST tax holiday, whereby corporations could continue to either administer the GST and keep the 10 per cent, which would flow straight down to their bottom line, or, conversely, lower their prices by 10 per cent. I suggested that could even be targeted at people who do not actually get the payroll tax cut.

The empirical evidence suggests that tax cuts have a bigger impact on the economy than do government spending initiatives. Economic theory suggests, of course, that government spending would have a bigger impact than tax cuts. But, as we now know, economic theory does not always work as well as economic experience. The empirical evidence suggests that tax cuts

would have been far more valuable from a stimulus perspective than would have other spending. My suggestion at the time was that this be aimed at the payroll tax and at the GST.

CHAIR—Thank you. We all agree that payroll tax is very pernicious, but your colleague Alex Robson put forward a proposition about income taxes.

Prof. Davidson—Yes, last week he put forward the proposition that instead of the government borrowing and spending the money, if they had had a tax cut of—I think he worked it out to be about $96 billion that the government has spent one way or the other, and that that money would be better given as a tax cut. At the margin, a tax cut would be better than a spending initiative. Bear in mind, however, that those tax cuts would be just as unfunded as would the spending, but nonetheless it would allow individuals to spend the money in better ways than those in which the government would spend the money.

Senator HURLEY—It does seem to me that you have started with a proposition that business and the market will manage things better than the government, and have organised your statistics to prove that. For example, where you were talking about the aggregate monthly hours and how they are simply returning to trend, you say that that proves that government spending has had no effect on unemployment, and yet you go on later in the paper to say that unemployment should go up to 7.4 per cent, so we have not yet finished with this. Whether the government is right or whether you are right on unemployment, we have not yet finished with an assessment of how monthly hours worked goes back to trend or not.

Prof. Davidson—First of all, it is not just my opinion that markets work better than governments. It is bitter experience of the 20th century. We know full well that governments fail—

Senator HURLEY—I do not want to get into this theoretical argument.

Prof. Davidson—Yes, I understand. My statistics all come from the Australian Bureau of Statistics. Those hours worked are their numbers, and all I have done is apply the time trend. The 7.4 per cent that you refer to is when I am actually auditing the government's budget papers. If you have a look in the submission, I make the argument that we are not providing our own forecast of the economy. On page 20 it says:

In this section it is important to note that we are not providing a macroeconomic forecast of the Australian economy, we are auditing the underlying assumptions in the Budget Papers.

So what we have done—

Senator HURLEY—So do you or don't you agree that unemployment may not have finished trending one way or the other?

Prof. Davidson—It may or may not have. It all really depends on the government's fair choices legislation because when you re-regulate the labour market, we expect unemployment to increase. I would have thought any increases in unemployment are simply the government's delivering on an election promise from the last election.

Senator HURLEY—That just confirms my view that you are starting from an ideological viewpoint and looking for ways to put statistics in a way that confirms that.

Prof. Davidson—You are entitled to your opinion, Senator, but I am just an economist and I am telling you what would happen if government follows particular strategies.

Senator HURLEY—Right. You were talking about how the past 25 years of hard won economic reform have put us in the position where we are, rather than the government's stimulus package. I would say that a part of that economic reform in the last 25 years has included, apart from the Howard government years, a steep increase in productivity in Australia.

Prof. Davidson—Yes, I have would totally—

Senator HURLEY—I would also say that a lot of what is included, clearly not the cash part of the stimulus but the infrastructure parts, will contribute to that productivity in the future and therefore set us up again.

Prof. Davidson—No, I totally disagree with the argument there. Certainly the school halls seem to be the most extraordinary waste of money that we have ever seen in our lifetimes. The *Australian* reported that $850,000, I recall from memory, was being spent on a single-pupil school and nobody thought to think why would we even think about giving this kind of money to a single-pupil school let alone actually give such an amount of money to a single-pupil school. And in today's *Australian* we read that they are spending $2.45 million on a school hall for a school that already has a hall, which will give it an extra 30 square metres of space, but nonetheless most of the kids will still have to stand outside. I cannot believe for one second that this is productivity enhancing expenditure.

Senator HURLEY—If you had been at Senate question time, you would have heard many of the articles in the *Australian* comprehensively taken apart and proved to be wrong. But even if we accept that, the examples in the *Australian* have been a small part of what is being spent in the stimulus. I do not really think you can—

Prof. Davidson—You may well be right, it may be a small part, but it is the tip of the iceberg.

Senator HURLEY—I do not think, Professor Davidson, that you could argue that the infrastructure spending on education and transport and health that the government has done will not contribute to productivity in some way.

Prof. Davidson—I would be very surprised if a primary school hall where kids have already got one, discounted back to the present at any reasonable discount rate, would add to the productivity.

Senator HURLEY—If that is the best argument you can raise about the total infrastructure spending, Professor Davidson, I will hand over to someone else.

CHAIR—Before I hand over to Senator Ryan, I just want to say that in my remarks I said that the American trade with China was largely in manufactured goods. Of course that trade has collapsed because the Americans and Europeans are not buying.

Prof. Davidson—If I can just add to that: value added for mining in Australia is less than 10 per cent of GDP. It is not a big number.

CHAIR—It is very nice to have it, though.

Prof. Davidson—It is better than nothing.

Senator RYAN—You mentioned in your answers to a couple of previous questions the issue of the increase in government debt, and I just wanted to explore that for an issue. We heard this morning from Dr Kates and Professor Leigh that one of the things that should be taken into account is the cost to the economy, deadweight or otherwise, of the increased taxation necessary to pay for either the servicing of the debt or the repayment of the debt given that all of this has been funded by borrowed money. Do you have a view on whether or not that should have been considered in the development of this package?

Prof. Davidson—Yes, it very much should have been. Professor Kevin Murphy of Chicago university has set out a very nice model. He says in order for a stimulus package to work, you have to consider the benefits of the stimulus spending compared to the deadweight losses of the taxation and the inefficiency of government spending. As I indicated before, and with my exchange with Senator Hurley, the government spending has been extraordinarily inefficient and the deadweight costs of additional taxation can be quite high. People estimate between 20 and 80 per cent for a deadweight cost, so it can be very high. And you would anticipate that that would be included into any cost-benefit analysis undertaken of the spending.

Senator RYAN—And so it is therefore a fair conclusion to draw that due to the increased burden of taxation that will be necessary in the future, compared to what would have been the case without this package, that there will be a medium- or long-term cost to the economy—

Prof. Davidson—Yes, absolutely.

Senator RYAN—as a direct result of the borrowing used to fund this package?

Prof. Davidson—The costs will occur in a number of ways. First of all, increased mortgage rates on all Australians. Even the OECD have come out and said for the Australian level of net debt, even if we just believe the government's numbers, that should add about a quarter of a per cent to our borrowing costs in future. Then of course there is the fact that government debt crowds out personal investment and private investment. So we would see a distortion in the economy away from the future and towards the present, which would mean that we will probably be underconsuming in the present and underinvesting into the future. All of this is due, in large part, to the effect of government debt. Government debt has a very, very deleterious impact on the economy.

Senator RYAN—That brings me to the point: comparing the way Australia has dealt with this particular global challenge with the so-called Asian crisis of the late 1990s and the US recession of the early part of this decade, would you consider the fact that Australia's budgetary position was in a strengthening phase—our debt position was falling at that time—along with other factors, was instrumental in Australia weathering those particular downturns without suffering a notable economic downturn itself?

Prof. Davidson—I think, for the present, that the fact that Australia went into the current crisis with no debt and with a strong budget surplus has been an important part of weathering the storm. As to the weathering of the storm in 1998—at that time we had a budget deficit and we had a lot of government debt—the impact in Australia was quite well cushioned by the exchange rate and the fact that the monetary authority did not increase interest rates like the New Zealand monetary authority did. It was the consequence of reforms taken by the Hawke government that was instrumental in the East-Asian crisis. In the early part of this century, to a large extent, it was because we were perceived to be an old economy; we were not a dotcom economy. The monetary authorities lowered interest rates very quickly but then, very importantly, raised interest rates again once it was clear that the crisis had passed. So it was Australia's reform processes working, and we have seen that again this time.

Senator RYAN—Do you consider that the approach underpinning this package and the package itself represents a seismic or otherwise significant shift in the way Australia has managed its economic policy since those reforms you mentioned of the early- and mid-1980s, where there was a focus on reducing government debt, trying to get to a budget surplus or a smaller deficit and increasing the business profit share of the economy?

Prof. Davidson—Yes. It is my opinion that the underlying logic of this current stimulus package is certainly a backward step, not only for Australia but for many other economies around the world. Professor Buchanan, who was a Nobel Prize winner in 1986, has made the argument that democracies have an inherent bias towards debt and deficit, and I had hoped that Australia had moved beyond that. Nonetheless, we have actually gone back into a world where, rather than letting the economic institutions—the market and those government instrumentalities such as the Reserve Bank and what have you—actually operate and let the automatic stabilisers operate, an activist fiscal policy has been adopted. I think that is very much a backward step.

Senator RYAN—Regarding your audit of the government's budget assumptions and estimates, which I think was a topic back in the earlier hearings into the stimulus in February, the issue of the projected 4.5 per cent growth, or the very rapid return to above-trend growth, was discussed. That is substantially above our historic average of growth, isn't it?

Prof. Davidson—Yes. That is above our historic average and it is certainly not something that we have experienced much of since the 1960s. There have been four episodes since the Hawke government came along. It is not at all plausible to believe that we would maintain rates of growth above 4½ per cent, especially when our trading partners are in deep recession and are going to recover slowly.

Senator RYAN—Would it be fair to say that, given the debates of the middle of this decade, where growth numbers beginning with three were considered to be inflationary and leading to skills shortages, which some of us considered to be a good thing because there was low unemployment, that a sustained growth rate of 4.5 per cent would pose serious inflationary threats?

Prof. Davidson—It would depend on other policies that government were actually operating. It might do but I would have thought that the Reserve Bank would quite strongly keep a lid on inflationary expectations. It might do but I cannot be totally sure. It would depend on what else was happening in the economy.

Senator RYAN—We heard earlier today that this package has a potential inflationary aspect to it. Do you have a view on that statement?

Prof. Davidson—I would have thought, given the qualitative easing which may have occurred and given the fact that the Reserve Bank may have compromised the quality of its balance sheet, that there may well be inflation down the track. I think the ball is very much in the Reserve Bank's court. If it will accommodate the amount of spending which the government has undertaken and is continuing to undertake then inflation can arise out of all of this. My hope is that it will not, but of course getting rid of that inflation in the system would imply higher interest rates.

Senator RYAN—Do you see there being a risk from interest rates rising at the same time as aspects of this stimulus package are being rolled out—for example, over the next 24 or 36 months—where there seem to be expectations in the market and otherwise that interest rates will start to tighten in the second half of this year? This stimulus package will keep stimulating, allegedly, over the next 18 to 24 months.

Prof. Davidson—There is always a problem when you have monetary policy and fiscal policy out of whack with each other. You get horrendous inconsistencies that do need to be managed very carefully. I would have thought that, if the economy is doing well, the stimulus package would need to be wound back.

Senator RYAN—What are some of the consequences of interest rates and monetary policy being tightened if a stimulus package is not wound back?

Prof. Davidson—I would have thought we will start seeing various distortions in the economy. Employment would be attracted to those areas of the economy where the stimulus package is operating—construction, education, health and these sorts of things, where at the moment there is no unemployment—and would be allocated away from those areas of the economy where inflation would be hitting hard. As the stimulus package unwinds, of course, all those people who have now trained up in these areas would be left with superfluous human capital and would be unable to move back. It would lead to overinvestment in some sectors of the economy and underinvestment in other sectors of the economy.

The way to think about this is to pour a jar of honey onto the table. You will see a mound of honey will develop where it is poured onto the table. When you switch off the pouring of the honey, that mound falls down. Those are resources being spread out throughout the economy. So the economy can actually be quite sticky and difficult to operate. It certainly cannot be easily manipulated, as the stimulus package seems to imply.

Senator COONAN—Following on from something you said to Senator Ryan, does it follow from your analysis that, if the rate of unemployment is not due to the success of the stimulus package, similarly winding it back would not send unemployment through the roof—if you could wind it back?

Prof. Davidson—No, I do not think that unemployment would go through the roof if the stimulus package were wound back. I do not know that it can be wound back. There are all sorts

of issues about changing laws that have been passed. But I am not convinced that unemployment would shoot through the roof if the stimulus package were wound back.

Senator COONAN—I am just going to put a figure to you. If, for example, you could wind back $20 billion that has not yet been expended, would that find your support?

Prof. Davidson—I think less government spending would always find my support.

Senator CAMERON—Professor Davidson, you are an academic economist. Is that correct?

Prof. Davidson—That is correct.

Senator CAMERON—You have never worked in industry?

Prof. Davidson—No, that is not correct.

Senator CAMERON—I am just asking the question.

Prof. Davidson—I have worked.

Senator CAMERON—As an economist?

Prof. Davidson—No.

Senator CAMERON—So all your economic analysis is based on an academic point of view and not what happens out there in real life in the economy?

Prof. Davidson—I do not understand your point.

Senator CAMERON—You have never actually advised a company or the Treasury; you have simply been an academic economist.

Prof. Davidson—Yes. That is one way of looking at it.

Senator CAMERON—In terms of this issue you raised earlier about modelling and the stimulus package, did you raise any concerns when the previous Prime Minister, John Howard, decided to invest $10.4 billion in the Murray-Darling Basin without going to cabinet or Treasury?

Prof. Davidson—I do not know the former Prime Minister.

Senator CAMERON—John Howard.

Prof. Davidson—No. I have never met him. Why would I raise a concern with him?

Senator CAMERON—I am not saying personally with him; I am saying in terms of the political and economic outcomes of a decision like that.

Prof. Davidson—No, I did not, because I have no interest in water economics.

Senator CAMERON—So you have no interest in water economics.

Prof. Davidson—No, and I did not have the Oxford Economics model available to me at that time.

Senator CAMERON—So a $10.4 billion investment in the economy did not attract any of your attention at that time, even when that investment did not go to cabinet or to the Treasury.

Prof. Davidson—Similarly I have not complained about the $43 billion National Broadband Network, because I do not actually know anything about broadband either. So it is really a case of saying things where I can make a contribution beyond, 'Gee, that's a lot of money.'

Senator CAMERON—Let us see what contribution you have made here.

CHAIR—Commendable.

Senator CAMERON—Sorry?

CHAIR—I just made a comment.

Senator CAMERON—What was that? To me?

CHAIR—No, to the witness. I said 'commendable'.

Senator CAMERON—Let us see where that commendable contribution leads us. Professor Davidson, why are you at complete odds with the IMF, the World Bank, the OECD and the treasuries of major advanced economies? Why have you got it so different from the bulk of economic thinking—and some of those economists would not be labelled Keynesians by any stretch of the imagination.

Prof. Davidson—The difference between my view and that of the IMF, the OECD and the World Bank and what have you is that last February I said the stimulus packages were a terrible idea and were not going to work, and they have not actually worked. Those economists all said, 'Spend billions of taxpayers' dollars on stimulating the economy to prevent recessions,' and they have failed. They now have to say something.

Senator CAMERON—So the IMF are just saying something, and all of their analysis is wrong. Is that what you are putting to this inquiry?

Prof. Davidson—No, I am suggesting to you that I do not agree with the analysis of those multinational organisations. The very important thing to remember about the OECD, the IMF, the World Bank and what have you is that those organisations are not Australian taxpayers. They are not going to be paying for the consequences of all this reckless spending, unlike my good self, who is an Australian taxpayer. So I have a far more vested interest in making sure that my advice is right, as opposed to them.

Senator CAMERON—But Ben Bernanke and other senior economists are indicating that all of the debt is manageable. Particularly, the IMF has indicated that Australia's debt is eminently manageable.

Prof. Davidson—Australia's debt relative to, say, the United States or Japan's level of debt is manageable. It is not a question of whether or not we can manage to pay off money that has been wisely invested. It is whether or not we want to pay off money that has been irresponsibly invested. We need to think about what value we are getting for our dollar that has been spent. I put it to you that we have not got good value for that money.

Senator CAMERON—What about some of the infrastructure projects that form part of the package?

Prof. Davidson—Name them.

Senator CAMERON—The Ipswich Motorway.

Prof. Davidson—The government's job is to build roads anyway. I would have thought that is a state government responsibility.

Senator CAMERON—Are you seriously putting to this inquiry that the federal government should play no role in investing in the nation's road infrastructure?

Prof. Davidson—I am putting it to you that if you wanted to build roads that you would give the money to the states and allow the state governments to make decisions as to what roads they wish to build.

Senator CAMERON—That is an interesting point of view!

Prof. Davidson—We have a constitution that actually has states that make decisions about these things. You do represent the states, don't you?

Senator CAMERON—I am here to ask the questions, not you.

Prof. Davidson—Actually, I am a taxpayer. I will ask questions too.

Senator CAMERON—You will not ask me any questions. I will be asking the questions, thanks very much. We are investing about $884 million in the Ipswich Motorway. I do not know if you have ever travelled on the Ipswich Motorway between Brisbane and Ipswich and been caught in a traffic jam there. If that is improved, isn't that an improvement to the long-term productivity of the country?

Prof. Davidson—It may well be. It raises the question, though, of why we do not have a toll road.

Senator CAMERON—Are you saying we should have a user-pays system?

Prof. Davidson—I am saying, have they actually compared a toll road to a government financed extension?

Senator CAMERON—So we should have a toll road in Ipswich. Should we also have a toll road on the Pacific Highway, where the government is investing $618 million on improvements?

Prof. Davidson—Having a tollway is one of the options which should be considered.

Senator CAMERON—What about the Pacific Highway?

Prof. Davidson—I drove down the Pacific Highway just yesterday. It seemed a fine stretch of road to me.

Senator CAMERON—It depends what time you were on it and what you were doing.

Prof. Davidson—It was at rush hour actually. The road changes from four lanes to two lanes very quickly and slows the traffic down. I am well aware of these problems, but you need to consider what the best option is for infrastructure spending. You simply say, 'Well we are going to expand a road.' For what purpose? Why? When? What alternatives were considered? What did the local government think of putting in money? There are a whole range of issues. You cannot simply say: 'We have got a bucket of money and we are going to toss it at the economy. This is good because we are tossing it at something called infrastructure.'

Senator CAMERON—Professor Sinclair Davidson, you are not simply an economist, you are a big-time political player through the IPA. I have had a look at some of your comments over a long period of time in the IPA and they are not simply economic points of view, they are strong partisan political points of view. You come here with a strong partisan political history, don't you?

CHAIR—You must not impugn the witness, Senator Cameron.

Prof. Davidson—Senator, I find the suggestion you have made most appalling. I am an economist and I am a person who has opinions. I am a taxpayer. I am entitled to have opinions. To suggest that I am somehow a partisan is very strange. I am a free-market economist.

Senator CAMERON—And you are a partisan against any government intervention in the economy.

Prof. Davidson—Most government intervention in the economy is not for the good.

Senator CAMERON—In your writings for the IPA, have you ever written anything positive about the government since it has been elected?

Prof. Davidson—Do you mean the current government?

Senator CAMERON—Yes.

Prof. Davidson—Not that I can recall.

Senator CAMERON—So the government has done nothing positive since it has been elected to power?

Prof. Davidson—I would not say that is true at all. The government has appointed Mr Beazley to the ambassadorship in the United States. I thought that was magnificent.

Senator CAMERON—Is that an economic issue?

Prof. Davidson—I do not know. You asked me whether the government had made a positive contribution.

Senator CAMERON—I thought you were here to talk about economics.

Prof. Davidson—You asked me, Senator, and I answered your question. You need to be more specific.

Senator CAMERON—Do you believe the government has made any positive economic decisions since it has come to power?

Prof. Davidson—Yes. The government delivered on the tax cuts that were promised by the Howard government.

Senator CAMERON—Is there anything else?

Prof. Davidson—The government scrapped the Fuelwatch scheme.

Senator CAMERON—Is there anything else?

Prof. Davidson—The government scrapped the GroceryWatch scheme.

Senator CAMERON—So these are big economic issues for you. You do not care about a $10.4 billion investment that did not go to cabinet but you can talk about Fuelwatch and GroceryWatch. Is that where you are at?

CHAIR—Senator Cameron, that is not a fair question.

Senator CAMERON—Of course it is a fair question. He raised the issue.

CHAIR—He has dealt with the issues. He has already told you that he is not interested in water. Be fair to this witness, Senator Cameron.

Senator CAMERON—The witness raised these issues. I have been absolutely fair to the witness. The witness is biased, but that is a problem for the witness.

CHAIR—He has a point of view and you do too, Senator Cameron.

Senator CAMERON—It is a biased point of view.

CHAIR—He might regard you as extremely biased.

Senator CAMERON—Where does Australia rank internationally in terms of government debt?

Prof. Davidson—Quite low.

Senator CAMERON—Do you believe we should go into more debt to underpin 210,000 jobs?

Prof. Davidson—I reject the premise that going into debt is going to protect 210,000 jobs.

Senator CAMERON—That is the Treasury projection in the budget papers.

Prof. Davidson—Yes, I have already audited the Treasury projections—

Senator CAMERON—So the Treasury has got it wrong. The IMF has got it wrong. The OECD has got it wrong. Every progressive economist around the world that supports governments intervening in this global financial crisis have got it wrong—except the IPA and Professor Sinclair Davidson. Is that the case?

Prof. Davidson—No, that is not true at all actually. You would find that there were a large number of economists that signed a petition for the Cato Institute in the United States, including five Nobel Prize Winners, criticising their stimulus package. So I think the argument that I am alone in the world in criticising stimulus packages is simply false.

Senator CAMERON—So the Governor of the Reserve Bank has got it wrong—are you saying that?

Prof. Davidson—No, the Reserve Bank did a fine job in lowering interest rates from 7¼ per cent to three per cent.

Senator CAMERON—That is not what I am asking you. When the governor says that the stimulus package should not be pulled back too quickly, has he got it wrong?

Prof. Davidson—The governor is a government employee.

Senator CAMERON—I am asking you whether he has got it wrong.

Prof. Davidson—Yes, I disagree with him on that point.

Senator CAMERON—So the governor has got it wrong. What about the Secretary of the Treasury—has he got it wrong as well?

Prof. Davidson—I disagree with him as well, yes.

Senator CAMERON—What about the ACCI business—have they got it wrong when they say, 'Keep the stimulus package in place. It has helped create jobs.' Have business got it wrong?

Prof. Davidson—Business are getting money from the government for nothing.

Senator CAMERON—That is not what I am asking you. I am asking you whether they have got it wrong.

Prof. Davidson—I suggest that they are acting in their own best interests.

Senator CAMERON—So have they got it wrong?

Prof. Davidson—They are acting in their own best interests.

Senator CAMERON—Have they got it wrong? I am simply asking you the question.

Prof. Davidson—No, they are acting in their own best interest.

Senator CAMERON—No, they have not got it wrong. So when they say that it is good to have the economic stimulus package in place, they are correct, are they?

Prof. Davidson—In the same way as Mr Connor Simpson from Freshwater in Queensland got it right because he was going to spend his stimulus money on Cover Girls. Business are taking money from the government for nothing—and good on them—but nonetheless, that does not make it good economic policy.

Senator CAMERON—So is it your position that the government should have done nothing—

Prof. Davidson—No, the government should have bailed out—

Senator CAMERON—Would you let me finish my question?

Prof. Davidson—Yes, carry on.

Senator CAMERON—Don't be so excited. It does not do an economist good to get excited.

Members of the committee interjecting

Senator CAMERON—No, I do not get excited. In terms of the stimulus package, if you are wrong and you are an isolated opinion and the Treasury is right, the IMF is right and the OECD is right that we are protecting jobs, and the Treasury got it right in that it is 210,000 jobs, isn't it better for us to continue with that package to ensure that there are no jobs lost and we do not have dislocation for individuals, dislocation for families and dislocation for communities? Isn't this the correct thing to do?

Prof. Davidson—If all of those people are right and I am wrong, then we have already seen the impact of the stimulus package.

Senator CAMERON—Which has been good.

Prof. Davidson—Allegedly.

Senator CAMERON—The figures from the OECD—their analysis—the figures from Treasury, the figures from business, all say that the package is working well and should not go away.

Prof. Davidson—The figures from the OECD suggest that it is only working in Australia. They need to then explain why it has not worked in the other 29 economies.

Senator CAMERON—Let's have a look at one of these the economies. Let us have a look at the United States. You argued that labour market flexibility was one of the factors.

Prof. Davidson—Yes, one of the many factors.

Senator CAMERON—An important factor?

Prof. Davidson—Yes.

Senator CAMERON—What about the labour market flexibility in the United States?

Prof. Davidson—There is a big difference between the United States and Australia in this instance. The crisis actually originated in the United States; the crisis did not originate in Australia.

Senator CAMERON—But we are in a global economy. China relies on the US for its exports and China relies on us for its imports of coal and iron ore. It is a cycle that we are locked into and you cannot simply say that it is a US problem, because it is a global problem, isn't it?

Prof. Davidson—No, the subprime crisis very specifically originated in the United States.

Senator CAMERON—But that crisis created problems around the world, didn't it?

Prof. Davidson—To lesser degrees and, in the case of Australia, our labour market flexibility was a good outcome for us. That does not mean that if we had a home-grown crisis that it would have been, but in response to an external shock, it has been.

CHAIR—Senator Cameron, we will have to stop now. We have gone a long way over.

Prof. Davidson—Thank you, I have enjoyed our conversation.

CHAIR—Thank you, Professor.

[2.15 pm]

DENNISS, Dr Richard, Executive Director, The Australia Institute

CHAIR—Welcome. Would you like to make an opening statement, Dr Denniss?

Dr Denniss—Yes. Thank you for calling me here today and for the opportunity to present some perspectives on this. Let me start by saying that I think it is misleading to assess Australian economic policy in terms of the fact that we avoided a technical recession; therefore we have no problem. Therefore, do we need a stimulus? In the last 12 months, more than 180,000 people have joined the ranks of the officially unemployed. That is an enormous number of people, with the forecasts that that number will continue to grow. By international standards that is a good outcome. By historical standards, compared to 12 months ago a very large number of Australian families are literally struggling to make ends meet. It is entirely premature for people to talk about reining in the stimulus for the simple reason that we have not overcome the adverse impacts of the global financial crisis. We have helped to avoid and minimise some of those impacts but the idea that because the growth rate was not negative for two quarters we have not incurred substantial economic problems is a strange conclusion to draw from the data.

Australia has higher and rapidly rising unemployment. That is an enormous social and economic problem and it should be tackled. I think the stimulus has been well-timed and an effective counter to rapidly declining demand. The government should be commended for undertaking what had become an unusual course of action which other countries have rapidly agreed was in fact the appropriate and effective thing to do. It was a large stimulus in terms of Australian politics—$42 billion is a lot of money. In fact, compared to what has actually occurred in other countries, as a percentage of GDP that is 2.8 per cent of GDP. I will leave a submission with you with some numbers on this. While the number sounds very large, it was a modest and timely injection. There is no doubt that some of that money might have been misspent along the way. I think that is unfortunate but probably unavoidable. Analysis of the efficiency of how the money is being spent needs to be undertaken from the perspective that the primary objective was to spend money quickly. The purpose of the stimulus package was to stimulate the economy. That must be the primary criteria against which it is judged. Of course, the more we can achieve along the way with the expenditure of that money the better. But the objective was to spend a large amount of money quickly, not to spend money perfectly in a drawn out fashion.

In terms of equity, I think that we could, should and still can do more to help those who are most adversely affected by a slowdown in the economy—that is, of course, the unemployed and those people who share a house with the unemployed. It was an unfortunate irony that the unemployed did not receive the $900 bonus payment. I think that providing money to unemployed people directly is likely to have a very positive stimulatory effect not just on the national economy but on the local economy in which those people live. There is no better way to target money towards the regions that are experiencing the most unemployment than to provide increased payments to those who are unemployed. I also think that spending money increasing the unemployment benefit would be both an equitable and efficient thing to do. It would

certainly help to inject money back into those regions. The growing gap between the disability pension and the unemployment benefit is a policy problem as well as an equity problem.

In our submission to the first stimulus inquiry, we suggested that a lot of the stimulus might be better spent through direct job creation, particularly through community organisations and local councils—again, I think, an effective way of not just spending money but spending it in regions that can absorb it and also in a way that can create jobs where they are needed most.

To conclude my opening statement, I think it is important that the stimulus package has been undertaken. I think it has been effective. I think the international evidence supports that. I think that we can learn lessons from what has occurred. The main lesson is that it is actually hard to spend a lot of money quickly. I think that, given that Australia can and will have other recessions in the future, we would be well served by beginning to prepare for recessions before they occur. By that I mean that, if people find it a challenge to spend a lot of money very quickly, there is no reason we cannot have a list of important but not urgent projects that are ready to go at any point in time. There is no reason that local councils and other organisations could not be encouraged to prepare lists of exactly such shovel-ready projects so that, if in the future we want to haggle over what the best way to spend the money is, we might have a broader range of options.

Some people seem to be suggesting that the stimulus has had no impact on the economy. To take up that point, I would just ask: where did the money go? If you pump billions of dollars into the economy and we have not observed any inflation, it has gone somewhere. It has obviously created jobs, employment and income for the people who received that money. As an economist, I cannot see how you could assert that it has had no impact on the economy. The two possible impacts are to expand output and to drive up prices. It clearly has not driven up prices, so it must have expanded output.

Senator BOB BROWN—I might start there. This morning we had Professor Kates from the RMIT here. He said that the $42 billion stimulus package has seen taxpayers fork out $1.5 million for each job created. That is not a good bargain, is it?

Dr Denniss—No. We have done some analysis of the dollar-per-job figures, and it is very hard. There are a number of ways you can do it, and you get a lot of different answers. The numbers I have seen and the numbers we have come up with are much lower than that. That said, I do think that, if the primary objective were to create jobs, spending that money on direct job creation would have been a more effective way of doing it. It does not mean that some of the money might not still have gone on infrastructure or other specific projects. When you employ someone for $50,000, you employ someone and the $50,000 still gets spent. What we have done instead is to give people $50,000 and hope that when they spend it a job will be created. One of the reasons for doing that was the need to spend the money very quickly, but again I think that that could perhaps be offset with better planning in the future. I do think the dollar-per-job figure looks quite high; I would not say it is as high as $1.5 million. But I think that, in terms of doing this better in the future—which I think is something the committee should think about—direct job creation and old-fashioned labour market programs might have been a better way to create some more jobs per dollar.

Senator BOB BROWN—Was $42 billion too much?

Dr Denniss—I do not think so. I think the proof of it is that unemployment is still rising and we have no evidence of rising inflation. The main argument against what economists call 'discretionary fiscal stimulus' is that, when the government decides to spend a lot of money, in doing so it might crowd out private sector investment and take up room that the private sector might itself have occupied. The fact that we see a slack labour market and no price pressures suggests that, as a result of all that government spending, there is still spare capacity out there. So, no, I do not think it is too big. As long as unemployment is rising and projected to rise in the medium term, there is probably room for a bit more.

Senator BOB BROWN—Do you have any projection as to when or how much that should be?

Dr Denniss—No, so I have not said, 'Here's how much extra the stimulus should be.' We have suggested that increasing the rate for the unemployed to that of the age pension would inject a substantial amount of money into the economy, it would do so in a way that helps the regions that are most affected and it is equitable and good policy in the long run. I do not think there is any particular magic number with these things but I do think that, if anything, we could do with more stimulus, certainly not less.

Senator BOB BROWN—Do you subscribe to the idea that we may be in for a longer recession, going for some years, and that we may even see another dip?

Dr Denniss—It is certainly a possibility, it is not unprecedented, and the reality is it will in large part be determined by what happens around the world. There is so much focus on the rate of growth, on GDP growth, when really what we need to worry about from a policy point of view is the number of unemployed people. If we have a sharp, short recession and then return to the trend rate of growth, we do not return to the trend level of unemployment. If you do not grow for a period of time and then you go back to growing at the same rate, you are way behind what you would have otherwise been. What happens in the Australian economy and in most developed economies is that after a recession the GDP growth rate gets back to where it was and you have five or seven years of high unemployment—it takes a long time to literally wash all those people out.

Senator BOB BROWN—I do not want to lead you on this but that leads to the question about how many jobs have been saved by the stimulus package, because that does mean that we minimise that gap you are talking about, doesn't it?

Dr Denniss—Absolutely.

Senator BOB BROWN—In some of the earlier evidence we have heard, the costing of jobs created has ignored the fact that some tens or hundreds of thousands of jobs have been saved, have been protected. Do you have any measure or assessment of that?

Dr Denniss—No, except to say that I think it is generally overlooked, and in a very significant way. For example, if we fail to take those things into account in terms of the jobs saved, we have failed to take into account the extra tax those people who did not lose their jobs are paying; we have failed to take account the fact that those people, because they are still employed, are still spending their old salary and keeping the economy going. When we just look at a very narrow

notion of how many jobs were created, it is very hard to accurately measure, but it is hard to imagine that anyone would strongly argue with the view that keeping people in work pays enormous dividends over the medium term. Not only do we spare them the pain and the inconvenience and the cost of a period of unemployment, but we spare the economy all the flow-on effects of them losing their jobs.

Senator BOB BROWN—If you are looking at a future stimulus package, what account do you take of the increased debt and the longer it is going to take for the economy or the government spending to catch up to pay for that?

Dr Denniss—The reality is that the level of debt in Australia is so low that it imposes no constraints on policymakers whatsoever. That does not mean that we should not be cautious about what things we choose to invest in, and certainly well-selected infrastructure and well-selected social programs would pay good dividends in the long run. But it is so important that we understand just how low Australia's level of net debt is. Also, the question that I would ask people who disagree is: if you think that we should balance the budget over the cycle, and most people seem to think that is what we should do, how do you balance the budget over the cycle if you do not have deficits in a recession? If you are running big surpluses in a boom time and you are afraid of having a deficit in a recession, then you are not proposing balance over the cycle at all; you are proposing permanent surpluses or a permanent balance. Going forward, Australia's level of debt is so low that we can afford to do anything we want. The question we have to ask ourselves is: what do we want to do?

Senator BOB BROWN—I asked about this earlier today. The prospect of increased taxes is coming down the line. The UK has just added a tax for high-income earners. Where do you think the increased taxation that may be in the next budget should be aimed?

Dr Denniss—The Australian economy can without doubt absorb increases in taxes. If Treasury thinks it will take six years to get the budget back into the black, that suggests to me that taxes are too low. It should not take six years to recover. We cut taxes while the economy was booming, and we cut taxes while the economy was booming in a way that suggested we thought the boom would last forever. I think that we went too far and we probably need to increase taxes.

To those who are terrified of tax rates destroying incentive, there are plenty of ways to increase tax revenue in a way that would minimise that. The first would be to abolish the enormous range of tax concessions that currently exist—the 50 per cent capital gains tax concession or the enormous concessions on superannuation. If the actual income tax rate for high-income earners were increased, there is virtually no chance that rich people will decide to be poor because the tax rate is just too high for them. You do not see a lot of evidence of high-income earners choosing to become low-income earners because they are so depressed by the tax rate. If the parliament wants to increase taxes, it should, and the economic effects of doing it wisely would be low.

Senator COONAN—The economy grew by one per cent in 2008-09 rather than by zero per cent, as was forecast in the budget. It is likely to expand rather then contract in 2009-10. Jobs ads are now rising for the first time since the crisis hit a year ago. Unemployment may bottom out at six per cent because it has been steady at 5.8 per cent for some time now. The deficit will

obviously be considerably smaller than the $57.6 billion that was forecast. All of those settings that were based on the budget forecast led to some emergency measures. With the economy doing much better than expected, I am interested to know whether there is not a real risk that continuing to pump massive amounts into the economy will be destabilising if it is not withdrawn as the emergency passes?

Dr Denniss—There is certainly a risk. There is an old joke about economics: it is like driving a car by looking in the rear-view mirror. We only know where we have been. No-one knows exactly where we will be in six months time or in 12 months time. The two risks in front of the RBA and the government are that we spend too much and get some inflation, or we do too little and get a lot more unemployment. No-one can tell you exactly what will happen. I am relieved, as I am sure most people are, that things look a bit better than they looked less than 12 months ago.

As to what we should do next, I think that the growth rate is starting to show some positive signs, but there are 180,000 people out there who thought they were in working families 12 months ago, and now they are not. I do not think they are sitting there saying, 'Gee, that risk of inflation is really on my mind right now.' I think they want us to create as many jobs as we can, as quickly as we can. There is no doubt some risk that, if we go really hard trying to use monetary and fiscal policy to create jobs, at some point we might get some inflation. Frankly, I think the risks of high unemployment in the short term are much greater than the risks of high inflation, and I would also argue that the costs of high unemployment are much greater than the costs of inflation. Nobody wants to see an inflationary outbreak, but I also do not want to see unemployment at 7½ per cent, even if we say: 'Isn't that better? It used to be at 10 per cent'. I do not want to see another 180,000 people involuntarily unemployed.

Senator COONAN—What would be the impact of higher interest rates? That is going to have a pretty big impact on people with a mortgage.

Dr Denniss—Absolutely. But if you were to ask me whether I would rather pay another per cent on my mortgage—I do not know about you, but if someone said, 'Richard, would you rather pay one per cent more on your mortgage', which is down three, 'or lose your job', I would pay the interest. I have got a mortgage. Nobody likes high interest rates. They take away your discretionary income. But the pain of high interest rates is spread across society. The pain of unemployment is concentrated on a very small number of people. They do all of our hurting for us. We fort of say to them, 'Here you go. You can miss out.'

Senator COONAN—I think we have got your point. How much more stimulus do you think you need? You said you would rather see more. How much more?

Dr Denniss—As I said, I would like to see more stimulus through good policy. I think it is good policy to align the unemployment benefit and the disability benefit—

Senator COONAN—In terms of a dollar amount, what are you saying would be the impact of the kind of total stimulus that you would say is appropriate?

Dr Denniss—We did not prepare a submission based around that. I came today to talk about how I thought it had gone and how I thought it could be made better—

Senator COONAN—Do you know how much the total stimulus is?

Dr Denniss—$42 billion.

Senator COONAN—It is $95 billion, actually.

Dr Denniss—What do you mean?

Senator COONAN—I can go through it. It might be helpful to the committee if we know what we are talking about here. In October 2008 there was a $10.4 billion economic stimulus package. We all know about that. We know the $15.2 billion COAG stimulus in November. We know the December stimulus—the $300 million regional and local community infrastructure and $4.7 billion Nation Building package; the $42 billion Nation Building and Jobs Plan, which is probably the one you were speaking about, and another $22 billion to come in the third, which I make $95 billion in announced stimulus packages. I am just interested to know how much more you think is appropriate.

Dr Denniss—The $95 billion you have described obviously is not for this 12-month period. Again I would just look at the scoreboard. Inflation is not rising and unemployment is. It is pretty obvious what state we are at in the business cycle. Clearly the economy can absorb more capacity. There is no evidence of crowding out. There is no evidence of inflation outbreak. As I said, I did not come here today to say, 'Here's what the number should be'—

Senator COONAN—I appreciate that.

Dr Denniss—but in terms of the direction, I think it can clearly absorb some increased generosity for that small number of people who are doing all of our hurting for us.

Senator COONAN—But you have not got any specific figure in mind.

Dr Denniss—No.

CHAIR—Are there any other questions? Senator Hurley.

Senator HURLEY—To continue on that theme a little bit, when the government was talking about the stimulus package it deliberately talked about short, intermediate and longer term spending, with the short spending being the cash stimulus and the intermediate mostly the school spending, and then the longer term spending on infrastructure to increase productivity. I just wondered if you would comment on that structure in terms of the longer-range outlook for the economy.

Dr Denniss—As I said before, I support what the government did, and I think it needs to be assessed in terms of its primary goal, which was to pump money into an economy that we feared was rapidly slowing. While the $900 cash payment would not have been my preferred policy tool, given the lack of any viable alternative it worked in terms of those objectives. I think some preparation would help us prepare for the next slowdown or the next recession so that perhaps there are other options before our policymakers. As I said, overall I am supportive of the nature and the composition of the stimulus package under the circumstances. The thing you have to

understand in assessing a policy like this is: nobody was hoping for, planning for or expecting an event as big and as sudden as this. My concern is that we should not get surprised by the predictable. If and when this happens again, how could we do it better? I think we need to be pragmatic in assessing how it has been rolled out today.

Senator HURLEY—Again, there are the job issues and the dollar amount per job. I will not argue about the specific amount, but I think you have said something along the lines that it is misleading. Professor Andrew Leigh referred to youth unemployment and the long-term effect that has on young people leaving school or university. But for older people, in their late 50s or even early 50s, who lose their job for a period of time, getting back into the job market is extremely difficult and it does have long range effects on them and their families for some time. It has a long-lasting effect. I was wondering whether you could give me your opinion on whether that kind of simplistic dollar amount is a bit misleading.

Dr Denniss—It obviously is. It is impossible to come up with a range of estimates as to dollars per job and I think that it should be a target of policy. If we are trying to stimulate the economy, we should look at all the options and say, 'How can we create as many jobs as possible per dollar?' I think that is an important goal but, to only assess policy from that perspective, I think, would be deeply flawed. Apart from the social and personal consequences of the period of unemployment, we have plenty of evidence to suggest that, once people become unemployed, the odds of them remaining unemployed are a lot higher. Similarly, once regions, especially smaller regions and regional centres, begin to decline, it is very hard to turn them around. Once particular small areas start to lose a few staff and a few jobs, before you know it, the school loses a teacher and the whole thing can unfortunately cascade downwards.

Senator HURLEY—As indeed it did in the nineties.

Dr Denniss—Absolutely. The social benefits of avoiding that, whilst hard to calculate, are very important to keep in our minds.

Senator HURLEY—I have not seen this argument so much recently, but certainly in the nineties there was some argument that, although unemployment was bad, it did have the beneficial effect of keeping wages down.

Dr Denniss—I have never been convinced that low wages were a good objective.

Senator HURLEY—There are some who do happen to think that is a good thing and that that in turn keeps inflation down. Have you seen any analysis recently that points to a view in that direction?

Dr Denniss—There is no doubt that, when there is high unemployment, there is at a national level less upward pressure on wages and in turn on price. But, again, what a cruel and inefficient wage constraint mechanism to impose enormous costs on a subset of society and say, 'Could you remain unemployed so that we can keep wages down somewhere else.' People talk about flexibility in the labour market and how this can solve all of our problems. Australia does have quite a flexible labour market but in Australia in the peak of the boom, there were regions in Australia with unemployment rates of over 10 per cent. They had exactly the same laws and regulations as regions that had two per cent. If we want to think that the only thing that affects

wages and employment is our regulatory structure, we have to be able to explain why it is that some pockets of disadvantage exist—and the answer is: where are the jobs? I think we do ourselves a disservice if we rely on the unemployed to solve those sorts of problems for us.

Senator XENOPHON—Dr Denniss, some commentators have taken the view that the stimulus package was necessary but they are concerned that, as the economy performs better than initially expected, we could overcook the goose—that we spend too much in the future which could impact on inflation and interest rates. Is there a case to adjust to circumstances—that, if the economy comes out of this contraction, we ought to be careful about the level of spend, particularly, say, in the 2010-11 and 2011-12 years? And you would include in that tax cuts as well as the stimulus package in terms of capital works.

Dr Denniss—I guess I am one of those people who never gets too worried about good news. I think it is great that the economy is doing better than we thought it would. As I said before, yes, there is some risk that we could overcook the goose. There is some risk that we could drop interest rates too low and have too much stimulus in that in three years time we might have some more inflation than we might otherwise have. But there is also an enormous risk that we might undercook the goose and that we respond prematurely to some early signs that things are not as bad as we thought.

I come back to the point that, as long as unemployment is rising and inflation is stable, there is room for more expansion and not less. So, yes, there is a risk, but if our main concern is the level of debt or the size of the deficit in four years time, then I would say that our level of debt will still be very small in four years time regardless. If we are worried about the deficit in four years time, then a couple of simple modifications to the tax concessions that I outlined before will raise all the revenue that any government will need to put that deficit back to where they want it to be. I think the risk of high and long-term unemployment dwarfs the risk of a modest outbreak in inflation or a risk of us having a deficit that is too big. Not only do I think the risk of unemployment is much greater, but I also think that the costs of unemployment are much greater. That is why I think we should keep going.

Senator XENOPHON—In terms of adjusting the policy levels, would you be looking to the two to three per cent inflation band being tested as an indication that you need to adjust policies in terms of spending?

Dr Denniss—Absolutely. Let us wait and see if we have an inflation outbreak and then we can do something about it if we have to. Think of it this way: if we were going to have unemployment targeting, what would the unemployment target be? I reckon that, if we were having unemployment targeting, it would probably be four or five per cent. Well, we are above that, and I think we should do something about it. Of course, everybody would like to see low inflation and of course everybody would like to see low unemployment. The hard question is: what if you had to pick? As I said, I think both from a risk point of view and a cost point of view, I would pick keeping our eye on unemployment at the moment. Of course, we should do everything we can to keep inflation check and ongoing competition policy. Look at the Telstra announcement. The front page of today's *Australian* pointed out that people spend as much on phones as they do on petrol. There are ways that we can keep the CPI down that do not require lots of people losing their jobs.

Senator XENOPHON—Finally, on the issue of unemployment, in terms of job creation—and there is debate about how much it costs to create each job—would you also say in a qualitative sense that there are some jobs that are created that are better value for the taxpayer in the sense that it will actually have an impact on the productive capacity of the nation in years to come? Is that something that we should be particularly mindful of when jobs are being created, in terms of reducing infrastructure bottlenecks, for instance?

Dr Denniss—Absolutely. Economists are allegedly concerned with the efficient allocation of scarce resources. The most efficient way to use scarce resources is to kill two birds with one stone. If we can simultaneously spend money in such a way that it helps keep unemployment low and helps solve some social or economic problems for us, I think we can and we should. For example, I think there is enormous unmet need in Australia for providing support for people who need high amounts of care, whether that is in child care, aged care or even in recuperation coming out of hospital. I could not think of a better way to stimulate jobs and make society a healthier, happier place than to spend a lot of money providing services that there is a huge need for. This idea that, when governments spend money it is wasted and when the private sector spends money it is perfect, I find bizarre. If you cut my interest rates and I go and spend it on something, no-one is ever going to question what I spent it on—that is entirely up to me. The ideology is that it is impossible for me as an individual to waste money. I would prefer to see the government spending money solving some social problems rather than giving me a tax cut or an interest rate cut so that I can go and buy something.

Senator XENOPHON—One of the arguments, though, in relation to the school halls is that there are some schools that are much better off than others that, on a needs basis, probably did not need an extra hall and that money could have been spent better on the sorts of things you have been talking about or, as has been put to me in some quarters, extra teaching facilities for some more disadvantaged schools. Do you have a concern that, in terms of the school-building program, some of that money could have been better allocated?

Dr Denniss—I do, and I said that at the outset. Some of the money that has been spent, to my eye, could have been spent on different things. But we have to assess the spending against its primary objective, which was to spend money quickly. It sounds strange, but that was the plan and I am glad they did it. I would not have spent money on some schools that look like they had plenty already, but I think there were administrative difficulties in spending it so quickly. I personally do not agree with all of the distribution associated with the stimulus. As I said, I was not a big fan of the $900 payment and I certainly think it is ironic, if not appalling, that the unemployed missed out on it. I probably would have quibbled, haggled or come up with an entirely different fiscal stimulus, but I am not the parliament. There are two questions for people: what do we think of the stimulus, and how in the future might we do it differently?

Senator BUSHBY—You have talked a lot about making a simple choice between people's jobs and inflation, but it is not that simple. The RBA are charged with trying to keep inflation within a particular target range. They are not going to allow inflation just to rise as things go on. They are actually going to employ monetary policy to stop that from happening. Indeed, there have been some statements recently from the Reserve Bank governor that the emergency interest rate settings that currently apply are unlikely to stay that way very long, and I understand the market is factoring in some inevitable interest rate rises even before the end of this year. Why

would the Reserve Bank move to increase interest rates from the emergency settings? What would they be trying to achieve?

Dr Denniss—There are a couple of things in your question. The first thing is that Australia's interest rates are now, by historical standards, quite low. Regardless of what happens, the most likely thing that would happen is that they will go up, not down.

Senator BUSHBY—But why would they go up? Why would the Reserve Bank be keen to see them rise?

Dr Denniss—I do not think anyone is keen to see them rise.

Senator BUSHBY—In certain circumstances it will move them.

Dr Denniss—My view would be that the RBA think that, if the Australian economy is motoring along nicely, the labour market is close to full employment and we are not too far away from what economists think of as equilibrium, the interest rate that is most consistent with staying on that path is around five per cent. We are a long way from that equilibrium path at the moment; hence, interest rates are a lot lower. I think the RBA are trying to remind everybody, 'Please don't go and buy the biggest house you can afford right now if the only reason you can afford it is interest rates are very low,' because they have no capacity to keep interest rates that low for the next 5, 10 or 25 years, which is the period of the average mortgage. It is unfortunate that the way that consumers and borrowers go about lending and borrowing in Australia seems to focus on: what can someone lend me today? There are some people out there taking some pretty big risks when perhaps they should not be.

Senator BUSHBY—There is no doubt that is the case. There is a significant risk that there are Australians who will look at the rate today and will not think beyond that. Are you suggesting that is the only reason why the RBA would consider raising rates, or do you think that it might be looking at raising rates to ensure that the Australian economy does not come out of the depression, in terms of levels of activity, too quickly?

Dr Denniss—There are competing views in economics about the dynamics of these things. Some economists worry about rates of growth and some economists worry about the rate of change in the rate of growth—that is, if the economy starts to grow very quickly, the chances of it overshooting are a bit higher. There is no doubt that the RBA will keep their eye on not just whether we are beginning to come out of recession but how fast we are coming out of recession.

Senator BUSHBY—That is right. Presumably—and we will have the Governor of the Reserve Bank before us in a week's time and, no doubt, we will ask him—the speed with which the economy might come out of it will be part of what they are looking at when they consider the appropriate level of the official rate. When they do move to increase the official rate, it will be with that factor in mind and part of it may be to send a signal to those people we discussed earlier who just look at the low rate and say, 'Whoo hoo.' Effectively, by doing so, they will be trying to slow the rate of growth or manage the rate of growth to ensure it does not happen too quickly and effectively dampen that rate of growth.

Dr Denniss—Yes. That is what their charter requires them to do and that is what they will do. You have to be careful to look at the logic. On the one hand, the stimulus is not doing anything and then the stimulus will not be the thing that is driving us onto the high-inflation trajectory, and if the stimulus is doing something then you have to look at the trade-off between inflation and unemployment. I just think that it is inevitable that interest rates will rise. I think it is inevitable that in a few years time—and I am not making a guess about when—when the economy has restored itself to a growth path that is consistent with our long-term average, interest rates will be higher than they are today. I do not think you can describe that as a failure of policy.

Senator BUSHBY—No, I am not saying it is a failure of policy. In a broader sense, there are two macro tools open to a government in order to foster growth of the economy: one is fiscal policy and the other is monetary policy. Fiscal policy is what we are here to talk about today, and it has obviously been employed in a relatively big way. If you look at the $95 billion, you are looking at about 4½ per cent of GDP. Monetary policy was also employed in a relatively sharp way but not to the full extent that it could have been. I think you note in your submission that there was some scope for further action, with hindsight.

Dr Denniss—Yes. Also, keep in mind that it is not obvious that we might not, in six months time, want to cut interest rates again. If we did rely more on monetary policy, we would be actually closing the door on relying on it more in the future.

Senator BUSHBY—I understand that. Similarly, if we spend $40 billion today, that is $40 billion that you presumably cannot spend in six months. I know you say we would go further into debt, but—

Dr Denniss—I was just going to say that there is an asymmetry. Once interest rates get to zero, you have a problem.

Senator BUSHBY—I know that.

Dr Denniss—You can keep spending more with fiscal policy—

Senator BUSHBY—To an extent. You run out of money. You should do so wisely at some point. What I really want to get to is: if the RBA starts increasing interest rates to effectively slow the rate of growth of the economy or even slow the economy a little bit if it goes too fast, on the one hand you will have the Reserve Bank employing monetary policy to slow the economy and that, according to noises made by the RBA and what the market is factoring in, looks like it is not too far off. On the flip side, you have the government borrowing money, which taxpayers will have to pay back in the future, to try and speed it up. You have the two main tools of macroeconomic policy working against each other to achieve equilibrium, in terms of employment and inflation, which presumably you could achieve by spending less and having a lower interest rate. You could still achieve the same outcome.

Dr Denniss—I do not think anybody thinks it is a good idea to have monetary policy and fiscal policy literally—

Senator BUSHBY—You can actually ratchet each up. The more you spend, the higher the interest rate; the more you spend—

Dr Denniss—You can, but I also think that well-designed fiscal policy can interact far more subtly with monetary policy than that. For example, if you are increasing interest rates and, in turn, you are reducing the disposable income of households with mortgages—30 per cent of the population—

Senator BUSHBY—Incidentally, increasing business costs, which has an impact on employment as well—

Dr Denniss—On investment? Absolutely.

Senator BUSHBY—Investment and employment.

Dr Denniss—Absolutely. If you are doing that, you are affecting one segment of the economy but, if you are simultaneously putting more money into the pockets of the unemployed, they are probably not paying off a mortgage on their dole. So you have to look at where the bottlenecks in the economy are and whose behaviour you are trying to affect. Unambiguously, you would like to see fiscal and monetary policy reinforcing each other, but I don't think it is fair to interpret interest rates moving from record lows to near record lows as contradictory fiscal and monetary policy. You have got to see that three per cent interest rates are expansionary monetary policy.

Senator BUSHBY—But, similarly, fiscal policy as currently employed is expansionary.

Dr Denniss—No, but my point is—

CHAIR—Senator Bushby, we are running out of time. It is an interesting discussion, but we have to move on.

Dr Denniss—I will just wrap up on this point—I think it is quite important. Interest rates way below three per cent are expansionary. You do not want to keep them there forever.

CHAIR—Thank you.

Senator CAMERON—The OECD are saying that the fiscal and economic crisis has moved into a jobs crisis, and you are one of the few economists who have come here today who have actually dealt with some of the human issues arising out of unemployment, which I find quite amazing. But you have raised that issue. The OECD are saying that there will be a new postwar high in 2010 of 10 per cent unemployed in the OECD. That is 57 million unemployed. In a global economy, can we cushion ourselves against this or are we going to be affected?

Dr Denniss—Absolutely we are, and I think that the more other countries do to proactively try and manage their economies the better for us as well as the better for them. Obviously I am concerned for them directly, but to an Australian parliamentary inquiry the question is: what does it mean for Australia? The worse they do their job, the harder it will be for us. OECD unemployment of 10 per cent will certainly affect Australia's capacity to export. It will affect the

number of tourists who come to Australia. There will be all sorts of obvious and less obvious effects, which again is why my concern is more for the danger of rising unemployment, not inflation.

Senator CAMERON—I am not sure whether you were here when Professor Sinclair Davidson was giving evidence and I am not sure if you have seen his written evidence, the paper that he has presented.

Dr Denniss—I saw it reported in the newspapers today and I heard the second half of his evidence.

Senator CAMERON—Basically, Professor Sinclair Davidson was saying: have less government intervention, cut interest rates, cut taxes on business and let business get on with creating employment. Do you agree with that as an alternative approach?

Dr Denniss—No, and I don't think it is—well, I suppose it is an alternative approach, but I do not see any strong theoretical or empirical evidence that supports proposing that at this point in time. Evidence from around the world suggests that that is basically doomed to failure. There is a nice old quote from Keynes, who said: 'When I'm wrong, I change my mind. What do you do?' There are a lot of people who have changed their minds, who might have perhaps agreed a few years ago with what Professor Davidson said who are putting their hands up now and saying, 'We need to try a bit harder.' I think the approach that monetary policy can solve all problems was reinforced by how successful it was over a long period of time where they were not any major problems. We have come across a big, idiosyncratic event and we had got used to just being able to tinker with monetary policy and that was enough. I do not see many people thinking that sort of tinkering is enough today.

Senator CAMERON—I know we are running out of time, so I will ask one last question on this. What Professor Sinclair Davidson said is that the package contains a lot of spending and little actual stimulus. He also argued that the package would not improve productivity. There are a whole range of infrastructure projects. One that really sticks in my mind is the Ipswich Motorway. If you have been up there, travelling on the Ipswich Motorway—and I am not a Queenslander—you will know it is absolutely horrendous, as a lot of our infrastructure is. So there is rail infrastructure, there is road infrastructure and there is other infrastructure being put in place. I have not seen anyone do an analysis about the productivity benefits that that might bring to the community in the longer term. The focus has been on short termism: 'You shouldn't spend this now and we shouldn't be doing it because it doesn't fit my theoretical dogma.' Do you have a view on that?

Dr Denniss—Spending money will create jobs. It may or may not also create inflation. It does not appear that at the moment it is. Spending money, as long as the money is invested well, will also create long run benefits. People might argue about which project they prefer, but as long as we are building things which in five years time people will say, 'I'm glad we built that,' then we have no problem. All we are doing is bringing forward a whole bunch of things we would have got around to doing at some point, and basically what economic theory suggests here is if you are ever going to get around to doing it, now is a good time to do it because otherwise you will have idle resources, unemployment. You will have people sitting around saying, 'Boy, I wish there was a job.' As long as we are aiming them at things that in the long run we will get value

from, then we will not only be increasing employment but we will also be increasing productivity. As long as you think in five years time that people will think, 'Gee that road in Ipswich is a good one,' then we have no problem. If we paid people to dig holes, it would create jobs, but we probably would not get excited about the hole in five years time. Even if we are building school halls in some places that do not need them yet, as long as we need them in five years time, we will have increased productivity.

Senator CAMERON—Professor Davidson said the government should not be investing, that it should be toll roads. Given that investment was frozen 12 months ago, we could not get any investment anywhere, how can you legitimise that approach by a professor of economics? I do not understand it. Have you got any explanation for that?

Dr Denniss—No. The whole purpose of a recession is that the private sector is unwilling to invest and the whole purpose of Keynesian stimulus is that the public sector invests where the private sector will not. So to propose that an alternative for government investment is private sector investment kind of misses the point. If the private sector was going to invest, you would not be having a recession.

Senator RYAN—Dr Denniss, one of the things we have heard about today has been the cost of taxation to the economy—deadweight or otherwise—ranging between 20c and 80c in the dollar, depending on what is used. One of the concerns I have, and it was discussed earlier today, is that through running up the debt necessary to pay for this package, we are increasing the burden of taxation in the future. It is possible to do it via spending cuts, but from what you have said previously I would assume you might lean towards increasing taxation or whatever, and that tends to have been the history of Australia anyway. That in itself will have a cost to the economy—previous economists have mentioned it; in fact everyone this morning has—in terms of growth in the future. I notice you said earlier that GDP growth and unemployment are two different things, but other than labour market regulation, GDP growth would probably be the prime determinant of employment growth. Does it at all worry you that with the increased burden of taxation that has to be imposed in the future to pay for this stimulus, we could be transferring part of this employment problem that you are so concerned about so that supporting jobs today, or saving them, whichever language one might use, may come at the cost of jobs in five years or 10 years as this debt is being funded by higher taxation?

Dr Denniss—I guess the short answer is no, it does not worry me.

Senator RYAN—So you do not believe there is an economic cost to a higher burden of taxation?

Dr Denniss—It is an overarching question. If you are forcing me to say yes or no, I would say, no, I do not agree. Here is the thing. Economists and econometric models typically assert that the size of GDP in 10 years time is fixed. No-one would dispute this, but the way we model the economy is we know where we will be in 10 years; we are haggling about how we are going to get there. The opposite is indeed the case. If we do not do everything we can to avoid a recession, the odds are the economy will be in a worse spot in 10 years time than we would otherwise be. In turn, the tax rates that you would require from having a smaller economy than you might otherwise have may indeed be higher. Think of it this way: if you and I earn exactly the same amount of income and we pay exactly the same amount into super, but I spend three

years unemployed and not paying any super, when I get my job back, even if we are earning the same amount of money again, I will never catch up to you.

Senator RYAN—I appreciate that point. I challenge the assertion that all economic models assume a fixed point of GDP 10 years hence. We had a discussion earlier on, and one of the models that was looked at—

Dr Denniss—Ask Ken Henry next Friday how the TRYM model works.

Senator RYAN—That is a model; that is not all models, Dr Denniss. I understand that you do not think there is a cost to the economy from taxation—that is fair enough. The other question I want to ask is in relation to increasing the Newstart payment. It would be fairer to characterise that more as a policy decision than a short-term stimulus, wouldn't it? That could be one component of a stimulus in the shorter term, but it would also be a longer term cost on the budget and the taxpayer than a project to build a road or a bridge.

Dr Denniss—Absolutely. I do not think many people would argue that unemployment benefits are one of the best—what we call—'automatic stabilisers'. If you increase the unemployment benefit, you will increase the effectiveness of the automatic stabilisers. But also keep in mind that, if you relied on increasing unemployment benefits to stimulate the economy, when the economy begins to grow and when unemployment begins to fall, the money automatically comes back out of the economy.

Senator RYAN—I appreciate that. With respect to the discussion around inflation and unemployment, you said that we are not seeing any inflation right now. Isn't it also fair to characterise inflation as something that has a lag effect? It takes a long time to appear and then takes a long time to eliminate. While unemployment, as we have seen, tends to spike and take a long time to eliminate, to say that we are not having inflation now, less than a year into this package, does not mean that we could assert that it is not leaning towards inflationary effects, surely?

Dr Denniss—Indeed. I said that unemployment is still rising and still predicted to rise. The combination of rising unemployment, stagnant employment growth and no presence of inflation reinforces, I think, my view. There are things that the government can do along the way. I gave the example of keeping prices down—

Senator RYAN—Sure. We are pressed for time. My last question is: do you believe that an inflationary environment—an economic environment with higher inflation—actually leads to greater unemployment over the medium term in the economic cycle, or do you believe that inflation is not something which we should be concerned about as a prime objective of fiscal and monetary policy?

Dr Denniss—Unless someone is talking about changing the RBA target range, in the long run it will not make any difference. I think the RBA will continue to be successful.

Senator RYAN—The RBA is required by its act to achieve full employment and monetary stability. From the lessons of the eighties versus the nineties and maybe even the seventies, many economists have argued that high inflationary environments are very destructive to the

investment necessary to provide for economic growth. Is that a concern with which you agree or disagree?

Dr Denniss—I would be concerned that, all other things being equal, we were trying to create a high inflation environment. But, in the middle of a big slowdown, I think it is extremely premature to be worrying about inflation just yet.

Senator RYAN—Lessons of the 1970s—but I will hand back to the chair.

CHAIR—We are going to have to finish up there. Thank you very much, Dr Denniss.

[3.13 pm]

MAKIN, Professor Tony, Private capacity

CHAIR—Welcome. Would you like to make an opening statement?

Prof. Makin—I thank the committee for inviting me here this afternoon. Having listened to the evidence just provided, I would at the outset say that I am opposed to much of what was said. A key part of my contribution to this debate has been to think about Australia as an open economy, not a closed economy. All the talk we have just heard about inflation, unemployment and trade-offs and so on was couched in terms of economies operating unto themselves. What has happened over recent decades is that there has been a large opening up of economies—the phenomenon of globalisation, which we have heard a lot about—and this has affected the way in which policy works. In Australia's case, we have had a long debate, which has since been forgotten, about the significance of our borrowing from abroad. In fact, it was an underpinning of Treasury policy literally for decades. I am a former Treasury officer and I worked in Treasury at the time when Treasury thought the current account deficit was the biggest threat to the Australian economy and that the growing foreign debt was the biggest threat to the Australian economy. At the time, I argued that it was not so for the reason that a lot of it was private.

What we are now seeing is a complete reversal of that argument. The foreign debt, the capital in-flow, the foreign borrowing is not significant; it never gets a mention much in the academic debate, at least. But what the fiscal turnaround has done has meant unequivocally that Australia must be increasing its borrowing from abroad to fund the budget deficit. I have done some empirical work on this to show that the relationship is really quite close. I have done another paper that is forthcoming in the peer-reviewed ANU journal *Agenda,* which shows that the budget deficit will add to the foreign borrowing. Other things remaining the same, this is going to increase interest rates. It must increase interest rates. It is adding to the demand for funds. Funds in net terms would be sourced from abroad. This would push up interest rates, there would be a higher risk premium on Australian borrowing, and the consequence of that will be two losses to the Australian economy. The first loss will be: the higher interest rates will crowd out private investment. That private investment means we will have a lower capital stock than we would have otherwise had, and into the future we will have a lower growth path.

The second cost is the sheer payment of interest abroad, which will be significant. It is a significant part of Australia's external position. A large part of the current account deficit is interest paid abroad on previous foreign borrowing. In this case it will be interest paid on new public debt, and that will be a net drain on the economy. Every dollar of interest paid abroad on public debt will be a subtraction from GDP. So there will be a net loss. In other words, fiscal stimulus leads to a loss for Australia if it means that we are borrowing more and if the funds are not put to productive use.

The distinction that should be made here is the distinction between fiscal expansion that is productive and fiscal expansion that is unproductive. Fiscal expansion that leads to productive investment and increases to capital stock is some of infrastructure which I endorse. A lot of it in the form of payments to stimulate consumption, wasteful government consumption or even

capital spending that pays no rate of return is going to be leading to a loss for the country as a whole. Infrastructure that does not pay a rate of return ultimately has to be serviced and the net loss to Australia is going to be the interest paid abroad on the capital that is put in place.

I might leave it at that. The main point I am making is the emphasis on the open economy. There are economic models that suggest outright that fiscal stimulus in an open economy just does not work. The Nobel prize winner Robert Mundell demonstrated that quite some time ago—that if you expand fiscal policy you push up interest rates. This induces capital inflow, the exchange rate appreciates, and this worsens competitiveness and worsens the trade account. We are seeing that now in evidence. The exchange rate has bounced back quite strongly. The fiscal stimulus may have been effective to a limited degree for the retail sector, but I venture that the appreciating exchange rate that is a consequence of it is very bad for other sectors of the economy, including manufacturing, which is quite labour intensive.

Senator BOB BROWN—As a former Treasury officer you are saying Treasury is wrong?

Prof. Makin—I am saying that Treasury is neglecting the open economy considerations. It was at the forefront of budget strategy for a long time. One reason why we had budget surpluses was that the Australian economy would not in net terms be borrowing abroad, because of public sector activity. The surpluses were mitigating against that. That was a rationale. If you look at the budget statements over the 1990s and going back further, the rationale for having surpluses in the first place was, in large part, influenced by the external constraint and the balance of payments constraint.

Senator BOB BROWN—What is the private sector indebtedness?

Prof. Makin—Total net debt in Australia is about 60 per cent of GDP and that is nearly all private now. The fiscal balance went to surplus for a long time and the net asset position was positive for the government sector. So we have gone from a positive asset position of about plus five per cent of GDP looking in prospect in a year or two to minus five per cent and there on to minus 15 per cent in a few years.

Senator BOB BROWN—Just for my edification, the money paid to service a private debt overseas is paid by Australians just the same as money paid to service a public debt overseas, isn't it?

Prof. Makin—Yes. But it is incurred in a different way. It is incurred because investment in Australia exceeds available private savings. So in net terms if the government sector is in balance, the external imbalance—that is, the current account imbalance or the capital account surplus which matches it—is reflective of higher investment over savings. If the investment is generating a return in excess of the interest paid abroad than we are benefiting. I have published papers to show that we have gained in that sense.

Senator BOB BROWN—But the very fact we are in an open economy which has gone into global recession means that the private sector globally is in a period of failure, isn't it?

Prof. Makin—The sector that failed was the banking and financial sector in the US—that is the heart of the problem.

Senator BOB BROWN—But that is part of the private sector of this open economy, isn't it?

Prof. Makin—Yes, that is true. There are many reasons for that failure. Some of them are due to government guarantees that have distorted behaviour in that sector. I think moral hazard is the key problem for banking sectors everywhere; it always has been: the fact that governments underwrite activities and provide guarantees—they are always there to bail them out. The actions of Greenspan over recent decades leading up to the crisis suggested that moral hazard was very high—that there was too much risk taking. There is no question about that. Another key factor I think was a Keynesian fear of deflation in the earlier part of this decade. I am also a former IMF official and I was working at the IMF in 2002-03. The biggest fear then was that the OECD region would experience deflation. The US Federal Reserve pumped liquidity in, kept interest rates extremely low and sowed the seeds for the excess in the housing market that eventuated. There has been a combination of market failure and government failure in the financial sector.

Senator BOB BROWN—What is the balance of that blame?

Prof. Makin—I would say that the balance of the blame is largely government failure—predominantly.

Senator BOB BROWN—Really? Even though it was a private sector failure?

Prof. Makin—Yes, but, the private sector failure occurred because of the government interference, including the problem we are always going to have, and that is with moral hazard. A radical solution is to revamp the whole banking system and have 100 per cent reserve banking where you do not have the moral hazard.

Senator BOB BROWN—It is very interesting, Professor Makin! So it is governments' fault that we are in this recession?

Prof. Makin—Look, it is a combination—

Senator BOB BROWN—but primarily governments' fault?

Prof. Makin—The American economist John Taylor has written a book on this setting out some of the government failure leading up to it. I think there was excessive money growth in the US; there was excessive interference in the mortgage market—the underwriting of Fannie Mae and Freddie Mac was a problem. Added to that there was a private sector failure, and that was in the finance sector. There was a private sector failure—there was too much slicing and splicing of debt, selling it on and the creation of that third tier in the US banking system. The merchant banking sector was not cognizant of the risks involved. Too much rocket science was put into it.

Senator BOB BROWN—Would I be wrong in saying, then, that better regulation in Australia avoided us being in the same problem?

Prof. Makin—I agree with that. I think a system here was more soundly regulated. That is true, yes.

Senator BOB BROWN—But that indicates, doesn't it, that good government intervention—that is, regulation—is not a bad thing?

Prof. Makin—When it comes to the banking sector, given that you have this is the starting point of moral hazard, then you do need to regulate, sure. I do not disagree with that.

Senator BOB BROWN—The stimulus package: has it not helped the economy?

Prof. Makin—I have written a few opinion pieces on this, suggesting the factors that helped Australia avoid a technical recession—although one could question whether we did avoid a technical recession because two of the three measures of GDP were negative. The relaxation of monetary policy I think was very important. The slashing of interest rates was very important. The depreciation of the Australian dollar, which plummeted from near parity with the US dollar down to about 62c at one stage and stayed at low levels for most of the two quarters when the global financial crisis reached its peak, was a great buffer.

I think it is interesting to compare what happened here in terms of policy response in the last 12 months with what happened with the Asian crisis. The Asian crisis happened in 1997-98. I was very interested in that issue at the time. The rhetoric was quite similar though not as extreme: it was the worst crisis we had had since the Second World War, not since the Depression, and all sorts of things were going to happen to the world economy. Nobody at that time advocated that all economies stimulate through fiscal expansion. What Australia did at that time was that it allowed two of the three things to happen that have happened in response to the last one. One was let the exchange rate depreciate, which it did, and the other was lower interest rates. It did not engage in fiscal stimulus, and yet we came through that crisis unscathed as well.

Senator BOB BROWN—But you are not saying that the Asian crisis affected, potentially, the Australian economy in the same way that—

Prof. Makin—We are highly exposed to Asia through exports and imports.

Senator BOB BROWN—You think more so?

Prof. Makin—We are more exposed to Asia directly as an open economy than we were to the US.

Senator BOB BROWN—Just on that, do you think the Chinese economy has played no role in helping Australia through this period?

Prof. Makin—I did not add it to the list of things there but there is no question that the demand from China for our exports has played a part as well in cushioning the economy. If you look at the March quarter national accounts, where we recorded that surprising positive in the accounts, exports were strong but also the exchange rate had done its work in curbing imports at that point. But I will note one thing about China. I was talking to a visiting delegation from their central planning body just a week or two ago. The fiscal stimulus there has worked, redirected to the home economy as opposed to moving away from reliance on international trade, but what they are saying is that there is no private investment, this is all public stimulus, and they

themselves are concerned about the lack of private investment going forward, which is essential to recovery.

Senator BOB BROWN—I am aware that the chair is going to stop me very shortly but I cannot miss this opportunity since you work with Treasury, and Treasury is coming here next week, to ask you: what question would you put to Treasury about the stimulus package and the further rollout of it and the potential for more?

Prof. Makin—Which question? I would say: why was it necessary in light of the economic theories that suggest it does not work? Secondly, why was constructed as it was without any emphasis on the private sector or the supply side of the economy?

Senator BOB BROWN—What I am meaning here is that there is evidence, and you have even said this, that it has to some degree worked. We are in the middle of this rollout now. What about the question of what Treasury is going to do with it: should it continue with it, diminish it or even get ready for further stimulus down the line?

Prof. Makin—I would argue strongly that it should be diminished, that it was excessive in the first place.

Senator BOB BROWN—To what degree?

Prof. Makin—To the maximum degree possible.

Senator BOB BROWN—What is that?

Prof. Makin—As I have said, I thought it was unnecessary largely at the outset. So: winding it back, scaling it right back, and trying to prevent any further commitments that do not meet a basic cost-benefit test, essentially. All projects from now on should be rigorously examined as to their benefits because the ultimate test is whether the benefits exceed the costs in terms of the interest paid abroad to foreigners.

CHAIR—Very interesting. Professor, do you believe the government has a forward plan for sustainable long-term growth in terms of minimising public debt to free up resources, long-term productivity returns on government investment, with reducing spending on publicly funded projects which incur debt? In other words, should we, as you just said, wind down the stimulus spending because it is no longer needed and let the market operate? It seems quite a lot of the allocated funding is yet to be spent. For example, I believe 75 per cent of the funding for infrastructure has not been spent as yet.

Prof. Makin—The budget set out that there would be a scale-back into the future, that real outlays would not exceed two per cent. We are yet to see the details of that scale-back and how it is going to be implemented, whether it is going to come through higher taxes, which would of course stymie future growth. Look, I am not privy to forward planning by Treasury, so I cannot be too specific about that.

CHAIR—Do you think they should have a forward plan?

Prof. Makin—I definitely think they should have a forward plan. I think they should be seriously considering the efficacy and the need for what has been done to date. If it has not been worthwhile then why continue doing something that is harmful?

CHAIR—So you are saying you see risks in excessive financial stimulus in the form of increased government spending to the economy.

Prof. Makin—Yes, for the reasons I mentioned at the outset, that is the excessive unproductive government spending is going to exacerbate the foreign borrowing issue, is going to lead to higher levels of public debt that have to be serviced because in net terms Australia will have run up net public debt abroad. That is going to be a drain on the economy.

Senator CAMERON—Professor Makin, I am a bit confused on some of your evidence and I want to go to some of these issues. First of all, congratulations: you are the third IPA contributor here today. The Institute of Public Affairs are really dominating today.

Prof. Makin—I would like to correct that. I am not formally affiliated with the IPA in any way. I was invited to attend a conference convened by the IPA. I presented a paper there. They posted it, as they did with other presenters, on their website. But I am not formally affiliated with IPA in any way.

Senator CAMERON—You have indicated that the stimulus may have been effective to a limited degree in the retail sector. Do you know what percentage of the retail sector is of the overall economy?

Prof. Makin—The retail sector accounts for about five per cent of GDP.

Senator CAMERON—It is a pretty important part of the economy domestically, isn't it?

Prof. Makin—It is not as important as other parts. The wholesale sector, manufacturing, agriculture, mining account for a bigger share than retail. Retail is unique in that a lot of the product that it puts on shelves is imported, so spending a lot on retail is spending a lot on imports.

Senator CAMERON—A big employer.

Prof. Makin—It is a big employer, but by favouring that particular sector it is actually improving their profitability. So it is in a way a form of subsidy to that sector, at the cost of other sectors.

Senator CAMERON—It does not matter if there are jobs being saved, the big problem is a subsidy to the sector. What is more important in the current circumstances: a subsidy, as you claim, to the sector or maintaining jobs in the sector?

Prof. Makin—It has come at the cost of other jobs; that is the point. Not only now but into the future the fact that the exchange rate is appreciating is due to the fact that the long-term interest rate is higher because of prospects of government borrowing. That is hurting

manufacturing. It is a concern to me that jobs in manufacturing are going to be lost because of the fiscal stimulus.

Senator CAMERON—I have been interested in manufacturing for many years. I have not seen any papers that you have written on manufacturing. I did not hear your voice when you were in Treasury arguing that manufacturing should be maintained. Is that something I have missed?

Prof. Makin—No. I do not advocate for any particular sector.

Senator CAMERON—You just did.

Prof. Makin—I am just saying that the exchange rate is going to adversely affect some tradeable sectors, including manufacturing.

Senator CAMERON—I just thought I had missed all these strong voices supporting manufacturing over the years, but obviously not. You indicated that you also worked for the IMF. Is current IMF Managing Director Dominique Strauss-Kahn wrong when he says:

While global growth appears to have turned the corner, we should not forget that so far, this has been mainly due to massive policy support.

… … …

Unwinding the stimulus too soon runs a real risk of derailing the recovery, with potentially significant implications for growth and unemployment.

Does he have it wrong?

Prof. Makin—He is broadly defining stimulus to include not only fiscal but also monetary and other forms. He is not identifying fiscal stimulus there. I have at no time argued against the relaxation of monetary policy to stimulate the economy. As regards the IMF position on fiscal stimulus, there is a very interesting tension within the IMF at the moment between what the director and chief economist say and what a lot of the research says. There is no consensus in terms of the research; in fact, there is a lot of critical work that has been published that suggests that fiscal stimulus is not an optimum policy response. If you read the managing director's comments closely over recent quarters, you see that one stage he was saying that economies that were borrowers should be cautious in exercising fiscal stimulus. That included us.

Senator CAMERON—On 5 September the managing director said:

Given the fragility of the recovery, there are risks that it could stall—though thankfully these risks appear to be receding. Premature exit from accommodative monetary and fiscal policies is a principal concern.

He is the boss. It does not matter what is going on in the back rooms; he is the most influential figure in the IMF. What is more important: the back room scuttlebutt and analysis or the public policy of the Managing Director of the IMF?

Prof. Makin—He is a former finance minister of France.

Senator CAMERON—Is that a subtle put-down?

Prof. Makin—No, it is not. I am just saying that there is a political angle in this and there is a strict economic angle. I would more favour the economic analysis done by the research economists at the IMF. I would also highlight that the Bank for International Settlements has exercised caution, and I point out that if you read the papers that have been produced by the fiscal affairs department of the IMF you will see that there is this great tension between what they are saying and what the managing director is saying.

Senator CAMERON—So the Managing Director of the IMF has it wrong. What about Timothy Geithner, the US Secretary of the Treasury? He says:

The classic errors of economic policy during crises are to act late with insufficient force and then put the brakes on too early. We are not going to repeat those mistakes.

You have the IMF, the US Secretary of the Treasury and the IPA down here somewhere. The main economic voices are out there disagreeing with what you are saying.

Prof. Makin—With respect, they are not academic voices. There was a petition signed by some 300—

Senator CAMERON—That is good. Who would want an academic running the economy? I said that this morning and the more I hear from academic economists the more I believe that it would be a fatal mistake.

Prof. Makin—Ben Bernanke is an ex-academic economist and he seems to be getting a lot of credit for what he has done.

Senator CAMERON—I will tell you what Ben Bernanke is saying now if you like. I can also quote Nicolas Sarkozy, Angela Merkel, and the OECD. According to you, they are all wrong. Is that your position? They are all wrong and you are right. The contributors to the IPA know where it is at, but the OECD, the IMF and Treasury do not know where it is at.

Prof. Makin—As I said, I am not formally affiliated with the IPA. I have attended one conference on invitation along with others from various different bodies. So I do not know why you have this thing about me and the IPA. If you look at the IPA website, you will see that I have a paper there that was presented at this conference, which included ex-public servants I used to work with here in Canberra from various departments. That aside, I guess you are asking me to make a judgment on whether governments are right and academics are wrong. I would say that the academics are usually at the forefront of ideas and that it is usually 20 years afterwards that governments pick up those ideas. Unfortunately, in public service circles in Australia, a lot of government economists have not been reading the literature over the last 20 years. If they had, they would not have engineered the fiscal excess that we are now seeing.

Senator CAMERON—They have all got it wrong and you have got it right—I think that is what you are putting to us.

Senator COONAN—On a point of order, you cannot just wrap something up and verbal a witness.

Senator CAMERON—I learned from you lot.

CHAIR—Senator Cameron, you have got to be fair to the witnesses.

Senator COONAN—It is not how long anybody has, it is whether you are correct or not. If you do not quite get what you want from the propositions you are putting to this witness, you just ignore it and wrap it all up into some conclusion that has got no support from the witness. You cannot do that.

Senator CAMERON—Do not lecture me about that.

CHAIR—Let us move on. The witness has said what he said and the readers of the *Hansard* will see exactly what the witness said and meant, notwithstanding the law according to Senator Cameron. So let us give the witness credit for his views. Senator Cameron, if you have further questions, please ask them because we have to move on quickly.

Senator CAMERON—You raise the issue that we are in a new type of global economy and that we are focusing on domestic issues. Are you putting to us that we are trying domestic solutions?

Prof. Makin—No, I was saying that we are ignoring the international implications of domestic policy changes—that is the point I was making. With reference to the trade deficit, foreign borrowing and foreign debt, the standard models suggest that if you implement fiscal stimulus then you push up interest rates, you appreciate the exchange rate and you are no better off than you were before implementing fiscal stimulus. That is the textbook model.

Senator CAMERON—Right, but you did indicate that we have a domestic focus. Do you accept that there is an international focus in trying to deal with this financial crisis?

Prof. Makin—Absolutely. I think coordinated monetary response was essential, as I have said all along.

Senator CAMERON—What about a coordinated international fiscal response?

Prof. Makin—That is where I differ. I just do not agree with that. The basic premise of the rationale for fiscal stimulus has been that spending has to be pumped up, but what is forgotten is that this comes at the cost of funds. You put pressure on available funds, you push up interest rates and it cancels out the benefits.

Senator CAMERON—What do you say then about the Chinese fiscal stimulus, which is one of the biggest in the world? It is being used to continue to drive our economy. Should they stop that as well?

Prof. Makin—That is up to them. It is not for me to say what the Chinese government should do. I would add to what I said before—because I did address that—by saying that the driver of

the Chinese economy at the moment is the fiscal stimulus. China is growing at between six and eight per cent. It was growing at over 10 per cent. There is concern there about the lack of private investment going forward. Without that private investment, the Chinese economy will stall.

CHAIR—Senator Cameron, this might have to be close to your last question.

Senator CAMERON—Okay. Professor, you indicated that private investment should be the way to take us through this. When the international economy is frozen, as it was after Lehman Brothers, how do you then get private investment operating without doing what the global economies have done and what Mario Draghi, the chairman of the Financial Stability Board, has talked about—breaking the negative feedback loop between the financial system and the real economy? How do you do it without both momentary and fiscal stimulus?

Prof. Makin—I just do not see that fiscal stimulus is a necessary add-on to that. The key problem is the monetary sector and the risk with discussion of large initiatives for fiscal stimulus is that you literally frighten the private sector off investing, because what high public debt means to the private sector is either higher taxes in the future or higher inflation in the future. My fear is that we are going to replay the 1970s, in which decade we saw a similar occurrence. We saw fiscal expansionism in the early part of the decade, public debt levels were rising and there was a tendency for governments to monetise that public debt—that is, the central banks just divide it up. That is one way to get rid of it, and of course that brought on high inflation which persisted for two decades. So I think a big risk going forward is that the extraordinarily high public debt will be monetised, which will bring us into a new era of high inflation.

Senator CAMERON—Our debt is low by international comparison. Do you accept that?

Prof. Makin—Our debt, yes. Our debt is low by international comparison—I accept that that is a fact—but the turnaround is one of the highest. We have gone from a net asset position to a debt position, and in net terms that must be foreign borrowing.

Senator CAMERON—And the fiscal stimulus that we have put in—the investment in roads, the investment in rail—has absolutely no productivity benefits in the long run?

Prof. Makin—No.

CHAIR—Senator Cameron, I think we have to move on to other people.

Senator CAMERON—I just want to hear the answer to this question.

CHAIR—That is fair enough, but this will be the last question.

Prof. Makin—I thought I had answered that before. I said that yes, that is beneficial. I agree with that, yes. I have said that and I have written an academic paper, published a few years ago, to say that fiscal stimulus can be beneficial provided it is investment and provided the rate of return is greater than the servicing cost.

Senator CAMERON—So you are arguing about 30 per cent of the package, not the 70 per cent. So you are not arguing about the whole package?

Prof. Makin—No.

Senator CAMERON—Seventy per cent is infrastructure; 30 per cent is the—

Prof. Makin—Well, it depends on the nature of the infrastructure. It has to be productive infrastructure. I would say that the productive infrastructure is fine, yes, but it is the sort of stuff that you would do anyway—should do anyway. I would agree that there has been some deficiency in the provision of infrastructure.

Senator COONAN—To finish off on that point, you have been making the point throughout your evidence that, in effect, for the benefits to exceed the cost you have to have value for money. Before you looked at winding back the stimulus, you would need to have a good look at whether what still had to be rolled out would provide value for money, I would think.

Prof. Makin—Yes, exactly.

Senator COONAN—Do you agree with that?

Prof. Makin—Yes, absolutely. That is exactly right. As I said before, each project going forward should satisfy a basic cost-benefit analysis. The benefits in terms of productivity and the return on the spending should exceed the cost, which now is going to be the interest cost on the public debt.

Senator COONAN—Yes, which we know is a pretty fair whack—I think about $12 billion, on our last estimate. Could I just ask a couple of questions going back a little bit. You answered some questions about the retail sector. How effective is activity in the retail sector as an indicator of the effectiveness of fiscal policy?

Prof. Makin—I do not think it is very effective. If there is a lot of increased activity in the retail sector to the extent that there is more spending on plasma TVs or other imported goods, then this is not stimulating the domestic economy. It may well be stimulating overseas economies, but it is not stimulating domestic economy.

Senator COONAN—You also talked a bit about an open economy, and I think we have the drift of that. For my interest and certainly that of the committee, in terms of the effectiveness of fiscal policy in stopping recession or alleviating the effects of recession, what is the difference between assuming a closed economy and assuming an open economy? For example, in a small open economy with capital mobility and a flexible exchange rate, what is the more effective policy—fiscal or monetary?

Prof. Makin—Unquestionably monetary policy is more effective. Monetary policy in an open economy works largely through the exchange rate, and we saw that. We saw that the relaxation of monetary policy by 425 basis points over a short period of time was a reason for the exchange rate depreciation, but there are other reasons as well. There was the collapse in commodity prices, which was also instrumental in that depreciation. That is where monetary policy gets its

kick in an open economy in that by lowering interest rates the exchange rate depreciates. The problem we have at the moment is that the exchange rate is appreciating too strongly which is going to choke off recovery or slow the pace of recovery as a consequence. This is standard textbook stuff, it is not rocket science, and the economists in international organisations are aware of this. Standard textbook analysis tells you that fiscal stimulus in an open economy with a floating exchange rate is ineffective, except if it is productive. That is to say fiscal stimulus in the form of a consumption-enhancing expenditure is ineffective.

Senator COONAN—I think I have seen you write about the fact that there are more significant financial benefits to households from, for example, relaxation of monetary policy. I think you did some figures, so could you tell us about that?

Prof. Makin—The interest rate cut has delivered more in terms of disposable income to the average householder with an average $200,000 loan than they would have got from the payout. It is not just households—

Senator COONAN—You mean from the cash splash.

Prof. Makin—From the cash splash, as you call it. The benefit of monetary policy is more widespread than that. There is the effect on business as well with lower interest rates and business finds its costs not as high. One thing with this crisis that has been neglected is that we have had this massive response in terms of demand management but the initial impetus really was on the supply side. It was interest or the availability of funds which was the shock to the system in the first instance. The response, nonetheless, was to spend or to increase aggregate demand, so the sector of the economy that was most value-affected initially was the supply side. Then there was the demand side reaction through lack of confidence.

Senator COONAN—With scarcity of credit.

Prof. Makin—Yes.

Senator COONAN—In some of your exchanges with Senator Cameron there was some discussion about the OECD and IMF—and I think you have probably answered this but just in case you have not—obviously the G20 has said that, whilst some international cooperation is very important, each country or each economy needs to look at how they actually manage their own exit strategies. That suggests to me—and I am just inviting a comment—that it is relating to not only how they would exit from monetary policy, because obviously that has flow-on global effects, but their domestic fiscal strategies are peculiar to their own economies. That particularly would suggest to me that each country needs to look, and can look, at what effect it is going to have on their own economy as to how they might wind back.

Prof. Makin—Yes, exactly. I think that in reading carefully the statements that have been made by the heads of international organisations, there has been a lot of discretion left to economies to implement the suggestions as they wish. As I said in a reply to Senator Cameron, the head of the IMF was not urging borrower economies to spend; in fact he made the statement that it may be wise for some economies to cut back government spending instead of increasing government spending. This has been an aspect of my position on this response. There has been none of that in Australia unfortunately. There should have been some cutback on government

expenditure to the extent that this would have freed up savings. If you think about the open economy you think about the saving-investment balance and the call on foreign funds that would have added to domestic saving and would have reduced the foreign borrowing requirement.

Senator BOB BROWN—What would you have suggested that the government cut back on?

Prof. Makin—I think that there are aspects of middle-class welfare that could have been trimmed.

Senator BOB BROWN—Which aspects?

Prof. Makin—I am no expert on the public sector accounts in Australia at the moment—I used to be when I worked in the sector—but as a broad matter of principle there are benefits from cutting back on wasteful government spending and I think that it is up to Treasury and the Department of Finance to identify those areas with assistance from elected representatives and senators.

Senator BOB BROWN—And you think that the IMF president was calling for a cut on wasteful spending rather than spending per se?

Prof. Makin—Yes.

Senator BOB BROWN—Did he say that?

Prof. Makin—I do not have his words in front of me, but he did say that there was scope for cutting back on spending. Implicitly that would be wasteful spending. The IMF has been for a long time a promoter of spending on productive infrastructure and not on government consumption. If there is a choice in consolidating accounts you are much better off cutting back on wasteful consumption as supposed to the productive infrastructure.

CHAIR—We have now reached our scheduled finishing time but I think that Senator Bushby has some questions and I believe that Senator Xenophon is online with a question.

Senator BUSHBY—Thank you, Professor Makin, for coming along today. What capacity existed to further utilise monetary policy to address the impact of the global financial crisis?

Prof. Makin—I think that there has been much more capacity in Australia than has been utilised. There was potential to lower interest rates a further three per cent at the official level even before fiscal stimulus was adopted. As I said earlier, the fact that fiscal stimulus was adopted has now militated against that option. But as I wrote in various articles at the outset of the global financial crisis, that was the preferred policy option: to use monetary policy, first and foremost, and only use fiscal policy subsequently if necessary.

Senator BUSHBY—So if the fiscal package had not been as large do you think that interest rates would have come down further?

Prof. Makin—Yes.

Senator BUSHBY—We heard earlier today that monetary policy takes time to work through the economy and is not as effective in achieving response in terms of growth of the economy in a timely way and that is why we need to have the cash spend. What are your thoughts on that allegation?

Prof. Makin—I do not agree with that because the exchange rate, I think, is the key variable to adjust. The exchange rate and the interest rate are both important but the exchange rate will adjust immediately with the fall in interest rates. You see that. The exchange rate will adjust in anticipation of a fall in interest rates and that is an immediate boost to competitiveness. That raises the receipts of exporters and it is a disincentive to import, which means it is a switch of spending—

Senator BUSHBY—From substitution to local or domestic—

Prof. Makin—from substitution to spending on domestic product, which is stimulatory.

Senator BUSHBY—If the planned spending of the remainder of the stimulus package was reduced or wound back, what impact would that be likely to have on interest rates?

Prof. Makin—It would take pressure off interest rates. As I outlined at the outset, the high budget deficit is going to increase the demand for funds from abroad. That in and of itself is going to push up interest rates because we face a rising supply price of funds from abroad especially under current conditions, and if interest rates are rising for that reason this is going to choke off some private investment. But undoubtedly interest rates would be lower if the fiscal stimulus were wound back.

Senator BUSHBY—If the fiscal stimulus was either wound back or had not been as big in the first place and that resulted in lower interest rates than we would have with the full fiscal package, what overall impact would that have compared to where we are heading? Obviously we are going to have a higher debt with higher interest rates and we would have had lower debt with lower interest rates. How would that have played out in the economy?

Prof. Makin—Going forward we would have a stronger recovery with lower interest rates because, as I said earlier, the key to recovery is private investment. A characteristic of any recession is a slump in private investment and a characteristic of recovery is a pickup in private investment. The lower interest rates are the better it is for private investment.

Senator BUSHBY—In the short term, could we have still achieved the desired outcomes of keeping unemployment low and the economy growing by employing the strategy of the lower fiscal and lower interest rates?

Prof. Makin—Yes. More should have been done with monetary policy and less with fiscal policy. It would have achieved a better outcome.

Senator XENOPHON—Professor, you may want to take this on notice, but we have talked about the cost-benefit analysis of infrastructure spend in terms of maximising the productive capacity for the economy: what sorts of benchmarks do you say are necessary to look at that to ensure that we maximise the benefit of any spend?

Prof. Makin—I think that the minimum requirement would be that the rate of return on the public investment would exceed the foreign interest rate. In net terms the budget deficits are going to add to Australia's foreign borrowing requirement and that must be serviced at the going world interest rate.

Senator XENOPHON—And you can point to what you think would be better in investments in terms of the productive capacity? And again, Professor, you can take that on notice.

Prof. Makin—Sure. Okay, on notice, yes.

Senator XENOPHON—Finally, you have economists like Paul Krugman who say that you need to look at the psychology, that economics is an imprecise science. One of the arguments for the stimulus package was that if people were worried about losing their jobs, by propping up the economy with the cash payments that actually limited or prevented a downward spiral in consumer confidence and, if there is a downward spiral in consumer confidence, people stop spending, which has its own effects on the economy. Do you acknowledge that that is a fact that needs to be considered in approaching fiscal policy in terms of the psychology of consumers and the psychology of people being concerned about losing their jobs?

Prof. Makin—I think that it is a bit more complicated than that. The psychology of consumers and households generally is affected by the prospects of future debt and future taxes, and there is evidence to support that for every dollar increase in public debt there is going to be an offset in consumer spending of about 60 per cent of that over a longer period than we are talking about here. But there will be an offset on the part of households because of their fear of paying higher taxes due to the higher public debt. So that is the reactive behaviour of households. In fact I have done some empirical work with a colleague to show that over the last 20 years the public-private offset has been about one, suggesting that stimulus measures like this ultimately prove futile in increasing consumption.

Senator XENOPHON—Again on notice, if you could send that to the committee, I would find that interesting. But also, the fear of unemployment must surely be a significant factor.

Prof. Makin—Yes, but again, we need to offset against at the reactive behaviour of firms, and what I have been emphasising is the investment drought which will be prolonged if firms themselves see higher taxes in prospect in the future and that higher interest rates are likely.

Senator HURLEY—I would just like to follow up on an interest rates question. You are really indicating that that is pre-eminent in determination of investment, but we have been hearing just lately that private investment is also dependent on the availability of funds and that it is extremely difficult for banks or private investors to get funds in the market. So in a sense, no matter how low the interest rates have been it would not have mattered because they cannot get the funds.

Prof. Makin—There is the quantity constraint and the price constraint, that is true. But that just adds weight to my argument about Australia as an open economy. If funds are in short supply—and they are globally—then we should not be out there borrowing to fund unproductive activity.

Senator HURLEY—So how long would you have the economy in Australia in this state when nothing is happening in terms of infrastructure and investment, hoping for the best, hoping that the funds will free up eventually?

Prof. Makin—Recoveries can be quick. There are some classic cases of quick recoveries following financially induced real recessions. In the United States in 1921, GDP fell by some 30 per cent and unemployment went up to 30 per cent, and it was all reversed within a space of 12 months. It was remarkable, a freakish example—but that is an extreme. The fact is that economies do recover, and they do recover by themselves; it is just a question of how long it is going to be. Keynesian economists would argue that the role of government is essential in terms of fiscal action, but there is a debate about that. There is the issue about the 1930s and many economists argue that it was because of government action that the depression lasted so long.

Senator HURLEY—I think that it would be a very optimistic government that would be prepared, on the theoretical basis of how markets would operate, to sit back and let unemployment rise and investment stall completely.

Prof. Makin—Sure. I think that governments feel the need to act and that is understandable, and governments do act. But I do not think that it is always based on proper economic analysis—because of the long-term consequences of the political action. It is a political response not an economic response.

CHAIR—I think that we will have to conclude there, Professor. Thank you very much.

Committee adjourned at 4.08 pm

The Senate

Economics References Committee

Government's economic stimulus initiatives

October 2009

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TABLE OF CONTENTS

Membership of Committee ..... **iii**

Chapter 1 ..... **1**

Introduction **1**

The referral 1

Conduct of the inquiry 2

Structure of the report 2

Chapter 2 ..... **3**

Spending initiatives **3**

Australian stimulus measures since the global financial crisis 3

Chapter 3 ..... **7**

Policy responses **7**

Fiscal policy and monetary policy 7

Keynesian policies 7

The hallmarks of a well-designed fiscal stimulus 14

Interaction between fiscal and monetary policy 15

Alternative stimulus approaches 17

Preparation for future recessions 19

Chapter 4 ..... **21**

Impact of the stimulus packages **21**

Australia outperforms 21

Australia was in a singularly strong position before the crisis 21

The impact of the fiscal stimulus in Australia 24

The effects on business and consumer confidence 28

Effects of higher national debt and implications for future taxation and long bond yields 30

Assessing the stimulus package with models 32

Chapter 5 ..... **35**

Should the package be scaled back? **35**

The change in the economic outlook since October 2008 35

Inflation and unemployment – the balance of risks 43

Chapter 6 ..... **45**

Conclusion and Recommendations **45**

Government Senators' Minority Report **49**

Introduction 49

Background to the economic stimulus initiatives 49

Efficacy of the spending measures 55

Costs and benefits of continuing the spending measures 59

Consequent changes in the stimulus "roll out" given the changed economic circumstances 62

Impact of spending measures on interest rates and taxpayer liabilities 63

Environmental impact of spending measures 66

Conclusion and recommendation 67

Additional Comments Senator Bob Brown, Australian Greens **69**

Additional Comments by Senator Xenophon **71**

Introduction 71

Distribution of the economic stimulus 72

Effects of the economic stimulus 73

Looking ahead 74

Conclusion 76

Recommendations 76

APPENDIX 1 ..... **79**

Submissions Received **79**

Additional Information Received **79**

APPENDIX 2 81

Public Hearing and Witnesses 81

APPENDIX 3 83

Composition of stimulus measures 83

Composition of the Economic Security Strategy 83

Composition of the COAG Funding Package 84

Composition of the December Nation Building Package 86

Composition of the Nation Building and Jobs Plan 87

Nation Building Infrastructure measures in the 2009–10 budget 91

Chapter 1
Introduction

The referral

1.1 Disruptions to the financial system have resulted in the global economy contracting in 2009, for the first time since the Second World War.[1] The Australian economy is less vulnerable to external shocks than many other advanced economies given its stronger and better regulated financial system and its mining industry's links to the strong Chinese economy, but nonetheless was expected to suffer a serious contraction as a result of the global downturn.

1.2 When the global outlook deteriorated sharply in late 2008, most advanced economies moved to implement some form of fiscal stimulus. A record of prudent fiscal policy going back more than a decade allowed Australia to introduce a larger stimulus than most countries, which further moderated the recession in Australia.[2]

1.3 The economic outlook has improved over recent months.[3] This has led to calls to scale back the economic stimulus initiatives announced by the Government in October 2008 that will be progressively wound down over the forward estimates to 2011-12. The Senate referred this issue to the Economics References Committee on 8 September 2009. It initially asked the Committee to report by 2 October 2009. The Committee presented an *Interim Report* on 30 September 2009, requesting an extension of the reporting date to 27 October 2009.

1.4 The Senate's reference requested the Committee to invite the Secretary of the Treasury and the Reserve Bank Governor and other pre-eminent economists to appear with the goal of a full update on the economic stimulus initiatives, which addresses:

> (i) the efficacy of the spending measures to date,
>
> (ii) the anticipated costs and benefits of continuing the spending measures,
>
> (iii) consequent change in the stimulus 'roll out' that ought to be entertained given the changed economic circumstances,
>
> (iv) anticipated impact of the stimulus spending on future interest rate movements and taxpayer liabilities,
>
> (v) an evaluation of the environmental impacts of the spending to date, and
>
> (vi) other related matters.

---

1 IMF, *World Economic Outlook*, October 2009; Angus Maddison, *The World Economy: Historical Statistics*, OECD, 2003; Secretariat estimates.

2 See Chart 5.1 in Chapter 5.

3 See Table 5.1 in Chapter 5.

1.5 In a sense, this inquiry is a sequel to that by the Senate Finance and Public Administration Committee in February 2009.[4]

Conduct of the inquiry

1.6 The 18 submissions received by the committee are listed in Appendix 1.

1.7 The Committee held public hearings in Canberra on 21 September and 9 October and in Sydney on 28 September. As instructed by the Senate, the witnesses included the Secretary of the Treasury (on 9 October) and the Governor of the Reserve Bank of Australia (on 28 September). The Committee also heard from a number of academic economists and business representatives. A list of witnesses appearing before the Committee at the hearings is provided at Appendix 2.

1.8 The Committee thanks all those who participated in this inquiry, especially those witnesses who made themselves available at short notice.

Structure of the report

1.9 The composition of the stimulus packages is outlined in Chapter 2, with further details in Appendix 3. The arguments presented to the Committee about the merits of Keynesian discretionary fiscal policy are the subject of Chapter 3. Estimates of the impact of the fiscal stimulus packages are discussed in Chapter 4. Chapter 5 evaluates the arguments for scaling back (faster or further) the fiscal stimulus in light of the stronger economic outlook. Chapter 6 presents conclusions and a recommendation.

4 *Nation Building and Jobs Plan - Inquiry into the provisions of the Appropriation (Nation Building and Jobs) Bill (No. 1) 2008-2009 and 5 related bills*, 10 February 2009. (hereafter *'Nation Building Report'*.)

Chapter 2
Spending initiatives

Australian stimulus measures since the global financial crisis

2.1 The Government has undertaken various fiscal initiatives since the collapse of Lehman Brothers in September 2008 sparked the global financial crisis.

2.2 The first package to be described as a stimulus measure was the Economic Security Strategy (ESS) in October 2008. This package included combined expenditure of $10.4 billion through various cash payments, a boost to the First Home Owners grant and further investment through the Nation Building Funds.[1]

2.3 In November 2008, the Council of Australian Governments (COAG) announced a $15.2 billion COAG funding package which included measures to address housing, hospitals and education.

2.4 A further $4.7 billion in stimulus expenditure was announced in December 2008 through the Nation Building Plan, which included investment in road, rail and the higher education sector.

2.5 A much larger stimulus package, the Nation Building and Jobs Plan, was announced in February 2009, adding approximately $42 billion worth of stimulus expenditure.

2.6 There were further measures announced in the May 2009 Budget which included $8.5 billion for investment in road, rail and port infrastructure, an initial investment of $4.7 billion in the National Broadband Network, $3.6 billion for development of clean energy technologies and $5.8 billion for various investments in the health, tertiary education and research sectors.

2.7 Summing up all these announced measures gives a total of more than $90 billion over five years (Table 2.2). Treasury itself indicated in the 2009–10 Budget Paper No. 1 that the scale of fiscal stimulus over four years would be almost $90 billion (Table 2.1).

1 The Hon. Kevin Rudd, Prime Minister of Australia, and the Hon. Wayne Swan, Treasurer, 'Economic Security Strategy', *Media release*, 14 October 2008, p 1.

Table 2.1 Composition of Fiscal Stimulus

Composition of Fiscal Stimulus ($b)	2008-09	2009-10	2010-11	2011-12
Transfers	**20.44**	**4.22**	**1.78**	**1.59**
Major fiscal stimulus packages				
ESS package (consumption)	9.55	0.65	0.07	0.00
Nation Building and Jobs Plan (consumption)	10.49	1.72	0.00	0.00
2009-10 Budget Measures				
2009-10 Budget net pension spend*	0.39	1.86	1.71	1.59
Investment	**4.52**	**21.93**	**17.27**	**4.91**
Major fiscal stimulus packages				
ESS package (investment)	0.12	0.07	0.00	0.00
Dec. Nation Building package (all investment)	0.88	1.95	0.39	-0.19
Nation Building and Jobs Plan (investment)	2.04	16.19	10.03	1.67
2009-10 Budget Measures				
2009-10 Budget infrastructure (investment)**	1.48	3.72	6.85	3.43
COAG reforms	**3.50**	**1.78**	**2.23**	**3.57**
COAG funding package (transfers)	3.50	1.78	2.23	3.57
Total	**28.46**	**27.93**	**21.27**	**10.07**

* This is the net effect of the pension and carer reforms and structural savings.

** These amounts do not include the provisions for future equity injections for the National Broadband Network, which are subject to the outcome of the Implementation Study and subsequent commercial negotiations.

2.8 The Treasury Secretary's tally was that:

> …around $79 billion of what may broadly be characterised as fiscal stimulus measures are expected to impact on the economy over three years from 2008-09 through to 2010-11.[2]

2.9 However, other Treasury forward estimates[3] operate through to 2011-12.

2.10 From Table 2.1, it would appear that there is at least $31 billion of discretionary stimulatory spending out of the remaining $45 billion over the forward estimates unspent. This discretionary stimulatory spending comes from the construction of the building and infrastructure elements of the stimulus package to ensure stimulus projects and funding will impact in the 2009-10 to 2011-12 financial years.[4]

2.11 Appendix 3 outlines the composition of the ESS, the COAG Funding Package, the December Nation Building Package and the Nation Building and Jobs Plan.

2.12 Chart 2.1 shows the projected contribution of the pre-budget packages over time, while Table 2.2 provides an itemised breakdown of the five packages.

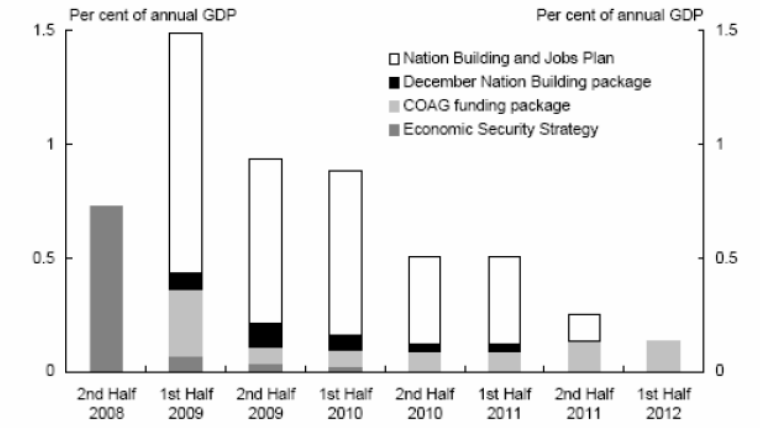
---

2 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 2.

3 Table 2.1: Composition of Fiscal Stimulus and Table 2.2

4 Coordinator-General, *Commonwealth Coordinator-Generals Progress Report 3 February 2009 – 30 June 2009*, Nation Building Economic Stimulus Plan, published August 2009, p 23.

Chart 2.1: Fiscal stimulus packages delivered by the Australian Government



(a) Impact on underlying cash balance as a per cent of annual nominal GDP.
Source: Treasury.

Table 2.2: Itemised Expenditure by Package

Economic Security Strategy – $10.4 billion (October 2008)	
($billion)	Item
$4.8	Cash payments ($1000-$1400) to various pension categories
$3.9	Cash payments ($1000) to families based on Family Tax Benefit or for dependent children
$1.5	First Home Owners Grant Boost
$0.2	Training – Productivity Places Program
	Fast tracking of nation building funds
COAG Funding package – $15.2 billion (November 2008)	
$4.8	Increased funding for the Australian Healthcare Agreement
$3.5	Funding for the National Education Agreement and education initiatives
$2.0	Indigenous reform (health, housing, economic development and service delivery)
$1.8	Hospitals and health workforce reform
$0.8	Affordable housing
$0.7	Improvements to emergency departments
$0.6	Business sector deregulation
$0.5	Preventative health measures
$0.5	Other
Nation Building Package - $4.7billion (December 2008)	
$1.2	New funds for Australian Rail Track Corporation
$1.6	Investment in university and TAFE infrastructure
$1.6	10% temporary capital investment allowance
$0.4	Bringing forward of road spending including black spots program
Nation Building and Jobs Plan - $41.5 billion (February 2009)	
$14.7	Building the Education Revolution (School construction and refurbishment)
$12.7	Cash payments to various categories
$6.6	Construction of 20,000 Social housing and Defence homes
$3.8	Energy Efficient Homes (Insulation and solar hot water rebate)
$2.7	Small business and general business tax break
$0.9	Black spots, boom gates and community infrastructure
2009–10 Budget – Nation Building Infrastructure Measures - $22.5billion (May 2009)	
$3.4	Road Network Investment
$4.6	Metro Rail
$0.4	Ports
$4.7	National Broadband Network
$3.6	Clean Energy Initiative (does not include $1b of existing funding)
$2.6	Investment in tertiary education, research and innovation
$3.2	Hospitals and Health Infrastructure
Total of all measures listed: $94.3 billion	

Chapter 3
Policy responses

Fiscal policy and monetary policy

3.1 There are two broad actions that can be undertaken to intervene in an economy that is facing a downturn. Monetary policy refers to action by the central bank to lower interest rates, encouraging higher rates of borrowing and investment, and improving cash flows for debtor households and firms as the size of repayments decreases.

3.2 The other approach is for the government essentially to pump money into the economy by running or increasing budget deficits. This can take many forms including tax cuts, tax rebates, or direct government spending such as government-funded construction of infrastructure, but all borrowed expenditure has to be repaid in the future. The various economic stimulus measures that are the focus of this inquiry include a mix of cash payments, some tax breaks and various forms of infrastructure expenditure.

Keynesian policies

3.3 One of the 20th century's pre-eminent economists, John Maynard Keynes famously wrote:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribblers of a few years back.[1]

3.4 But even he may have been surprised at the frequency with which his ideas were lauded and contested during this inquiry, over 60 years after his death. His name has become synonymous with the idea that in a recession, when there is a deficiency in private demand due to low business confidence, the government can usefully stimulate total spending in the economy by either increasing payments to households or cutting their taxes so that they will spend more, or directly spending money itself on infrastructure payments. This, it is said, will reduce the extent to which lower demand leads the economy to operate below capacity with increased unemployment, with both commensurate social and economic costs.

---

1 John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936, Chapter 24.

3.5 Keynes expounded the case for an 'activist' fiscal policy, most notably in his influential book, the *General Theory*.[2] It became the economic orthodoxy of the post-war years up until the 1980s, when classical monetarist theory began to prove itself. The basic approach to managing the business cycle was adopted by most governments. Even Richard Nixon said "we are all Keynesians now".[3]

3.6 The Keynesian approach was widely adopted worldwide to stave off the effects of the global financial crisis and was enthusiastically applied by the Government in Australia.

3.7 But not all witnesses accepted the basis of the Keynesian approach:

> The standard theory of recession is wrong. That is my conclusion from a number of years of research on these issues. The use of Keynesian demand side theories to restore growth to economies in recession is misconceived... Keynesian stimulus, as we have had here in Australia and in America and elsewhere, is actually an obstacle to returning to economic growth and full employment rather than being any kind of assistance.[4]

> …we have actually gone back into a world where, rather than letting the economic institutions—the market and those government instrumentalities such as the Reserve Bank and what have you—actually operate and let the automatic stabilisers operate, an activist fiscal policy has been adopted. I think that is very much a backward step.[5]

3.8 One aspect of this is to assert that business cycles are inevitable and nothing should or can be done, at least through fiscal policy, to moderate their size:

> …economies are subject to periods of rapid growth and periods of recession and therefore the overreaction to the downturn at the beginning of this year has been wrong. We have not had the need for this kind of stimulus to be taken because the business cycle would actually have covered most of the change that we need to have anyway.[6]

3.9 Other witnesses espoused an alternate view that accepts the idea that fiscal policy can be effective and should be employed:

> …there is a logic, when the private sector suddenly does not want to borrow and wants to contract and de-leverage, for someone who has a strong balance sheet to come in and temporarily go in the other direction, not

---

2 The full title is *The General Theory of Employment, Interest and Money* (1936).

3 President Nixon made the statement when taking the United States off the gold standard in 1971. In some accounts the quotation is "I am now a Keynesian". A similar quotation has been attributed to Keynes' rival as the 20th century's greatest economist, the free-market monetarist Milton Friedman.

4 Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, p 2.

5 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 51.

6 Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, p 3.

> permanently but just for a temporary period. That is a stabilising thing to do…[7]
>
> …it is important, where government can, to try to smooth the economic cycle and not simply to see this additional two percentage points of unemployment as being a statistic but as being many young people whose livelihoods will be better if they do not spend a scarring period of unemployment early in their careers.[8]
>
> Some people seem to be suggesting that the stimulus has had no impact on the economy. To take up that point, I would just ask: where did the money go? If you pump billions of dollars into the economy and we have not observed any inflation, it has gone somewhere. It has obviously created jobs, employment and income for the people who received that money.[9]
>
> The prescription from economic analysis is clear, that major fiscal expansion is warranted in response to deficient demand. The concerted expansion in many countries is easing recession.[10]

Fiscal multipliers

3.10 Treasury argued that the debate on the efficacy of fiscal policy is a debate about the size of the 'fiscal multiplier'. This is the ratio of the consequent increase in GDP to the size of the fiscal stimulus.

3.11 Treasury provided fiscal multiplier estimates from the OECD and IMF, reproduced in Table 3.1.

Table 3.1: OECD and IMF estimates of fiscal multipliers

	OECD				IMF
	Australia		United States		G-20
	Year 1	Year 2	Year 1	Year 2	
Infrastructure	0.9	1.1-1.3	0.9	1.1-1.3	0.5-1.8
Government consumption	0.6	0.7-1.0	0.7	0.8-1.1	
Transfers to households	0.4	0.7-0.8	0.5	0.8-0.9	

Source: *Treasury briefing paper*, p 4.

7 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, pp 27-8.

8 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 28.

9 Dr Richard Denniss, Australia Institute, *Proof Committee Hansard*, 21 September 2009, p 62.

10 Professor Ross Garnaut, *The Great Crash of 2008*, Melbourne University Press, October 2009, p 211.

3.12 A recent study by Ilzetzki, Mendoza and Vegh was discussed during the Committee's final hearing.[11] It concludes:

> Relatively closed economies have long-run multipliers of around 1.6, but relatively open economies have very small or zero multipliers.[12]

3.13 Treasury argued that the Australian economy is in the former category, and so likely to have a higher multiplier:

> They break their sample into those countries that have a high trade share and those countries that have a low trade share, and the criteria they use is that your exports plus your imports have to be greater than 60 per cent. We are very clearly in the category of countries with a low trade share. Our trade share—exports plus imports—is about 40 per cent.[13]

3.14 The multiplier effects may well be higher when Australia acts at the same time as a number of other countries:

> …if there is a global downturn and everyone responds with fiscal policy then the exchange rate effect is much less important because everyone is stimulating their economies. If you like, you can think of the whole globe as a closed economy and in that world the relevant multipliers are the ones for a fixed exchange rate because the whole world is providing fiscal stimulus.[14]

3.15 The size of the multiplier will vary across the cycle:

> If you are in a fully employed economy, our presumption would be that the multiplier would be close to zero—to the extent that, if you are in a fully employed economy and the government engages in expansionary fiscal policy then a range of offsetting things will happen which will completely crowd that out. Whether it is the private sector responses that you are talking about or the anticipation that the Reserve Bank will tighten monetary policy in order to offset it, leading to the exchange rate rising, there are a range of ways in which that will be offset. In a fully employed economy, I would agree with you that the best estimate would be a fiscal multiplier of zero. In a situation such as that Dr Henry talked about earlier, in which private sector demand is retreating and public sector demand is acting to take its place, the strong balance of evidence is that such spending

---

11 *Proof Committee Hansard*, 9 October 2009, pp 4-5.

12 Ethan Ilzetzi, Enrique Mendoza and Carlos Vegh, 'How big are fiscal multipliers?' *CEPR Policy Insight*, no 39, October 2009, p 1. Similarly the OECD conclude there are 'lower multipliers for more open economies'; *Economic Outlook Interim Report 2009*.

13 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5. While Australia is not a 'closed' economy in the sense of having heavy tariff restrictions, its physical insularity means that it is likely to always engage in less international trade than do European countries with adjoining partners.

14 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5.

> has a positive multiplier, and I think that is accepted by the IMF, the OECD and by most interested observers…[15]

Ricardian equivalance

3.16 One academic argument against the efficacy of fiscal policy is based on 'Ricardian equivalance'. This idea, popularised by Robert Barro, draws on a conjecture dating back to the pioneering British economist David Ricardo two centuries ago.[16] Dr David Gruen of Treasury described the argument to the Committee as follows:

> The idea is that consumers who are in a position to smooth their consumption through time will realise that the extra government spending now implies extra government debt which will need to be paid back at some time in the future and they respond by reducing their consumption now…It certainly works in theory; the question is how relevant it is to the real world…my reading of the evidence is that it is more convincing for economists than it is for the real world.[17]

3.17 Interestingly, even David Ricardo himself did not believe in Ricardian equivalence.[18] It remains the view of most economists that only a small proportion of the population's spending decisions would be based on Ricardian equivalance:

> ...there is not much empirical support for this motivation for savings.[19]

3.18 Dr Gruen referred the Committee to his own research on this topic:

> Many years ago I went out and asked people how much they knew about the level of Australian government debt. I then asked academic economists how much they thought people would know, and it turned out that the academic economists massively overestimated the amount of knowledge of the people I had asked.[20]

---

15 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 20.

16 Robert Barro, 'Are government bonds net wealth?', *Journal of Political Economy*, November 1974, pp 1095-1117; David Ricardo, *The Principles of Political Economy and Taxation*, 1817, Chapter XVII.

17 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 19.

18 Ricardo makes the theoretical point but warns that in practice people do not behave this way. See the Ricardo reference above and Andrew Abel, 'Ricardian equivalence theorem', *New Palgrave Dictionary of Economics*, 1987, p 175.

19 Max Corden, 'The theory of the fiscal stimulus: how will a debt-financed stimulus affect the future', *Melbourne Institute working papers*, no 15/09, June 2009, p 9.

20 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 19. The research is described in David Gruen, 'What people know and what economists think they know: Surveys on Ricardian equivalence', *Australian Economic Papers*, June 1991, pp 1-9.

'Crowding out'

3.19 Critics of the Keynesian approach argue that even in a recession, government spending displaces private spending:

> Public debt has the effect of crowding out private investment and increasing interest rates. So we would have expected Australia to be paying slightly higher interest rates than it would be if it were not for that net debt. Certainly I think a very low, negative net debt position is prudent fiscal policy, and a balanced budget.[21]

3.20 Economists generally agree that crowding out can be a problem. Witnesses disagreed about the extent it would apply in Australia.

Open economy crowding out

3.21 Professor Makin argued that the Keynesian arguments are less applicable, and crowding out concerns starker, in an open economy. His interpretation is that:

> …the budget deficit will add to the foreign borrowing. Other things remaining the same, this is going to increase interest rates. It must increase interest rates…there would be a higher risk premium on Australian borrowing, and the consequence of that will be two losses to the Australian economy. The first loss will be: the higher interest rates will crowd out private investment. That private investment means we will have a lower capital stock than we would have otherwise had, and into the future we will have a lower growth path. The second cost is the sheer payment of interest abroad, which will be significant. It is a significant part of Australia's external position.[22]
>
> The Nobel Prize winner Robert Mundell demonstrated that quite some time ago—that if you expand fiscal policy you push up interest rates. This induces capital inflow, the exchange rate appreciates, and this worsens competitiveness and worsens the trade account.[23]

3.22 The Reserve Bank Governor's interpretation was that to the extent that the stimulus package made the economy stronger, this would lead to a higher exchange rate:

> …economies which are stronger rather than weaker typically have a firmer currency relative to what they would have if they were weak. One reason for that is that in such economies return on capital tends to be positive and higher rather than lower, which means that foreign funds find it attractive to come there. Of course, one dimension of that is that such countries, not always but typically, have a higher interest rate structure across the board

---

21 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 44.

22 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 77.

23 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 77.

> than a country that is comatose. We have low but still positive interest rates, whereas Japan has them at zero as do a number of countries now.[24]

3.23 A similar view was expressed by some business representatives:

> We think that the stimulus package has improved domestic confidence in the Australian economy, the level of investment and the level of activity, beyond what would otherwise have been the case. We think that that level of confidence and activity has given foreign investors greater confidence in the Australian economy and that has contributed to the higher dollar by making us a more attractive place for investment.[25]

3.24 There could be (partly) offsetting effects whereby the stimulus package puts downward pressure on the exchange rate as some of the extra spending leads to higher imports:

> Any increase in imports must then lead to depreciation of the exchange rate…any reduction in demand for domestic goods caused by a leakage into imports will be offset by an increase in demand for domestic goods caused by a rise in exports.[26]

3.25 In total, witnesses did not highlight any impact of the stimulus measures on the exchange rate, particularly as most of Australia's trading partners also implemented stimulus packages themselves. Treasury commented:

> We have also seen significant movements in the exchange rate, most of which we would judge to be unrelated to domestic policy settings.[27]

> The substantial movements in the exchange rate over the past 12 months are likely to reflect not only shifts in underlying demand for Australia's commodity exports and subsequent terms of trade impacts, but also shifts in both risk aversion among investors and sentiment regarding Australia's relative economic prospects. While the initial fall in the exchange rate has been a positive for growth, the relatively short duration of the exchange rate trough, the volatility and the subsequent sharp reversal mean that the contribution to growth over the past year is likely to have been modest. In practice, it usually takes some time for trade flows to respond to exchange rate changes.[28]

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24 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 19.

25 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, pp 64-5.

26 Max Corden, 'The theory of the fiscal stimulus: how will a debt-financed stimulus affect the future', *Melbourne Institute working papers*, no 15/09, June 2009, p 4.

27 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 2.

28 *Treasury briefing paper*, p 9.

The hallmarks of a well-designed fiscal stimulus

3.26 There are three criteria which seek to take into account some of the arguments against fiscal stimulus measures outlined above to ensure fiscal stimulus packages are successful.[29]

3.27 The stimulus needs to be ***timely***, with the stimulus being applied while the economy is in a downturn and is operating beneath productive capacity. If a stimulus occurs too late, there is increased danger that the government spending will occur on top of recovering private demand. As well as being too late to have any positive effect during the downturn, this would also increase the risk that the excess demand would fuel inflation and higher interest rates to the detriment of the economy's recovery. This argument is often used to prove the superiority of monetary policy as being more responsive and not subject to political delay or an implementation lag.

3.28 A second criterion is that the stimulus be well-***targeted***. The stimulus needs to be directed in ways that maximise the multiplier effect of the government expenditure.

3.29 The experience shown by the fiscal stimulus packages have tended to be of low value and much of the investment by the Government has been of poor quality that does not provide an economic benefit. Many of the projects were poorly conceived and have provided very little to the wider community – that could be perhaps viewed as "make-work" projects, which are very expensive and provide little benefit.

3.30 Over longer time periods, direct government spending also has a high multiplier effect. Indeed, every dollar of direct government spending flows through to the economy directly. However, direct government expenditure can take some time to be approved by parliament and then further time to get underway. For instance, the lead time on infrastructure projects such as highway construction can take months to years, potentially coming too late to be useful. As a result, direct government expenditure in the form of infrastructure projects will generally have an implementation lag.

> Standard textbook analysis will tell you that fiscal stimulus in an open economy with a floating exchange rate is ineffective, except if it is productive. That is to say fiscal stimulus in the form of a consumption-enhancing expenditure is ineffective.[30]

3.31 The third criterion is that stimulus measures should be ***temporary***. This is because the longer stimulus measures are applied, the greater effect they have on the long-term national budget. The effects of higher national debt are discussed above.

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29 The three criteria are attributed to Larry Summers (currently the director of the US National Economic Council, a professor at Harvard University at 28 and later its president and formerly US Treasury Secretary) by Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, p 5.

30 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 88.

3.32 The stimulus package, as announced by the Government, is planned to continue to roll out until 2012. This is clearly not a temporary fiscal stimulus.

3.33 Despite this, the Governor of the Reserve Bank believed the stimulus packages well met the temporary and timely criteria, although acknowledged the questions about the effectiveness of the targeting.

> I think it is pretty hard not to conclude that it was quite timely. It was very fast. The bulk of it is temporary. Notwithstanding the discussion earlier about 2011 effects, the big impacts are in 2009, which is presumably the year in which the economy would need the most support. On the targeting, that is probably where people are going to differ about just what should be targeted.[31]

Interaction between fiscal and monetary policy

3.34 While three per cent was the lowest the Reserve Bank's official cash rate has ever been, and similar interest rates had not been this low since the 1950s, nonetheless it would have been possible for the Reserve Bank to take them down to (near) zero as has been done in some overseas countries. This would have been consistent with a less expansive fiscal policy, as discussed by Professor Tony Makin.[32]

3.35 However most economists believe that taking interest rates this low would not have been a desirable setting for monetary policy:

> Yes, monetary policy becomes less effective the closer you get to zero.[33]

> I think it is immeasurably to Australia's advantage that, however we have arrived where we are, we do not find ourselves with the overnight rate at zero,[34]

> …cutting interest rates to very low levels is something that you do if there is no alternative, but that there are attendant dangers in having extremely low interest rates, certainly for any extended period of time…After all, one of the arguments presented about what led to this global mess was an extended period of ultra-low interest rates in the US.[35]

3.36 The Governor of the Reserve Bank elaborated on this trade-off:

> In principle, at the level of logic, of course I guess they [the Government] could take a sequence of decisions which slow down the demand in the economy which would otherwise be occurring and that would presumably have some impact on the outlook, including for inflation, and therefore we

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31 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 22.

32 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 89.

33 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 26.

34 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 22.

35 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5.

> would be on a different course from the one we would otherwise be on. So in principle that is possible. I still think though that one should also ask the prior question of whether that is a better set of outcomes. Is it the best outcome to have a huge budget surplus and very low interest rates? There is often a presumption that that is good. I am not sure I share that presumption because there are things that go wrong with very low interest rates and there are possibly reasonable things that the governments can do with the money. I am a bit reluctant to accept that presumption.[36]

3.37 It is hard to quantify the trade-off between monetary and fiscal policy settings:

> There is an interesting question out there as to what expenditure is fiscally equivalent to a one percentage point cut in interest rates. I wanted to have that number to present to you today but…My quick skim of the literature suggests it is not there. [37]

3.38 The Committee acknowledges the lack of desirability of reducing the official cash rate to zero. However, the Committee does consider that scope existed to lower it further, without leading to a huge budget surplus.

3.39 One view is that monetary policy is more nimble and can 'fine tune' around fiscal policy:

> We are sufficiently uncertain as to what the path out of the downturn will be that I think it makes sense just to let fiscal policy roll and let monetary policy, which takes effect much faster, do the finetuning.[38]

> The consensus that emerged in the 1980s…was that there were considerable limitations in using fiscal policy to finetune the economy…monetary policy is probably better able to play that role. But certainly I never interpreted that consensus as implying that, when an economy is hit with an unprecedented negative shock, one should expect that monetary policy could play all of the role.[39]

3.40 It can be argued that the present crisis was unusually well-suited to allowing consideration of how best to employ both monetary and fiscal policy:

> One of the things that made this crisis so unusual and unprecedented—certainly from Australia's perspective—was that we got such a strong and unequivocal signal from the rest of the world in the middle of September that something truly catastrophic was happening in the global capital markets. We were very confident—and that confidence grew over a period of just a couple of weeks—that an enormous negative shock was coming our way. The shock had arrived in the sense that it had already had an impact on share markets and the exchange rate, as you explained, and it was very clear that that was going to lead to a very substantial negative shock to

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36 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 24.

37 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 32.

38 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 23.

39 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 4.

> the real economy…That is an extremely unusual situation and it radically changes the calculus of whether discretionary fiscal policy is a good idea or not.[40]

3.41 An alternative view is that monetary policy is always far more effective than fiscal policy:

> Unquestionably monetary policy is more effective. Monetary policy in an open economy works largely through the exchange rate, and we saw that. We saw that the relaxation of monetary policy by 425 basis points over a short period of time was a reason for the exchange rate depreciation…[41]

3.42 There is general agreement that it is undesirable for monetary and fiscal policy to be at odds. However evidence was received arguing both that this was the case in Australia and not. The Committee considers that Australia is facing a distinct likelihood that these two arms of policy will be working against each other. Indeed, the recent twenty five basis point increase in the official cash rate is specifically intended to slow the economy being sped up by the Government's fiscal policy.

Alternative stimulus approaches

Tax cuts as an alternative

3.43 Many economists argue that tax cuts would be a more effective means of stimulating the economy than one-off payments or government spending:

> Had they gone down the road of, say, finding ways to reduce taxes…which would have a direct effect on business profitability and on cash flow then the reaction within the business community would have been a lot stronger. Not only would employment have been protected in the way that the stimulus was intended but it would be much more general... using the payroll tax system might have been the optimum.[42]

> a [income] tax cut would be better than a spending initiative…it would allow individuals to spend the money in better ways than those in which the government would spend the money. [43]

3.44 Other economists prefer spending to tax cuts as a short-term stimulus:

> My read of that [summary of economic literature] is that the multipliers are highest for infrastructure, next highest for consumer handouts and lowest

40 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, pp 13-14.

41 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 88.

42 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, pp 6 and 9.

43 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 48.

> for business tax breaks. The impact of business tax breaks on the economy seems to be fairly low.[44]
>
> Some have argued that these should have been permanent tax cuts. The difficulty with that is that it does put you into a fiscal position which is pretty hard to unravel unless you are willing to make some hard choices on the expenditure side.[45]

3.45 Treasury considered the cash payments to be superior to a tax cut on the grounds that they were faster to implement and would have a one-off effect on the budgetary fiscal balance. Permanent or semi-permanent tax cuts would have built in a long-term decrease in tax revenues and negative effect on the fiscal balance.[46]

3.46 Behavioural economic theory suggests that cash payments administered in a lump sum were more likely to be spent when compared to the smaller, regular amount that would result from tax cuts.[47]

3.47 However, the work of Milton Friedman and his permanent income hypothesis states that the choices made by consumers regarding their consumption patterns are determined not by current income but by their longer-term income expectations. In essence, transitory, short-term changes in income have little effect on consumer spending behaviour.[48]

Other alternatives

3.48 There are other alternative approaches to preserving employment in a downturn, such as more direct labour market programmes. Views differed about their effectiveness:

> …a lot of the stimulus might be better spent through direct job creation, particularly through community organisations and local councils—again, I think, an effective way of not just spending money but spending it in regions that can absorb it and also in a way that can create jobs where they are needed most.[49]
>
> My read of the literature on active labour market programs is that wage subsidies are more effective than direct job creation schemes. But we do not have a great deal of high-quality evidence on how best to create jobs in the

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44 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 28. This is consistent with Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, pp 15-17 and the OECD's *Economic Outlook Interim Report 2009.*

45 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 37.

46 *Nation Building Report*, p 47.

47 *Nation Building Report*, p 49.

48 Milton Friedman (1957), *A Theory of the Consumption Function*, Princeton University Press, chapter 2, 'The Permanent Income Hypothesis', pp 20-37.

49 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 62.

> Australian context. It would be nice to have some really rigorous studies and randomised trials that compared wage subsidies, direct job creation and training, which are the three main things we think about doing in a downturn.[50]

Preparation for future recessions

3.49 Some witnesses commented that the quality of spending in the stimulus packages would be better if thought had been given to possible projects before the recession hit:

> In a perfect world, you would have a long list of infrastructure things that you would get out, dust off and turn on when the need comes. I have been through a few cycles now and I have not seen that happen quite so easily yet, because it is not feasible to do that.[51]

> The main lesson is that it is actually hard to spend a lot of money quickly. I think that, given that Australia can and will have other recessions in the future, we would be well served by beginning to prepare for recessions before they occur. By that I mean that, if people find it a challenge to spend a lot of money very quickly, there is no reason we cannot have a list of important but not urgent projects that are ready to go at any point in time. There is no reason that local councils and other organisations could not be encouraged to prepare lists of exactly such shovel-ready projects…[52]

3.50 The problem with this idea is that while economic theory operates in a perfect world, the real world is not like this and it appears that a number of the projects have been selected on the grounds of being more in the vein of political spending rather than income-generating infrastructure.

3.51 This idea could be aligned with another recent proposal to deal with lags in implementing fiscal policy. A paper cited by witnesses to this inquiry refers to a proposal that the legislature agree to a fiscal stimulus package that would take effect only if a specific triggering event occurred. The trigger suggested was a three-month fall in employment. As well as allowing negotiations to occur *before* the stimulus was needed, a further benefit could be that:

> …this approach could boost household and business confidence by making clear that fiscal stimulus would be used against a serious economic slowdown.[53]

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50 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 39.

51 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 21.

52 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 62.

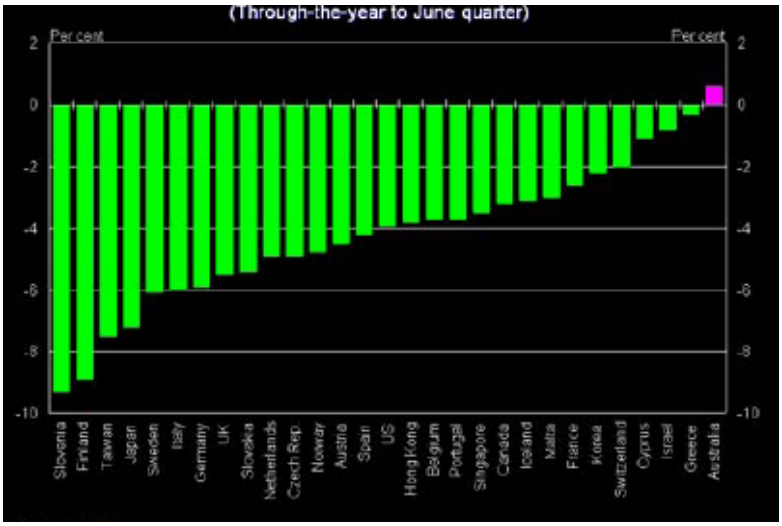
53 Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, p 11. The original proposal is attributed to Martin Feldstein, a Harvard professor, long-time president of the National Bureau of Economic Research and former chair of the US Council of Economic Advisers.

Chapter 4
Impact of the stimulus packages

Australia outperforms

4.1 Australia is the only advanced economy in which real GDP in the June quarter of 2009 was higher than in the June quarter of 2008 (Chart 4.1).

Chart 4.1: Real GDP growth rates



Source: Dr Ken Henry, Treasury, speech to Australian Institute of Company Directors, 23 September 2009.

4.2 This is clearly an impressive performance by Australia. It is not clear to what extent this is attributable to the stimulus packages, or the legacy of prior sound economic management, or the relative contributions of these or other factors.

Australia was in a singularly strong position before the crisis

4.3 Australia was in a stronger position before the crisis than were most comparable countries. Treasury note:

> An additional factor that is likely to have contributed to Australia's resilience during the crisis is the structural reforms to financial, labour and product markets undertaken over recent decades. These structural reforms have lifted the economy's productive capacity and improved the flexibility and speed with which both firms and individuals respond to both positive and negative economic shocks. The resilience of the Australian financial system to the Global Financial Crisis illustrates this point. Macroeconomic stability also reinforces the economy's structural flexibility and efficiency by providing businesses and households with more certainty in making their decisions.[1]

1 *Treasury briefing paper*, p 10.

4.4 The Governor of the Reserve Bank cited three reasons why Australia's performance has been better than that in other OECD economies:

> Firstly, our financial system was in better shape to begin with…Secondly, some key trading partners for Australia have proven to be relatively resilient in this episode…Finally, Australia had ample scope for macroeconomic policy action to support demand as global economic conditions rapidly deteriorated, and that scope was used. The Commonwealth budget was in surplus and there was no debt, which meant that expansionary fiscal measures could be afforded. In addition, monetary policy could be eased significantly without taking interest rates to zero or engaging in the highly unconventional policies that have been needed in a number of other countries.[2]

4.5 Elaborating on these points, Australia was well prepared to face an external shock as its financial system was sounder. This is particularly significant given that the current crisis had its source in the financial sector. In a number of countries large banks have had to be 'rescued' by governments injecting equity, making emergency loans or even (temporarily) nationalising them. By contrast, none of these measures have been necessary in Australia. The four major Australian banks now constitute four of only nine among the world's largest 100 banks which are rated AA or better.[3]

4.6 Australia was also supported by the important role played by its mineral exports. A large proportion of these go to China, whose economy continues to be the strongest growing in the world. This is partly a fortunate accident of geography: the tyranny of distance has become the blessing of propinquity. But it also reflects diplomatic efforts by previous Australian governments to develop trade ties with China, particularly in the minerals sector. China is now the major purchaser of Australian iron ore and coal, particularly in Western Australia. In the earlier part of 2009 the level of Chinese imports of iron ore and coal increased significantly which in turn provided a boost to the Australian economy which made an important contribution to preventing this country going into a technical recession.

4.7 Another important difference between Australia and most other OECD countries has been the greater fiscal discipline exercised here. Like the average OECD economy, Australia had a significant budget deficit during the early 1990s recession. But unlike many other countries, Australia moved back into surplus as the economy recovered and maintained a surplus for most years until the current downturn (Chart 4.2).

4.8 This fiscal prudence meant that Australia entered the financial crisis with a much smaller government debt than most other countries (Table 4.1).

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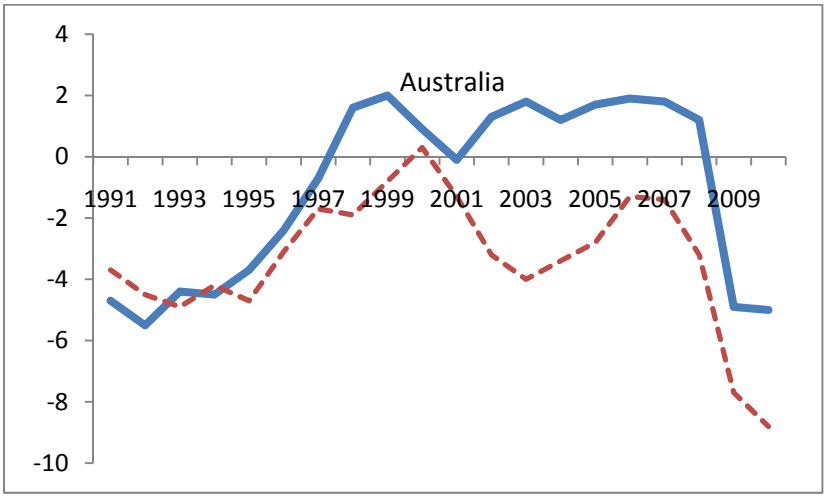
2 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 3.

3 Reserve Bank of Australia, *Financial Stability Review*, September 2009, p 24.

Chart 4.2: General Government Financial Balances: Australia vs OECD

(1991-2010; per cent to GDP)



Source: Secretariat, based on data in *OECD Economic Outlook*, June 2009.

4.9 Chart 4.2 shows that economic management over the last decade set Australia apart with the capacity to *afford* a stimulus – leaving aside the question of its efficacy or desirability – giving Australia the "ample scope" for fiscal action referred to by the RBA Governor in his opening statement to the committee.[4] The chart also illustrates the magnitude of the impact of the Rudd government's fiscal spending on Australia's financial position compared with the OECD average.

Table 4.1: General government financial liabilities

Per cent to GDP, 2008

	gross	**net**		**gross**	**net**
Australia	14	-7	Netherlands	65	25
Austria	66	33	New Zealand	26	-16
Belgium	93	74	Norway	56	-125
Canada	68	22	Sweden	47	-14
France	76	42	Switzerland	46	10
Germany	69	45	United Kingdom	57	34
Japan	172	84	United States	71	48

Source: *OECD Economic Outlook*, June 2009.

4 Mr Glenn Stevens, Governor, Reserve Bank of Australia, Proof Committee Hansard, 28 September 2009, p 3.

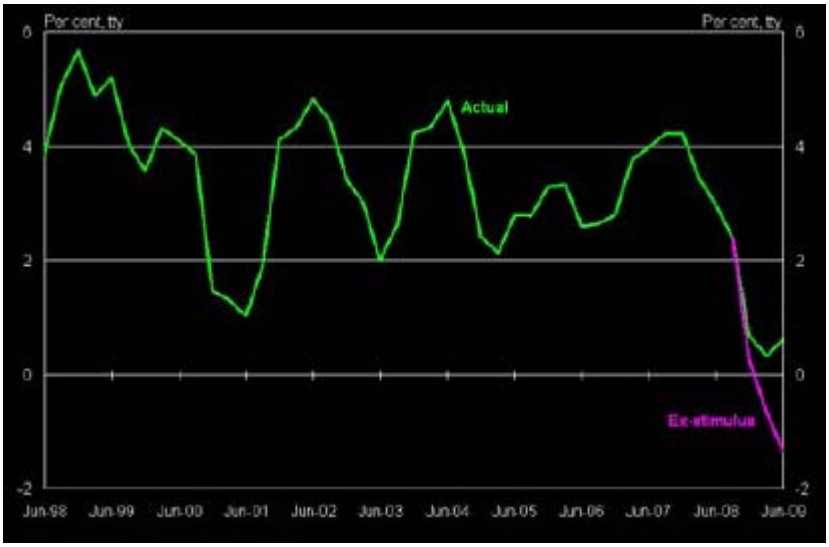
The impact of the fiscal stimulus in Australia

Overall impact

4.10 Treasury is the premier source of economic advice to the government of the day and was the architect of the various spending initiatives outlined in Table 2.2.

4.11 Treasury estimate that in the absence of the fiscal stimulus measures, rather than recording modest growth, GDP would have instead fallen by 1.3 per cent through the year to the June quarter 2009 (Chart 4.3).[5]

Chart 4.3: Australian real GDP growth rate



Source: Dr Ken Henry, Secretary, Treasury, speech to Australian Institute of Company Directors, 23 September 2009.

4.12 Elaborating to the Committee, the Treasury Secretary said:

> Without this stimulus, we estimate that the economy would have contracted not only in the December quarter of 2008 but also in the March and June quarters of this year. Our estimates of these impacts are based on internal modelling informed by studies of the effects of fiscal stimulus by the International Monetary Fund, the OECD and a range of academic researchers. They are corroborated by ABS data, by private sector surveys on how the stimulus was spent and by an examination of the experience of countries that have not had such a large stimulus in place.[6]

4.13 Asked about the relative contribution of fiscal and monetary policy, Treasury opined:

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5 Dr Ken Henry, Secretary, Treasury, *Proof Committee Hansard*, 9 October 2009, p 8.

6 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, pp 2-3. The basis for these calculations is discussed later in this chapter.

> …fiscal policy's contribution to growth over that period has been substantially larger than the contribution of monetary policy…[7]

4.14 The reasoning behind this conclusion was set out in Treasury's written contribution:

> The official (nominal) cash rate was reduced from 7.25 per cent at the end of August 2008 to its current level of 3.00 per cent in April 2009,[8] a reduction of 4.25 percentage points...[as] underlying inflation fell by ¾ of a percentage point between the September quarter 2008 and the June quarter 2009…[the] real official cash rate has fallen by 3.50 percentage points…However, bank lending rates have fallen by less than the reduction in the official cash rate…about 2½ percentage points. Using the findings of Gruen, and Naveen[9], a 2½ percentage point reduction in the real interest rate would contribute 0.85 per cent to GDP in the first year. However, the majority of the cash rate reductions occurred less than a year ago.[10]

4.15 This analysis may, however, have underestimated the contribution of monetary policy to GDP growth. It is not real rates which matter to households but rather the change in their nominal household disposable income resulting from changes in nominal interest rates. These effects were very large. For example, a 3 per cent reduction in nominal interest rates on outstanding household debt of $1.3 trn (including households and unincorporated enterprises) increases household income by $39 bn each year, and that is about 3 per cent of GDP in a year.

4.16 As can be appreciated this is a very significant impact of monetary policy on potential consumer spending and thereby business confidence. Arguably the reduction of interest rates (monetary policy) had a much greater impact than the cash contributions provided by the government in the so-called "$10bn cash splash".

4.17 The Committee would be interested in the outcome of Treasury analysis of the relative contributions of monetary policy compared to fiscal policy in stimulating consumer spending and business confidence,

4.18 The underlying strengths of the Australian economy particularly the level of government debt and the strength of the banking system which as has been stated elsewhere includes four of the 9 AA- or better rated banks in the world's largest 100 banks.

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7 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 20. This accords with a US study which concluded 'true fiscal stimulus implemented promptly can provide a larger near-term impetus to economic activity than monetary policy can'; Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, p 8.

8 Since this was written the cash rate has been increased to 3.25 per cent.

9 David Gruen, John Romalis and Naveen Chandra, 'The lags of monetary policy', *Reserve Bank of Australia Research Discussion Papers*, no 9701, June 1997.

10 *Treasury's briefing paper*, p 8.

4.19 Another undoubted factor in preventing the Australian economy going into recession was the rebound in the Chinese economy leading to China substantially increasing purchases of Australian iron ore and coal.

4.20 When asked by Senator Eggleston what would have been the consequences for the Australian economy if the China factor had not been in play, Glenn Stevens, Governor of the RBA, replied that other measures would have been taken. The form of such other measures was not identified by the Governor.

The impact of the cash payments

4.21 There was debate over whether the cash payments were spent or saved and this was relevant to the extent that they acted to stimulate demand. One approach to assessing the efficacy of the cash payments was to examine retail sales data to see whether there appears to have been an associated increase:

> An analysis undertaken by Tony Meer of Deutsche Bank—and reported at Peter Martin's blog and then in *The Age*—tends to suggest that retail sales were far in excess of what we might otherwise have thought. But Ashton and I have undertaken an analysis of the retail sales, and our argument is that, simply by extending the ABS trend data—which they stopped doing in November last year—and putting in another very commonly used trend figure, retail sales trends are not unusual at the moment and retail sales are at about trend.[11]

> …we undertook a forecasting exercise and we imagined that we were back in May 2008…and tried to forecast retail sales… by and large, the actual retail sales is within a 95 per cent confidence band of what we would have expected in May last year—which again suggests to us that retail sales are not that unusually different from what they might otherwise have been if we could forecast this from almost over a year ago.[12]

4.22 The Reserve Bank regards the stimulus package as having supported demand:

> If the intention was to support demand in the economy… my conclusion would be that those measures have supported demand quite materially over the last… nine or 10 months.[13]

4.23 A similar view was expressed by the business community:

> With the rationale that government spending be provided to promote stimulus in the economy, we considered it should initially be provided to households to promote private spending…Support to households has

11 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 42.

12 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 42.

13 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 6.

> bolstered retail spending, and this evidence has been recorded amongst our retail members and those in the hospitality and restaurant-cafe sector.[14]

4.24 Clearly this is the case. Much of it was spent. The real question is whether the level of support justified the cost and represented best value for money.

Eligibility

4.25 Some argued that the cash payments could be more equitably and efficiently targeted:

> In terms of equity, I think that we could, should and still can do more to help those who are most adversely affected by a slowdown in the economy—that is, of course, the unemployed and those people who share a house with the unemployed. It was an unfortunate irony that the unemployed did not receive the $900 bonus payment. I think that providing money to unemployed people directly is likely to have a very positive stimulatory effect not just on the national economy but on the local economy in which those people live. There is no better way to target money towards the regions that are experiencing the most unemployment than to provide increased payments to those who are unemployed.[15]

The impact of the infrastructure spending

4.26 Accepting for the sake of argument that stimulus spending is an efficient and effective use of resources – and the committee notes there was credible opinion contrary to this view – it makes sense at least to have a mix of types of stimulus, and it needs to be noted that there have been several examples of inflexibility and waste in the application of the fiscal stimulus packages:

> Certainly the standard wisdom on fiscal stimuluses is that you get a smaller multiplier from household handouts but you can do them quickly. You want a mix of quick, less effective household handouts and slower but possibly higher multipliers through infrastructure spending.[16]

> In terms of the formulation, there may not have been a more sensible package…There was the cash splash designed to support the household sector ASAP. Then there was the idea of supporting economic activity more generally…Then there are some of the longer term projects. To me that make sense…I think most financial market economists…would think the

14 Mr Greg Evans, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 28 September 2009, p 54.

15 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 61. This concern was also raised during the Senate Finance and Public Administration inquiry. In addition, there were concerns that students who enrolled late may miss the training bonus.

16 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 30.

package was reasonably well structured given the economic circumstances.[17]

4.27 There has been differing views about the infrastructure spending:

> Analysis of the efficiency of how the money is being spent needs to be undertaken from the perspective that the primary objective was to spend money quickly. The purpose of the stimulus package was to stimulate the economy. That must be the primary criteria against which it is judged. Of course, the more we can achieve along the way with the expenditure of that money the better. But the objective was to spend a large amount of money quickly, not to spend money perfectly in a drawn out fashion.[18]

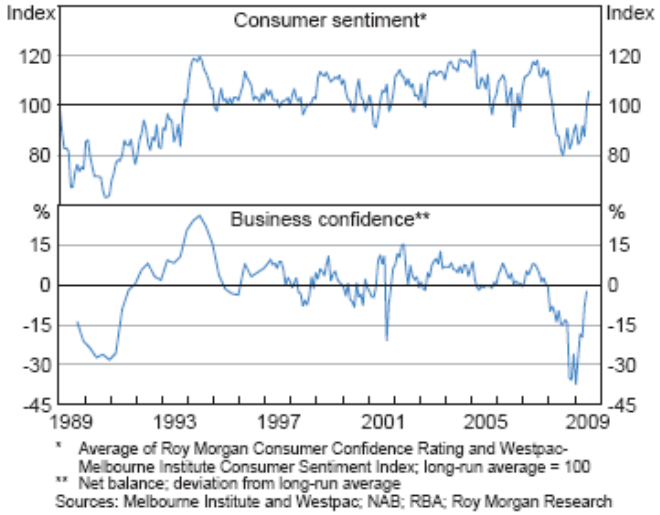
4.28 Business is more supportive, at least in respect of some of the infrastructure spend:

> … But we have some confidence that there will be expansions of capacity that will come from some of the investments in infrastructure…[19]
>
> That would increase productivity, yes.[20]

The effects on business and consumer confidence

4.29 Both business and consumer confidence has picked up since late 2008, as shown by the RBA compilation of consumer and business sentiment in Chart 4.4.

Chart 4.4: Sentiment indicators



Source: Reserve Bank of Australia, *Statement of Monetary Policy*, August 2009, p 35.

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17 Mr Rory Robertson, *Proof Committee Hansard*, 28 September 2009, p 43.

18 Dr Richard Denniss, Australia Institute, *Proof Committee Hansard*, 21 September 2009, p 61.

19 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p 64.

20 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p 64.

4.30 The Committee heard evidence that the business community would have responded with even more vigour to alternative measures directed to the business community:

> Had they gone down the road of, say, finding ways to reduce taxes—payroll taxes and other kinds of taxes related to business—which would have a direct effect on business profitability and on cash flow then the reaction within the business community would have been a lot stronger. Not only would employment have been protected in the way that the stimulus was intended but it would be much more general. In fact, a higher profitability for business and higher cash flows would actually have led to, I believe, an actual improvement in the level of economic activity relative to what we have seen here.[21]

4.31 There was a compelling argument that the stimulus has led to a degree of unproductive, even counterproductive, investment through the creation of artificial supply chains:

> On the second issue, of structural balance: what I mean here is that, if we are going to have recovery, that recovery will come through private-sector businesses again generating their own growth. The important thing here is that the supply chains are related, so you not only will have growth in final demand at some level but the actual supply chains within the economy that are feedstock into those businesses will also be growing.
>
> Having the kinds of structural imbalances that the stimulus has—which mean that, ultimately, it will have to be wound back; you cannot continue with these forms of expenditure—means that all the structural aspects that go into these expenditures will also have to be wound back. Had we instead opted for an approach that went towards raising the profitability of private-sector businesses, then the actual structures that we put in place, the supply chains, would themselves have been productive because they would have been feeding into the ability of firms to actually produce what other people are willing to buy. In that way, rather than being a structure that has to be wound back as the stimulus is withdrawn, this would have been a structure that would have become a permanent feature of the Australian economy and contributed to growth.[22]

4.32 In the absence of fiscal stimulus, the Reserve Bank of Australia would have responded by further lowering interest rates and would have had the capacity to do so. As a result, the exchange rate would also have been lower.

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21 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, p 6

22 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, p 9.

Effects of higher national debt and implications for future taxation and long bond yields

4.33 The fiscal stimulus packages will obviously add to government debt. However, the bulk of evidence is that prudent fiscal policy in the decade before the crisis means that government debt will remain manageable. The Committee does note, however, that there are consequences attached to the payment of this debt, such as the wiping out of the surplus, higher taxation and higher interest rates. At best, it will take 10 years to pay the entire debt off, and at worst, decades… was this really necessary? The Committee believes that there are opportunities to minimise some of these consequences if the fiscal stimulus packages were recalibrated.

4.34 This tax burden that will be necessary to repay the debt incurred as a result of the stimulus package was acknowledged by the Treasury Secretary and other witnesses:

> Of course the stimulus that is being provided at the moment, to the extent that it is debt financed, will have to be repaid in the future. That means that at some stage in the future either government spending will be lower than it otherwise would have been or tax settings will be higher than they otherwise would have been. But that future time will be a period of faster growth in private sector activity and the judgement has been made that in those circumstances where the private sector is growing much faster than it is at the moment the government will have the ability to repay debt without doing damage to gross domestic product growth.[23]

> …it is inevitable that these payments have to be paid for in some sense, but how the fiscal tightening is done is a matter entirely for policy. You could do it through expenditure cuts or tax increases… An inevitable impact of Keynesian fiscal policy is that if you inject money into the economy in bad times then you are going to have to get it back in good times.[24]

> The raising of taxation to pay interest on and repay debt will reduce to some extent the productive capacity of the economy. For moderate amounts of debt this is likely to be small in comparison with the waste of productive resources through unemployment.[25]

4.35 The actual cost of raising taxation to meet the debt will depend on the quantitative effect of the 'dead weight loss' arising from taxation (which is a reflection of the extent to which it discourages economic activity). There is debate about the size of this effect:

> People estimate between 20 and 80 per cent for a deadweight cost…[26]

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23 Dr Ken Henry, Secretary, Treasury, *Proof Committee Hansard*, 9 October 2009, p 10.

24 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, pp 23 and 27.

25 Professor Ross Garnaut, *The Great Crash of 2008*, Melbourne University Press, October 2009, p 157.

26 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 50.

> To those who are terrified of tax rates destroying incentive, there are plenty of ways to increase tax revenue in a way that would minimise that. The first would be to abolish the enormous range of tax concessions that currently exist—the 50 per cent capital gains tax concession or the enormous concessions on superannuation. If the actual income tax rate for high-income earners were increased, there is virtually no chance that rich people will decide to be poor because the tax rate is just too high for them…If the parliament wants to increase taxes, it should, and the economic effects of doing it wisely would be low.[27]

> …taxes do distort economic activity. Those tax driven distortions either reduce the size of the economy below the size that it would otherwise be or in other ways impose welfare losses on citizens. That is generally the case. It is certainly not the case always, and as you would be aware, Senator, it is not the case if the tax is being used, for example, to correct for an environmental externality—and there are a large number of other interesting cases in which taxes that raise revenue actually turn out to be welfare enhancing rather than welfare detracting. But as a general point it is true. What is also true—and this is the reason why people get interested in tax policy—is that different taxes have different effects.[28]

4.36 There are varying views about the impact of higher (prospective) government debt on the interest rate that needs to be paid on that debt. The Reserve Bank does not see this impact as significant, but their words sound a note of warning about the global impact of government debt on borrowing costs, and hence the risks for Australia:

> I do not think that, at the moment, it is easy to discern much impact here. The long range in Australia is between five and 5½ per cent, which is about normal. It has been around that, on average, for the last decade. For a country like Australia, what we are talking about in government long-run borrowing costs is that there is a global rate which, roughly speaking, is the US Treasury rate, and we will be paying above or below a little margin, depending on our individual soundness. If we find that government borrowing rates are a lot higher in the years ahead, I do not think it will be because of Australia's outcomes. It will be because there is a lot of government debt being issued around the world by countries that have really serious fiscal problems, like the Americans and the British…[29]

4.37 The Australian Office of Financial Management put more emphasis on domestic influences:

> In particular, the relative strength of the economy and the expectations about inflation and exchange rates can have an impact.[30]

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27 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 64.

28 Dr Ken Henry, Secretary, Treasury, *Proof Committee Hansard*, 9 October 2009, p 8.

29 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, pp 11-12. See also his comments on pp 14-15.

30 Mr Neil Hyden, Chief Executive Officer, Australian Office of Financial Management, *Proof Committee Hansard*, 28 September 2009, p 30.

4.38 It also described a countervailing influence on long bond yields, referring to the:

> …changed attitude to risk on the part of many investors which has led to a flight to quality and safety. So there has been an increased availability of funds for investment in government debt. While governments have had a very much increased volume of borrowing, that has been able to be satisfied by an increase flow of funds into the sector.[31]

Assessing the stimulus package with models

4.39 A perennial problem in macroeconomics is that there are no controlled experiments. We cannot take two identical economies and subject just one of them to a stimulus package. There is always room for debate about how the economy would have evolved in the absence of a stimulus package. As the Treasury Secretary remarked:

> …we will never know the precise impacts of the fiscal stimulus on the economy.[32]

4.40 It should be noted that there are no absolutes in any of this modelling, and it will never be known the precise impact of each element of the fiscal stimulus package, and therefore claims about jobs saved need to be considered against that background.

4.41 One approach is to use a macro-econometric model to address these 'what if" questions. But confidence in the results will depend on confidence in the model used. More usual is to use economy-wide models, a range of single-equation studies and other sources such as surveys and business liaison to form a view about the impact of alternative policies.

4.42 The Committee asked Treasury for more information about their calculations on the impact on employment of the stimulus package. Treasury explained that they first calculated the impact on real GDP:

> Taking the dollar amount of spending in the fiscal stimulus package, we then make adjustments for behavioural responses by households and businesses. For one-off transfer payments to households, we assume the spending propensity to be 0.7 in the forecast period. The remaining amount of the transfer payments is assumed to be saved by households, at least over the forecast horizon. In contrast, for direct government spending, the spending propensity is assumed to be 1…the next step is to…apply an import share of 0.15…This gives us direct (or first round) fiscal multipliers to GDP of 0.6 for transfer payments and 0.85 for direct government

31 Mr Neil Hyden, Chief Executive Officer, Australian Office of Financial Management, *Proof Committee Hansard*, 28 September 2009, p 32.

32 Dr Ken Henry, Secretary, Department of the Treasury, *Proof Committee Hansard*, 9 October 2009, p 2.

> spending…To estimate the effects on real GDP, we adjust the nominal spending numbers for inflation…[33]

4.43 The impact of the stimulus as calculated in this way is subtracted from the real GDP forecasts to give alternative 'pre-stimulus forecasts', shown in Table 4.2, and illustrated by Chart 4.3 above.

Table 4.2: Treasury forecasts of real GDP with and without stimulus

(annual percentage change)

	2008-09	2009-10	2010-11
Pre-stimulus	-0.9	-2.0	3.4
Contribution of stimulus	1.0	1.6	-1.2
Post-stimulus	0.1	-0.4	2.1

Source: *Treasury briefing paper*, p 4.

4.44 Treasury then calculated the employment impact:

> The modelling work suggests…a 1 per cent increase in GDP leads to a ¾ per cent increase in employment over time…The peak impact of the stimulus packages estimated at Budget was the addition of 210,000 jobs and the level of employment remains higher through to the end of the forecast period…The peak unemployment rate was estimated to be 1½ per cent lower as a result of the fiscal stimulus.[34]

4.45 Dr Kates is very sceptical about Treasury's modelling showing the stimulus package having a significant impact:

> …the Keynesian model cannot be used to demonstrate that a Keynesian stimulus has a positive effect on the economy.[35]

4.46 Dr Kates states that in the absence of the stimulus package the unemployment rate would have been 0.3 percentage points higher. This represents 34,000 people. On this basis he concludes that, given a $43 billion cost for the stimulus package, it has cost over a million dollars per job saved.[36] Other estimates of the employment impact of the package are much higher. As noted above, Treasury puts it at over 200,000 jobs. This would imply the cost per job saved is much less than this. (Furthermore, such calculations ignore the additional taxation paid by those in work and the savings from lower unemployment benefits. It also assumes the spending brings no other benefits than creating jobs.)

33 *Treasury briefing paper*, p 3.

34 *Treasury briefing paper*, p 5.

35 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, p 4.

36 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, p 5.

4.47 Professor McKibbin, noted economist and member of the Reserve Bank Board, submitted the results of his global modelling using the G-cubed model. This suggested that the global fiscal stimulus would increase real GDP in all countries in the first year, but higher real interest rates would then moderate the impact.[37] His modelling led him to argue for a fiscal stimulus in Australia about half as large as that proposed by the Government.[38]

37 Professor Warwick McKibbin, *Submission 15a*, pp 24-26.

38 Professor Warwick McKibbin, *Submission 15*, p 1.

Chapter 5

Should the package be scaled back?

5.1 Even if there was a case for timely large fiscal stimulus packages to meet an imminent recession, it can be argued that the economic environment has improved significantly and so a smaller stimulus would now be appropriate.

5.2 Those witnesses who opposed the stimulus package argued that the stimulus was far too large and were of the opinion that the scaling back of the stimulus package should happen sooner rather than later to ensure that the cost to the economy did not exceed the benefits.

> …I thought it was unnecessarily large at the outset. So: winding it back, scaling it right back, and trying to prevent any further commitments that do not meet a basic cost-benefit test, essentially. All projects from now on should be rigorously examined as to their benefits because the ultimate test is whether the benefits exceed the costs in terms of the interest paid abroad to foreigners.[1]

5.3 Given the recent economic data that has been published by a number of outlets including the Treasury and the Reserve Bank of Australia, it is the opinion of the Committee that the three 'T's that have been espoused by Treasurer Swan needs to be expanded to include a fourth "T", tweakable. This would reflect the ability of the Treasurer to work with the new economic data and make effective decisions about future spending in the Australian economy.

> We set clear criteria that stimulus be timely, temporary and targeted. And we met them.[2]

> But perhaps the lesson from the crisis that his stimulus needed a fourth T – tweakable.[3]

The change in the economic outlook since October 2008

5.4 The first stimulus package was introduced in October 2008 when the collapse of Lehman Brothers had shaken global financial markets. The IMF's October 2008 *World Economic Outlook* stated:

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1 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 81.

2 The Hon Wayne Swan, *One Year On: Fiscal Stimulus and the Path Ahead*, Address to the Australian Business Economists, Sydney, 12 October 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2009/028.htm&pageID=005&min=wms&Year=&DocType=, accessed 19 October 2009

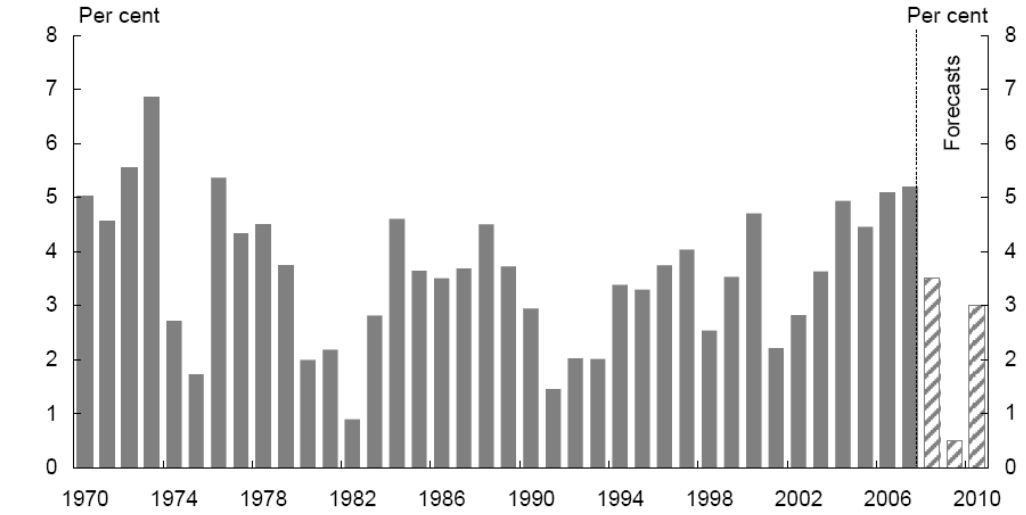
3 Mike Stutchbery, 'Make stimulus timely, temporary, targeted and tweakable', *The Australian*, 15 October 2009, pp 28.

> The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s…The situation is exceptionally uncertain and subject to considerable downside risks. The immediate policy challenge is to stabilize financial conditions, while nursing economies through a period of slow activity and keeping inflation under control.[4]

5.5 The *Mid Year Economic and Fiscal Outlook 2008-09* released in November 2008 commented that the global financial crisis had 'entered a new and dangerous phase.' While Australia was better placed than most to withstand the fallout, it 'was not immune from the effects of the global financial crisis and the global downturn'.[5]

5.6 In February 2009, the *Updated Economic and Fiscal Outlook* noted that the global outlook for the global economy had deteriorated sharply, with the IMF cutting its forecast (Chart 5.1) for global growth and now forecasting a deep global recession.[6]

Chart 5.1: World GDP growth



Source: IMF and Treasury.

5.7 It warned that 'the weight of the global recession is now bearing down on the Australian economy. Growth is expected to be significantly weaker than previously anticipated and unemployment will be higher.'[7]

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4 International Monetary Fund, *World Economic Outlook*, October 2008, p.xv, http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf (Accessed 7.02.09).

5 The Hon. Wayne Swan, MP, Treasurer and the Hon Lindsay Tanner, MP, Minister for Finance and Deregulation, *Mid Year Economic and Fiscal Outlook 2008-09*, 2008, p.1

6 The Hon. Wayne Swan, MP, Treasurer and the Hon Lindsay Tanner, MP, Minister for Finance and Deregulation, *Updated Economic and Fiscal Outlook 2008-09*, 2009, p.1

7 The Hon. Wayne Swan, MP, Treasurer and the Hon Lindsay Tanner, MP, Minister for Finance and Deregulation, *Updated Economic and Fiscal Outlook 2008-09*, 2009, p.1.

5.8 The recent economic evidence suggests that the *Updated Economic and Fiscal Outlook* greatly over predicted the impact on Australia, regardless of the impact or otherwise of domestic stimulatory policies.

> He agrees the stimulus has limited the downturn. "But there are hard times ahead," he writes. "Sustainable full employment will require reduction of average incomes and living standards below those to which Australians became accustomed before the crash. The Australian government, community and business leadership has barely begun to contemplate the adjustment that is required."[8]

5.9 The economic outlook now looks more favourable. The IMF's *World Economic Outlook Update* of July, 2009 states:

> The global economy is beginning to pull out of a recession unprecedented in the post–World War II era, but stabilization is uneven and the recovery is expected to be sluggish. Economic growth during 2009–10 is now projected to be about ½ percentage points higher than projected in the April 2009 World Economic Outlook (WEO), reaching 2.5 percent in 2010.[9]

5.10 The Australian economy has rebounded far better than Treasury estimated, and the Governor of the Reserve Bank provided three reasons as to why Australia has been the best performing economy in the OECD:

> Firstly, our financial system was in better shape to begin with, being relatively free of the serious problems that the British, the Americans and the Europeans experienced.
>
> Secondly, some key trading partners for Australia have proven to be relatively resilient in this episode… China will easily achieve their eight percent growth target for 2009, led by domestic demand. Many of our other Asian trading partners also have returned to growth recently. Ongoing strength and demand for resources has kept Australia's exports growing and ours terms of trade, even though well off their peak, remain quite high by historical standards.
>
> Finally, Australia had ample scope for macroeconomic policy action to support demand as global economic conditions rapidly deteriorated, and that scope was used. The Commonwealth budget was in surplus and there was no debt, which meant that expansionary fiscal measures could be afforded. In addition, monetary policy could be eased significantly without taking interest rates to zero or engaging in the highly unconventional policies that have been needed in a number of other countries.[10]

5.11 The fact of the matter is that the Australian economy has rebounded from the global financial crisis as a result of the strong prudential regulations and other

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8 Ross Garnaut, 'Garnaut warns PM on stimulus', *The Australian*, 9 October 2009, p 1.

9 *World Economic Outlook Update*, 8 July 2009, p1.

10 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 3.

legislative instruments that kept the Australian financial sector out of most of the trouble associated with the problems in other countries.

> Our banking system has continued to earn a positive return on its capital, unlike those in a number of other countries.[11]

5.12 Both official and private sector economic forecasters have become more optimistic. As an example, the evolution of the Reserve Bank's forecasts is shown in Table 5.1.

Table 5.1: RBA forecasts of through-the-year growth in real GDP, by date of forecast

	Nov 2008	Feb 2009	May 2009	August 2009
2009	1½	½	-1	½
2010	2	2½	2	2¼
2011	n.a	n.a	3¾	3¾

Source: RBA, *Statement on Monetary Policy*, various issues.

5.13 Treasury spoke of their improved confidence:

> …it is no secret that the next set of economic forecasts will likely include stronger forecasts of gross domestic product growth and a peak unemployment rate lower than the 8½ per cent that was forecast at the time of the budget. Much economic data released since the budget has been more favourable than we or indeed others expected. Business and consumer confidence in particular have proved to be remarkably resilient. Australia's export performance has also been surprisingly strong...[12]

5.14 This is reflected by the Reserve Bank's decision to increase the cash rate to 3.25 per cent and it could result in an increase in unemployment or a reduction in the number of hours worked.

> Our job is to not only try to manage that path in a way that pays due regard to the unemployed and all that goes with that, of course, but also to try to make sure that we do not give ourselves some bigger problems down the road – which, if we had those, would be very detrimental to the unemployed.[13]

5.15 However, Treasury were cautious about the outlook, despite the Reserve Bank of Australia considering the balance of risks now rendering the current very expansionary setting of policy no longer necessary or possibly imprudent:

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11 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 3.

12 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 3.

13 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 9.

> The world recovery is only in its early stages. Those elements of domestic demand that have performed the strongest have been assisted by fiscal and monetary stimulus and, in particular, household consumption and parts of business investment have been greatly assisted. Evidence of a self-sustaining recovery in private activity remains tentative at this time. …all credible forecasters are expecting the economy to continue to operate below its productive capacity in the next year or two, even taking into account the stimulus still to come.[14]

5.16 It was pointed out by Treasury, the Reserve Bank and ACCI that the package always envisaged a gradual withdrawal of the stimulus (see Chart 2.1 and Table 2.1 above):

> We are beyond the period of peak impact of the fiscal stimulus. From that point, as stimulus is to be gradually withdrawn, the contribution to economic growth will subside and it will soon turn negative. Indeed, on our estimates, the fiscal stimulus package will make a negative contribution to GDP growth in every quarter in 2010…[15]

> In due course both fiscal and monetary support will need to be unwound as private demand increases. In the case of the fiscal measures, this was built into their design. The peak effect of those measures on the rate of growth of demand has probably already passed. The extent of support will tend to tail off further over the next year or so.[16]

> …within the fiscal stimulus arrangements proposed by the government there is an inbuilt winding down in any case. For example, the household spending initiatives are gone; the first home owners boost is being wound down from the end of this month; and the investment allowance proposals for large business ended on 30 June and for small business will end at 30 December.[17]

5.17 The debate is therefore more properly about whether the withdrawal should be accelerated.

> As things change, you need to recalibrate your policy.[18]

> By the government's own account, growth (in 2011) would be at 4.5 per cent, so why are we still stimulating the economy.[19]

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14 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 3.

15 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 3.

16 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, pp 3-4.

17 Mr Greg Evans, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 28 September 2009, p 60.

18 Stephen Walters, JPMorgan chief economist, quoted in David Crowe and Adrian Rollins, 'Calls mount to cut stimulus spending', *The Australian Financial Review*, 8 October 2009, p 6.

19 Scott Haslem, UBS economist, quoted in David Crowe and Adrian Rollins, 'Calls mount to cut stimulus spending', *The Australian Financial Review*, 8 October 2009, p 6.

5.18 Making judgements about the direction of the stimulus package requires balancing risks, and when asked about the need for an alternative plan to use the remaining stimulus in the face of an overheating economy, the Governor of the Reserve Bank was open to the recalibration of the packages.[20]

5.19 The Committee considers that we need to take into account a serious risk that maintenance of excessive stimulus for too long could raise unemployment through its effects on interest rates and the crowding out of more productive private investment. More recently, it has been suggested that the fiscal stimulus should be unwound more quickly than scheduled.

> If growth is stronger than Treasury had anticipated at the time it was put in place then it would be appropriate to bring it back faster.[21]

5.20 The view that accelerated withdrawal of the stimulus package now would be premature is not shared by the Committee. The Committee strongly believe that the recalibration is warranted and fortified by the recent increase in the official cash rate, and are of the opinion that the fourth "T" must now come into play.

> As the economy picks up, the fiscal stimulus could push up interest rates… Swan this week suggested that Australia's fiscal stimulus was "best practise". First, it was much more "timely" than the delayed Keating government stimulus response to the early 1990s recession… Second, Swan suggested that his stimulus was well "targeted" because the first stage of cash handouts to lower income earners and families provided a quick-acting boost to consumer spending… Third, Swan told an Australian Business Economists lunch that the clear timetable for withdrawing the stimulus meant it was suitably "temporary". But perhaps the lesson from the crisis is that his stimulus needed a fourth T – tweakable.[22]

5.21 The Reserve Bank of Australia agrees that the fiscal stimulus should be wound back but does not state that it should be done as urgently:

> I think it is a bit hard to claim that as of this moment there is too much growth in the economy. I have not had a serious problem with what has occurred on the fiscal front thus far. The presumption we are making is that things will be delivered and then wound back more or less on the schedule that is set out in the budget…I am not sure that I would say that that outlook is a terribly worrying outlook really. This has been a good episode for Australia. We have come through this well. We are in recovery now, I

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20 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 20, 24 and 25.

21 Mike Stutchbery, 'Make stimulus timely, temporary, targeted and tweakable', *The Australian*, 15 October 2009, pp 28.

22 Mike Stutchbery, 'Make stimulus timely, temporary, targeted and tweakable', *The Australian*, 15 October 2009, pp 28.

> think. It is important that these measures be wound back over time, but they are on track to be so.[23]

5.22 Additionally, there is concern that the maintenance of the package for an extended period of time will result in an increase in government investment and the crowding out of more productive private investment.

> Public debt has the effect of crowding out private investment and increasing interest rates.[24]

5.23 Respected economic commentator Professor Ross Garnaut has warned the Government of the dangers associated with maintaining the inefficient and wasteful fiscal spending:

> By further fuelling excess spending, the Rudd Government's budget stimulus will have to be followed by "hard times" and lower living standards that the government has "barely begun to contemplate".[25]
>
> He argues Australia's macro-economic policy response to the global financial crisis has relied heavily on one of the biggest and earliest budget expansions of any high-income country and less on lower interest rates.[26]

5.24 The Governor of the Reserve Bank was asked as to the impact on interest rates if the remaining stimulus spending was not spent and clearly stated that it would impact on interest rate pressures:

> If the presumption is an impact on demand that is $20 billion of $30 billion less, over three years that is a level of demand that is nearly a percent of GDP a year lower. So, all other things being equal, the course of the economy would be a bit different. What we are responding to is total demand, more or less, rather than where it comes from. It is really the total that counts more. So in that hypothetical scenario, yes, I think that would have some bearing on the future path of interest rates.[27]

The fiscal package as a commitment

5.25 The Committee also heard the argument that the package should be implemented as promised even if it now may be viewed as slightly larger than required, but does not accept this in itself as a valid reason to continue fiscal policy of a size and spend that is capable of distorting the economy:

> …when you are announcing the program you have got to understand that circumstances may well change and you should stick with that program.

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23 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 7.

24 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 44.

25 Ross Garnaut, 'Garnaut warns PM on stimulus', *The Australian*, 9 October 2009, p 1.

26 Ross Garnaut, 'Garnaut warns PM on stimulus', *The Australian*, 9 October 2009, p 1.

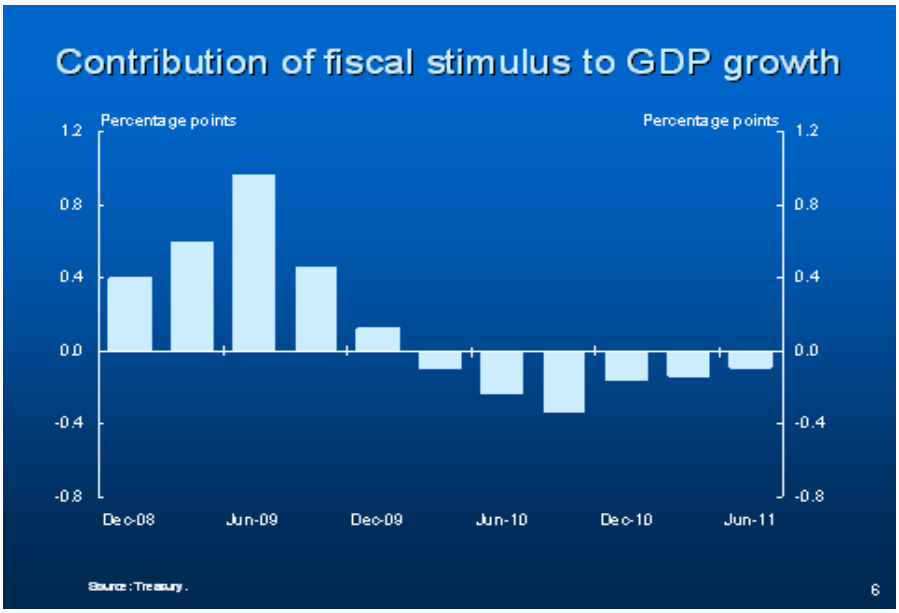
27 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 26.

> Because of the change in direction that you give, the signals that you give economic actors to their businesses and the people who will be employed in them, quite deliberately, you ought to stick with them.[28]

5.26 It can be argued that this is a rather empty argument and a result of the poor design of the stimulus package to start with. The cost to the economy for maintaining the stimulus package at the current rate could result in negative pressure on GDP growth (see chart 5.2).

> The stimulus will be detracting from GDP growth from the start of 2010…[29]

Chart 5.2: Contribution of fiscal stimulus to GDP growth



Source: Treasury[30]

5.27 Given the design of the stimulus packages, there has been some media comment as to how the packages could be tweaked to maximise their benefit to the Australian economy.

> It could have begun with a burst of cash handouts and an initial capital works budget for the first nine months of so. Then the Treasury could have produced an updated economic assessment to guide the final size and

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28 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p 66.

29 Mike Stutchbery, 'Make stimulus timely, temporary, targeted and tweakable', *The Australian*, 15 October 2009, p 28.

30 The Hon. Wayne Swan, MP, Treasurer, 'One Year On: Fiscal Stimulus and The Path Ahead', *Address to the Australian Business Economists*, 12 October 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2009/028.htm&pageID=005&min=wms&Year=&DocType= , accessed 19 October 2009.

> withdrawal of the remaining stimulus. That might conclude some of the investment spending should be delayed, better planned or shelved.[31]

5.28 As an alternative means of reducing the stimulus package expenditure, given that much of the stimulus package has already been spent and the remaining expenditure could be delayed or spent over a longer period of time which would have the effect of reducing annual expenditure but retaining the total spending over a longer timeframe.

> In summary, it notes that around $79 billion of what may broadly be characterised as fiscal stimulus measures are expected to impact on the economy over three years from 2008-09 through to 2010-11.[32]

Inflation and unemployment – the balance of risks

5.29 Many witnesses are concerned about inflationary risks from the package:

> …given the qualitative easing which may have occurred and given the fact that the Reserve Bank may have compromised the quality of its balance sheet, that there may well be inflation down the track. I think the ball is very much in the Reserve Bank's court. If it will accommodate the amount of spending which the government has undertaken and is continuing to undertake then inflation can arise out of all of this.[33]

5.30 Others are focused more on unemployment risks:

> We know that the best predictor of poverty in Australia is not having a job, so trying to minimise job loss is important in the short term and, as I think we spoke about earlier, the long term. If kids experience a period of unemployment early in their careers, you can see that in their wage trajectory and their occupation later on in their careers. They recover, but not fully. I think that is partly due to the loss of skills, the absence of gaining experience and just the psychological impact of the feeling that you are not worth employing. So, to the extent that policy can ameliorate unemployment, I think that should be a top policy goal.[34]

> There has been no evidence presented to this committee that I am aware of, and certainly none presented by the Governor, that suggests that we have any imminent inflationary pressures.[35]

5.31 Despite this, the October 2009 minutes of the Reserve Bank of Australia meeting clearly indicate the RBA holds concerns about underlying inflation and now

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31 Mike Stutchbery, 'Make stimulus timely, temporary, targeted and tweakable', *The Australian*, 15 October 2009, p 28.

32 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 2.

33 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 52.

34 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 36.

35 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 18.

predict that the expected trough in inflation will be significantly higher than earlier thought.[36]

5.32 Over the course of the inquiry, the Government has been changing its rhetoric and appears to be preparing to recalibrate the remaining components of the fiscal stimulus packages.

36 Reserve Bank Board Minutes, 6 October 2009, http://www.rba.gov.au/MonetaryPolicy/RBABoardMinutes/2009/rba-board-min-06102009.html, accessed 20 October 2009.

Chapter 6

Conclusion and Recommendations

6.1 The Report shows that there is a range of opinions from credible economists on the need for and the appropriate size, timing and duration of economic fiscal stimulus in Australia.

6.2 The Report also shows there is a range of views as to the appropriateness of reconfiguring the package given the improvement in underlying economic conditions.

6.3 At one extreme was a view that a more rapid winding back of the fiscal stimulus would reduce economic growth and increase unemployment from what it would otherwise be. An alternate view was that continuing an inappropriate degree of poorly targeted fiscal stimulus would also have costs. These would include higher inflation, higher interest rates, a crowding out of more productive private sector investment and therefore higher unemployment.

6.4 This shows that continuing with an inappropriate degree of fiscal stimulus is not a cost-less option.

6.5 In this regard the Committee notes that the RBA has recently stated that its expansionary monetary policy settings are no longer appropriate and indeed may be imprudent.

> In particular, underlying inflation was still, on the latest data, above the target and, while current forecasts suggested it would fall in the coming year, the expected trough in inflation was significantly higher than earlier thought. Keeping interest rates at very low levels for an extended period could therefore threaten the achievement of the inflation target over the medium term. More generally, very expansionary policy could result in the build-up of other imbalances in the economy, which would ultimately be detrimental to economic growth.
>
> Overall, members concluded that, while downside risks to the domestic economy could not be ruled out, they had diminished significantly over recent months. This meant that the balance of risks was now such that the current very expansionary setting of policy was no longer necessary, and possibly imprudent. The Board therefore decided in favour of raising the cash rate.[1]

6.6 This opinion lends weight to the view that an expansionary fiscal policy is also no longer necessary and possibly imprudent, leading to the Committee's view that the fiscal stimulus package should also be recalibrated with a view to maximising value for money from all remaining projects.

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1 Reserve Bank Board Minutes, 6 October 2009, http://www.rba.gov.au/MonetaryPolicy/RBABoardMinutes/2009/rba-board-min-06102009.html, accessed 20 October 2009

6.7 There was no evidence taken as to which unspent fiscal stimulus elements could be reduced, postponed or offset and will otherwise lead to imbalances.

6.8 The overall stimulus imparted to the economy from fiscal policy could be reduced in a number of ways.

6.9 One way would be to focus only on the components of spending that are classed as part of the fiscal stimulus package and to reduce or reschedule these expenditures over a longer period of time. It would appear that there is approximately $31 billion of discretionary stimulatory spending out of the remaining $45 billion over the forward estimates unspent.

6.10 An alternative approach would be to reduce the total stimulus injected into the economy by identifying offsetting cuts to other areas of government spending.

6.11 There was a consensus view that a range of factors have contributed to Australia's exemplary economic performance. These include the continuing strong growth of China and demand for Australia's exports; the legacy of rapid growth, strong budget position and sound prudential regulation of the financial system that was left by the previous Coalition government; the rapid move to strongly accommodative monetary policy; the fall in the A$ in the second half of 2008; and the fiscal stimulus.

6.12 There was a range of opinions as to the relative contributions of each of these factors to the exemplary performance of the Australian economy. What was clear though was that fiscal policy alone was not the only significant factor.

6.13 No evidence was submitted on one of the terms of reference, specifically an evaluation of the environmental impacts of the spending to date. Consequently, no comments have been made on this issue.

6.14 The committee notes that the economy has strengthened and that the rationale for maintaining the proposed spending levels by the Rudd Government are no longer valid and is of the firm opinion that the levels of spending need to be reduced, postponed or offset to prevent the economy from overheating, in line with the Reserve Bank's Board view as expressed in their latest Board minutes of 6 October 2009.

Recommendation 1

6.15 The Committee recommends:

That the Government commission an urgent independent report to be prepared on the fiscal stimulus packages listed in Appendix 3 to include

(a) A cost benefit analysis of all the remaining projects, including the timing implementation for spending on those projects

(b) Recommendations on the feasibility of reducing, postponing or recalibrating the remaining discretionary funding, on a project by project basis.

That the Report be published on the Department of Treasury's website within 14 days of its receipt.

Senator Alan Eggleston
Chair

Government Senators' Minority Report

Introduction

Terms of reference

On 8 September 2009, the Senate, on the motion of Senator Bob Brown, resolved to refer to the Senate Economics References Committee a range of matters concerning the Government's economic stimulus package for inquiry and report by 2 October 2009. Subsequently, the reporting date was extended to 27 October 2009.

The inquiry was conducted in accordance with the following terms of reference:

1. That the following matter be referred to the Economics References Committee for inquiry and report by 2 October 2009:

   The economic stimulus initiatives announced by the Government since October 2008.

2. That the Senate requests the committee:

   (a) to invite the Secretary of the Treasury, accompanied by any other officials he considers appropriate, to appear before the committee, on or after the morning of Monday, 14 September 2009, for the purpose of giving evidence on the matter;

   (b) to invite the Reserve Bank Governor, Mr Glenn Stevens, and other independent pre-eminent economists to appear before the committee, on a date to be determined by the committee, for the purpose of giving evidence on the matter; and

   (c) to hold public meetings to take evidence from those witnesses, in the form of a full update on the economic stimulus initiatives, which addresses:

      (i) the efficacy of the spending measures to date,

      (ii) the anticipated costs and benefits of continuing the spending measures,

      (iii) consequent change in the stimulus 'roll out' that ought to be entertained given the changed economic circumstances,

      (iv) anticipated impact of the stimulus spending on future interest rate movements and taxpayer liabilities,

      (v) an evaluation of the environmental impacts of the spending to date, and

      (vi) other related matters.

Background to the economic stimulus initiatives

The global financial crisis and global recession

From the middle of 2007, financial markets began showing signs of considerable turmoil as the realities of trade in exotic financial derivatives and the explosion in sub-prime lending that had characterised the finance market boom became clear.

As subsequent events would reveal, inadequate regulation and greed on the part of financial market players would set in train a sequence of events in the United States, the United Kingdom and Europe that would culminate in the collapse, nationalisation or government bailout of major banks, insurers and credit providers. These included Citigroup, American International Group, Northern Rock, Fannie Mae, Freddie Mac, Bank of America, Goldman Sachs, Morgan Stanley, Royal Bank of Scotland, Lloyds TSB, HBOS and a number of major continental European financial institutions. The list of institutions involved reads like a veritable Who's Who of those who only months earlier would have considered themselves "masters of the universe". As we now know, these emperors had no clothes.

Following the collapse of Lehman Brothers, it was clear that the world financial system was on the brink of collapse. Banks lacked the confidence to lend to one another and credit markets froze as financial markets began to price in the risk of a catastrophic systemic failure. Share markets experienced the steepest and most rapid falls in stock prices in nearly 80 years. Major currencies around the world, Australia's included, came under abnormally heavy selling pressure, although in Australia's case this has proved to be short term.

All of these circumstances fed into a dangerous feedback loop that saw market confidence crash, creating the conditions for an unprecedented falls in global trade, production and investment. By October 2008, it was clear that without government intervention, every advanced economy was heading for a deep and protracted recession.

Governments the world over, with the encouragement of the IMF and OECD, put in place fiscal stimulus packages while central banks added monetary stimulus by reducing official interest rates to unprecedented lows. In some cases, governments resorted to what is called "quantitative easing". By January 2009, the International Monetary Fund was forecasting the first worldwide recession in the post-World War II era.

The consequences of the global financial crisis have been pervasive. Since October 2008, there have been nearly 50 government sponsored bailouts of major banks around the world. Financial institutions have suffered losses and asset write-downs totalling around A$1.9 trillion. The banking system aggressively deleveraged resulting in huge increases in costs of capital and investment funds drying up around the world including in Australia.

Virtually every major advanced economy with the exception of Australia has fallen into recession and taken together, the G7 economies have contracted for five consecutive quarters.

Some of these countries would suffer their biggest falls in output on record. In the year to June 2009, GDP in the United States fell by 3.9%, in the United Kingdom by 5.5%, and in Japan, GDP fell by 6.4%. Collectively, the world's advanced economies have shrunk by 4.3% in the year to June 2009, with 29 out the world's 33 advanced economies experiencing recession. Only Australia, Greece, Korea and Slovakia have avoided technical recession.

The global financial crisis quickly developed into a global crisis of employment. In the United States alone, almost six million jobs have been lost since September 2008. Worldwide, the International Labour Organisation estimates that 60 million jobs will have been lost by the end of this year as a result of the global economic downturn.

Australia was not immune to the effects of the global financial crisis and took swift and decisive steps to cushion the Australian economy, community and families from the worst effects of the global financial crisis. On the Friday before the government acted (October

12, 2008) to introduce the Retail and Wholesale Bank Guarantee, the Australian share market suffered its biggest fall since the 1987 stock market collapse. Share prices fell 8.3 per cent in one day, wiping nearly $73 billion from the value of the share market, and taking the total loss for that week to just under 16%. In the week before the introduction of the bank guarantees, the Australian dollar fell 12.5 cents (16%) against the US dollar, the biggest weekly fall since the Australian dollar was floated in 1983.

The human impact of the global financial crisis has been severe and the Government was determined to cushion Australians from the worst impact of the crisis. Despite unfounded claims over the effect of the stimulus on interest rates and debt raised by the Coalition, the evidence to the inquiry from the Reserve Bank, Treasury, business and market economists demonstrates the correctness of the Government's approach.

Economic and social costs of severe economic downturns

Protracted downturns result in permanent dislocation from the labour market, skills atrophy, and risk creating an entire generation of unemployed. Otherwise viable businesses are destroyed and productive investments are foregone. This capital and skills destruction can permanently reduce an economy's long-term capacity, to say nothing of the "scarring" effects of unemployment to the individuals involved.

Evidence presented to the Committee demonstrates that the human, social and economic costs of severe downturns can be substantial and long-lasting. Professor Andrew Leigh highlighted the pervasive long-term costs of joblessness:

> "I think it is important to bear in mind how slowly economies tend to recover from recession. The unemployment rate of the late eighties was not again achieved until the late 1990s, and the scarring cost of unemployment is pretty substantial. I left school in 1990, just as the economy was hitting the skids, and that was a terrible time for young kids to leave school. So I think it is important, where government can, to try to smooth the economic cycle and not simply to see this additional two percentage points of unemployment as being a statistic but as being many young people whose livelihoods will be better if they do not spend a scarring period of unemployment early in their careers."[1]

> "We know that the best predictor of poverty in Australia is not having a job, so trying to minimise job loss is important in the short-term and, as I think we spoke about earlier, the long-term. If kids experience a period of unemployment early in their careers, you can see that in their wage trajectory and their occupation later on in their careers. They recover, but not fully. I think that is partly due to the loss of skills, the absence of gaining experience and just the psychological impact of the feeling that you are not worth employing. So, to the extent that policy can ameliorate unemployment, I think that should be a top policy goal."[2]

For these reasons, limiting the more severe consequences of economic downturns can have long-lasting benefits. This view was put by a number of witnesses before the Committee:

> "It is hard to imagine that anyone would strongly argue with the view that keeping people in work pays enormous dividends over the medium-term. Not only do we spare

[1] Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.28.

[2] Ibid, p.36.

> them the pain and the inconvenience and the cost of a period of unemployment, but we spare the economy all the flow-on effects of them losing their jobs."[3]

> "Long term joblessness leads to poverty (for example, Newstart Allowance is just $228 per week for a single adult), poor health, a loss of confidence and skills, tensions within families, and often the need to move to areas where housing is cheaper, which concentrates these social problems in the same areas. This means that many Australians will not 'bounce back' as the economy recovers. For example, over one on five Newstart Allowance recipients lack a decent and secure home, over one in four could not pay a utility bill (within the last 12 months) and over four in ten are unable to afford necessary dental treatment. If we can prevent high levels of long term joblessness from becoming entrenched, many of these social problems, and their high costs to Governments in future years, can be avoided. This should be a major objective for economic and social policy over the next two years. It is vital that the Government apply the same foresight and energy to this problem as it did to avoiding a more severe downturn in the first place."[4]

The Australian Government response to the global recession

The Australian government's stimulatory response to the collapse of financial markets and the looming collapse of the real economy has been part of an internationally coordinated response and has been four-fold.

The government:

1. Guaranteed the deposits of financial institutions and offered access to a government guarantee for their wholesale funding, a response made necessary by the extraordinary events up to October 2008.
2. Provided direct cash support to households to support consumer confidence, consumption and housing investment.
3. Committed to direct public investment in local infrastructure projects that could be undertaken immediately; providing support to employment in labour intensive construction and associated industries.
4. Committed to direct public investment in critical long-term economic infrastructure necessary for creating the conditions for a step up in productivity and thus, accelerating Australia's recovery from the effects of the global financial crisis.

The majority of evidence presented to the Inquiry was that the fiscal stimulus was an appropriate response given the scale and severity of the global crisis and that the stimulus has been effective in averting a much sharper and deeper downturn in the Australian economy:

> "Avoiding the mistakes of the past, a consensus emerged to undertake speedy fiscal stimulus and monetary easing. The Australian government was right to take this path and in fact to act more quickly and decisively than most. While the return to more normal growth levels is still some time off, at the time of the announcement of the

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[3] Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p.64.

[4] Australian Council of Social Service, *Submission 2*, p.2

> December and February stimulus arrangements the economic outlook was deeply concerning and, given this, the scope and scale of stimulus was entirely warranted."[5]
>
> "I think the international consensus, including the OECD and the International Monetary Fund, is that Australia's policy settings, at least to date, have been quite consistent with what is generally regarded as an appropriate stance, including in respect of timeliness and being temporary and well targeted."[6]
>
> "I think the governments and central banks of the world did the right thing by acting as quickly and as forcefully as they could. I genuinely do believe the world was on the brink of a catastrophic economic and financial meltdown. I think that policymakers everywhere moved sharply in the right direction."[7]
>
> "It made sense for policymakers in Canberra to ensure that fiscal policy also put its shoulder more firmly to the wheel. Other economists can speak for themselves, but my guess is that the majority of financial-sector economists with public-policy backgrounds at the RBA and Treasury also felt that the February stimulus package made a great deal of sense."[8]

A view was expressed by a minority of academic economists that Governments should do little, if anything, to limit the impact of deep recessions on the economy and workers. The retrospective advice from a minority of academic economists who are completely opposed to government intervention in the economy demonstrates the difference between "blackboard economists" and those economists who have responsibility for fiscal and monetary policy of a real and practical nature.

The government set clear criteria that the stimulus be timely, targeted and temporary. The impact of the intervention through the stimulus package has assisted the economy avoid a recession with all of the associated negative social and economic implications.

The stimulus was designed intentionally to reach its maximum impact on growth quickly and then to gradually withdraw as a recovery in private sector activity builds. By design, the fiscal stimulus will be withdrawn gradually as the economy strengthens. This ensures that both arms of macroeconomic policy – fiscal and monetary policy – continue to work consistently during the economic recovery, as they did during the downturn.

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5 Greg Evans, Director, Australian Chamber of Commerce and Industry, *Proof Committee Hansard,* 28 September 2009, p.54.

6 Dr Ken Henry, Secretary of the Treasury, *Proof Committee Hansard,* 9 October 2009, p.15.

7 Rory Robertson, Economist, Macquarie Bank, *Proof Committee Hansard*, 28 October 2009, p.50

8 Rory Robertson, Economist, Macquarie Bank, *Opening Statement to the Senate Economic Committee Inquiry*, 28 October 2009, *Proof Committee Hansard*, p.2

The size and composition of the stimulus

The table below sets out the size and scope of the economic stimulus measures adopted by the government since October 2008. The measures include the Economic Security Strategy (October 2008), the Nation Building Package (December 2008), the Nation Building and Jobs Plan (February 2009) and measures included in the 2009-10 Budget.

Table 1: Composition of the fiscal stimulus[9]

Composition of fiscal stimulus ($b)	2008-09	2009-10	2010-11	2011-12
Transfers	**20.44**	**4.22**	**1.78**	**1.59**
Major fiscal stimulus packages				
Economic Security Strategy (consumption) (Oct. 2008)	9.55	0.65	0.07	0.00
Nation Building & Jobs Plan (consumption)	10.49	1.72	0.00	0.00
2009-10 Budget measures				
2009-10 Budget net pension spend[a]	0.39	1.86	1.71	1.59
Investment	**4.52**	**21.93**	**17.27**	**4.91**
Major fiscal stimulus packages				
Economic Security Strategy (investment) (Oct. 2008)	0.12	0.07	0.00	0.00
Dec. 08 Nation Building Package (all investment)	0.88	1.95	0.39	-0.19
Nation Building & Jobs Plan (investment)	2.04	16.19	10.03	1.67
2009-10 Budget measures				
2009-10 Budget infrastructure (investment)[b]	1.48	3.72	6.85	3.43
COAG Reforms	**3.50**	**1.78**	**2.23**	**3.57**
COAG funding package (transfers)	3.50	1.78	2.23	3.57
TOTAL	**28.46**	**27.93**	**21.27**	**10.07**

a. This is the net effect of the pension and carer reforms and structural savings

b. These amounts do not include the provisions for future equity injections for the National Broadband Network, which are subject to the outcome of the Implementation Study and subsequent commercial negotiations.

9 Source: Treasury Briefing Paper for the Senate Inquiry into the Economic Stimulus Package; received by the Senate Economics References Committee, 2 October 2009.

Efficacy of the spending measures

Design of the fiscal stimulus measures

Against the criteria that the Government set for the design of the stimulus package – that it be timely, targeted and temporary – the majority of evidence to the Committee found that these objectives were met. The Governor of the Reserve Bank noted that:

> "The three Ts—temporary, timely and targeted—are a standard set of desirable criteria amongst people who talk about this. I think it is pretty hard not to conclude that it was quite timely. It was very fast. The bulk of it is temporary. Notwithstanding the discussion earlier about 2011 effects, the big impacts are in 2009, which is presumably the year in which the economy would need the most support. On the targeting, that is probably where people are going to differ about just what should be targeted. That inherently is, I think, largely a set of decisions which are properly made in the political realm. It is the job of the political process to make that decision."[10]

A similar view was put by one market economist:

> "In terms of the formulation, there may not have been a more sensible package. It is an unprecedented episode, but I am not sure there has been a package like this one. There was the cash splash designed to support the household sector ASAP. Then there was the idea of supporting economic activity more generally. Someone thought of building in pretty well every school in Australia, so there will presumably be nearly 10,000 buildings. That is obviously designed to generate extra economic activity in every community in the country. Then there are some of the longer term projects. To me that make sense. Other economists can speak for themselves, but I think most financial market economists, many of whom grew up in the Reserve Bank and Treasury, would think the package was reasonably well structured given the economic circumstances."[11]

Professor Andrew Leigh was asked his view on the efficacy of various stimulus measures, in particular the effect of the consumption and infrastructure elements of the Nation Building and Jobs Plan on employment and aggregate demand, as opposed to alternative proposals for tax cuts that have been advanced over the past year.

> **"Senator CAMERON**—One of the other arguments we heard this morning was that it would be better if we simply reduced taxes to business and let business get on with the job. What is your analysis of that approach?
>
> **"Prof. Leigh**—My favourite primer on multipliers is a Bookings Institution paper by Doug
> Elmendorf and Jason Furman that you are probably aware of and that I regard as a nice review of the literature. My read of that is that the multipliers are highest for

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[10] Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p.22

[11] Rory Robertson, Economist, Macquarie Bank, *Proof Committee Hansard*, 28 October 2009, p.43

> infrastructure, next highest for consumer handouts and lowest for business tax breaks."[12]

The economic impacts of the Government's stimulus measures

Treasury presented evidence to the Committee on the economic impacts of the fiscal stimulus packages. This analysis, outlined in the briefing paper[13] and confirmed in its appearance before the Committee, demonstrated the fiscal stimulus had played a critical role in keeping Australia out of recession.

> **"Senator BOB BROWN**—Thanks, Chair, and thank you, Dr Henry and gentlemen. The first question, of course, is: without the stimulus package—and we were talking with you last about the $42 billion stimulus package that was being considered in February—would we have moved into recession?
>
> **"Dr Henry**—It is our view that yes, we would. It is our view that, as I indicated in my opening remarks, in the year 2008-09, the fiscal stimulus accounts, on our estimates, for all of the growth that occurred in that year. Dr Gruen or others at the table may correct me if I get this wrong, but I think, in through-the-year terms to the June quarter of 2009, the Australian economy grew by 0.6 per cent, and our view is that without the fiscal stimulus the Australian economy would have contracted by 1.3 per cent through the year to the June quarter 2009. I think a contraction in the economy of 1.3 per cent through the year would be regarded by most people as a fairly significant recession."[14]

Treasury's analysis shows that in the absence of the fiscal stimulus, the Australian economy would have contracted for three consecutive quarters – in the December quarter of 2008, and the March and June quarters of 2009 – and by 1.3 per cent over the year to June.[15] Instead, in large part due to the fiscal stimulus, the Australian economy recorded positive growth of 0.6 per cent, making Australia the only advanced economy to grow in the year to June.

As to its effects on household consumption, Treasury's modelling, supported by two recent Australian studies cited in the briefing paper, indicate that the transfer payments to households have led to growth in household consumption of 1.7 per cent over the year to June 2009, as opposed to a contraction of 1.3 per cent that would have occurred in the absence of the stimulus.[16]

Overall, Treasury estimated at Budget, that the stimulus measures added 1 per cent to GDP growth in 2008-09 and 1.6 per cent to GDP growth in 2009-10. In terms of its impact on employment, Treasury estimated that the peak impact of the stimulus at Budget was the

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12 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.28

13 Treasury Briefing Paper for the Senate Inquiry into the Economic Stimulus Package; received by the Senate Economics References Committee, 2 October 2009.

14 *Proof Committee Hansard*, 9 October 2009, p.8.

15 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p.2.

16 Treasury, Briefing Paper, op cit, p.6.

addition of 210,000 jobs, which in turn leads to higher employment levels throughout the forecast period. The peak unemployment rate is therefore estimated to be 1.5 percentage points lower than it would otherwise have been in the absence of the stimulus.[17]

The Governor of the Reserve Bank presented a similar view that the stimulus measures had been effective in supporting economic activity:

> "A straightforward reading of the economic outcomes would, I think, suggest that the various policy measures have been effective in supporting demand."[18]

> "If the intention was to support demand in the economy in a period in which we had a very serious global downturn and which all the indications were that that was going to affect Australia significantly, and if the intention is to provide some temporary support to demand in such a period, my conclusion would be that those measures have supported demand quite materially over the last—it is now September—probably nine or 10 months."[19]

Governor Stevens agreed with Treasury's view that the stimulus measures had kept the Australian economy out of recession.

> **"Senator BOB BROWN**—Do you think we would have faced a recession and/or depression in this country had these stimulus packages not been there?

> **"Mr Stevens**—I do not think we would have faced 'the Great Depression'. For the reasons I set out in my opening remarks—the root problem here of financial excesses, too much leverage, too much risk taken, housing market collapses et cetera that you have seen in these other countries — we did not really have that problem. We would have been affected. We would have had recession. I am not sure we would have had depression—personally I would not have thought that—but we certainly would have faced a deeper downturn than we have ended up having. And that is costly, of course."[20]

The view that the economic stimulus had been effective in supporting economic activity and employment was also shared by business groups:

> "Our assessment of the measures is that, in combination with interest-rate reductions and similar policy actions in other parts of the world, they have made a material difference to economic activity over the past nine months, and, had they not been in place, the economy would have deteriorated much more sharply than it has done."[21]

One of the principal motivations for the Government's economic stimulus package was to support employment. High unemployment has a human as well as an economic cost. Although Australia's unemployment rate has increased and may not yet have peaked, there

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17 Ibid, p.5.

18 Mr. Glenn Stevens, Reserve Bank Governor; *Proof Committee Hansard*, 28 September 2009, p.3.

19 *Proof Committee Hansard*, 28 September 2009, p.6.

20 Mr. Glenn Stevens, Reserve Bank Governor, *Proof Committee Hansard*, 28 September 2009, p.7.

21 Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p.63.

can be no doubt that had the Government not acted to support demand, the situation would have been much worse.

> "In terms of reducing unemployment relative to what it otherwise would have been, I think that it was an effective package."[22]

The majority of evidence presented to the Committee was that stimulus had been effective in limiting the impacts of the global recession on economic activity and employment in Australia.

It became apparent during the course of the inquiry that there is a significant divergence of opinion between those charged with the on-the-ground management of the Australian economy and those who could be referred to as "blackboard" economists about the efficacy of the stimulus measures undertaken so far. This divergence was put to the Secretary of the Treasury by Senator Cameron:

> **"Senator CAMERON**—We have had lots of academic economists come before us and argue, I suppose, their academic bias in terms of some of these issues. We have had lectures on Say's law, we have had lectures on the evils of Keynesianism and why we should be looking at Hayekian economic approaches. I am just wondering if all that lecture we got was really relevant in terms of the practical circumstances that governments and treasuries around the world face. Have you got any views on that? I am sure you have looked at some of the commentary and analysis that has been put to the committee. We have got to weigh all this up, I suppose.
>
> **"Dr Henry**—I used to be an academic economist myself. It is easier to be an academic economist.
>
> **"Dr Gruen**—Are you going to leave it there?
>
> **"Dr Henry**—No, look, the issues that have been raised in testimony before the committee, on my brief reading of them—and I have not read them perhaps as closely as I might have in answering this question—it is not that the issues that have been raised should be entirely discounted in all circumstances; certainly not. But, whilst being very aware of those issues for many years, I can tell you that, confronted with the crisis that the world has been dealing with these past 12 months or so, those few quibbles with the use of expansionary fiscal policy—or expansionary monetary policy, for that matter—or other actions of governments to prop up credit markets are not ones that I considered should detain us for too long. They were rather quickly put aside."[23]

Differences of opinion between economists are as old as the economics profession itself. The conduct of inquiries such as this will occasionally provide a battleground for the prosecution of economic debates which are at times essentially ideological in nature. One of the defining features of the global financial crisis is that its causes and remedies have undermined the central tenets of neo-liberal economics. Those academic and business economists who subscribe to neo-liberal economic theory have been quite active in recent

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[22] Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.22.

[23] *Proof Committee Hansard*, 9 October 2009, p.13.

times defending their faith.

This is perhaps understandable; however, what government senators are mindful of is the need for public policy to reflect real-world circumstances and the needs of the people who are most likely to be hard hit by an economic crisis such as that which we have witnessed over the past year.

Government senators are of the opinion that in the absence of the stimulus, Australia's aggregate economic performance would have been far worse over the course of the past year than would have otherwise been the case in the absence of fiscal stimulus. Indeed, in the absence of the stimulus, Australia would have joined the rest of the developed economies in recession with its consequent catastrophic effects on employment, consumer and investor confidence and Australia's medium and long term economic prospects.

Costs and benefits of continuing the spending measures

Rationale for continuing with fiscal stimulus

The Australian government's response to the global financial crisis is part of a global response coordinated by the G20 in what has been an unprecedented global effort to support the level of economic activity to avert the worst consequences of a global recession.

The most significant decision of the G20 governments has been to inject US$5.5 trillion worth of stimulus to the global economy. The result of this coordinated action has seen the thawing of credit markets, recovery in equity markets, stability begin to return to labour markets and a return of consumer and business confidence. Despite this, 'there continue to be strong headwinds in the global economy'.[24]

Earlier this month, IMF Managing Director, Dominique Strauss-Kahn cautioned governments of the risks of premature withdrawal of fiscal stimulus:

> "For a start, the crisis is not over. The recovery will be sluggish, and private demand is not yet self-sustaining. The spectre of de-leveraging will be with us for some time. And on the demand side, consumption is still tentative, especially in countries where household balance sheets remain weak. Rising unemployment is likely to cast a long shadow. Even as growth recovers, it will take some time for jobs to follow suit. Indeed, unemployment will continue rising in many countries through 2010…So, the global economy remains in a very precarious position. Premature withdrawal of policy support could kill the recovery. For sure, policymakers should design credible exit strategies. But it is too soon to implement them."[25]

The view presented by business groups is that the Australian economy has not reached the point where the fiscal stimulus should be withdrawn.

> "Despite improving economic news and improving consumer and business confidence levels, the fundamentals of the economy remain fragile. This is according to both official statistics and the surveys of the ACCI. We expect the labour market to

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[24] Dr. Ken Henry, *Proof Committee Hansard*, 9 October 2009, p.14.

[25] Dominique Srauss-Kahn, Managing Director, International Monetary Fund, Opening Address to the 2009 Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund, Istanbul, October 6, 2009.

> continue to worsen and note the shift from full-time to part-time employment has to some extent masked the severity of the slowdown. Retail trade remains subdued, as does business investment, and credit conditions continue to constrain opportunities for business. Most importantly, international conditions amongst our trading partners remain weak. In conclusion, we do not believe these are the circumstances where fiscal stimulus should be withdrawn; noting that in any case the design of these arrangements sees a phased wind-down."[26]
>
> "While we see the measures as having made a very positive contribution, we do not think we can say that the economy is out of the woods yet. We remain concerned that a considerable share of the promising signs that we see in the economy are closely related to the stimulus itself rather than to a self-sustained rise in demand. We expect further rises in unemployment and further falls in hours worked, both of which will flow through the economy more broadly, and we remain conscious of the lagged impacts of the falling commodity export prices on company profits, investments and dividends and the impacts that that will also have as they flow through the economy. For these reasons we are very wary of calls for the fiscal measures to be wound back ahead of the inbuilt schedule for their withdrawal. We think that this could undermine the recovery that appears to be taking hold."[27]

Indeed, Dr Henry pointed out that if the stimulus package were to be withdrawn now, it would risk stalling the economy and a further 100,000 jobs could be lost.[28]

Several witnesses were concerned at the dollar cost of the jobs created as a result of the stimulus packages.[29] However, these concerns ignore the fact that tens of thousands of Australians have kept their jobs as a result of the stimulus. This affords the economy a measure of protection in the medium term as people still in employment continue to support demand in that they still have income to spend.[30]

The economic impact of unemployment has the potential to cause irreversible damage in local economies. This is especially so in rural and provincial centres. Even during the boom of recent times, there were regions in which unemployment remained unacceptably high. The loss of further jobs in many of these places could lead to irreversible decline.[31]

A significant feature of the labour market changes resulting from the effects on Australia of the global financial crisis is the fall in aggregate hours worked, in the order of 3.5%.[32] Rather than shedding labour as has been the case during earlier economic downturns, employers and employees have been agreeing to reduce hours. While this reduction has not always been voluntary, the shift from full-time to part-time employment has to some extent masked the downturn in the labour market. As Dr. Burn of the Australian Industry Group noted:

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[26] Greg Evans, *Proof Committee Hansard*, 28 September 2009, p.55.

[27] Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p. 63.

[28] Dr. Ken Henry, *op cit*, p.14.

[29] For example, Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, pp 4-5, 8.

[30] Dr Richard Denniss, *op cit* p.64.

[31] Dr. Richard Denniss, *op cit* p.67.

[32] Mr. Rory Robertson, *op cit* , p.40.

> "I think the reduction in hours worked works out at about an equivalent of 250,000 (full-time equivalent) jobs fewer than a year ago."[33]

The most recent labour market data indicates that Australia's rate of unemployment fell in September to 5.7 per cent; making Australia the only developed economy to experience relatively stable labour market conditions in recent months. There is however no cause for complacency over Australia's employment performance. Close inspection of the employment data reveals that over the past twelve months, full-time employment has fallen by a little over 151,300 jobs, equivalent to about two per cent of the workforce. The stark fact remains that there are still 658,000 Australians who want a job but do not have one.

The reality is that total employment is a lagging economic indicator and a number of recent economic forecasts point to continuing softness in the labour market over the next year. As indicated above, unemployment may not have yet reached a peak and in the opinion of government senators, any withdrawal of the fiscal stimulus to which the government has committed itself would have the very strong potential to lead to further, unnecessary job losses.

A particular area of concern to government senators is the unacceptably high level of youth unemployment and the dramatic decline in apprenticeship commencements over the past year. The Minister for Employment, Education and Workplace Relations recently told the House of Representatives that this decline is in the order of 20 per cent.[34]

The Minister informed the House that in order to arrest this decline, the government is making some minor adjustments to the stimulus package to encourage an increase in the number of apprenticeship commencements. This entails redirecting $100 million of Job Fund money toward a concerted effort to "kick-start" apprenticeships.[35]

Long-term benefits of fiscal stimulus

One of the central elements of the Government's stimulus spending has been spending on infrastructure, including the Building the Education Revolution program and transport infrastructure projects. Several witnesses were concerned that the infrastructure program was not good value for money.[36] However, it was also noted that infrastructure spending can and does create jobs.[37] Building essential roads does have a payoff.[38] Much of the planned infrastructure will have an impact on the supply side capacity of the economy, which will increase the economy's long-term productivity level.

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[33] Dr. Peter Burn, *op cit*, p 67.

[34] Hon. Julia Gillard MP, *Proof House Hansard*, 19 October 2009, p.27.

[35] *ibid*

[36] See, for example, Dr. Steven Kates, *op cit*, p E5; Professor Sinclair Davidson, RMIT University and Institute of Public Affairs; Proof Committee Hansard, 21 September, 2009 p.49; Professor Tony Makin, *op cit*, pp 81, 87

[37] Professor Andrew Leigh, *op cit*, p.29

[38] Professor Andrew Leigh, *op cit*, p.31

> "But we have some confidence that there will be expansions of capacity that will come from some of the investments in infrastructure."[39]

> "But it is certainly the case that that capital or infrastructure spending component of the fiscal stimulus package—significant pieces of it, at least—is intended to enhance future supply capacity. We would generally expect that that would have some positive implications for future labour productivity growth."[40]

Dr Gruen, Executive Director, Australian Treasury also highlighted the long-term economic benefits from the fiscal stimulus that arise from limiting the skill and capital erosion typically associated with deep and protracted economic recessions.

> "It is also reasonable to argue that to the extent that you avoid a more serious downturn you get less loss of skills and you do less damage to the human capital formation that goes on the job. It is reasonable to argue that the fact that Australia has managed to have a much smaller rise in unemployment, both up until now and in prospect, than in other countries probably means that there are some—they are modest but nevertheless they exist—long-term productivity benefits. Deep downturns have a scarring effect on people."[41]

In the opinion of government senators, the view that stimulus spending in the circumstances that have accompanied the global financial crisis should only be seen as incurring costs is disingenuous.

The view that there only costs associated with fiscal stimulus ignores the very great costs to business, their employees and to the economy and society as a whole that would accompany not undertaking fiscal stimulus measures.

Consequent changes in the stimulus "roll out" given the changed economic circumstances

Based on the evidence put before the Committee confirming the remaining fragility of the global economy, despite signs of nascent recovery in some areas, government senators are of the opinion that no persuasive evidence was put to us that would persuade us to adopt the view that economic conditions have changed sufficiently to warrant withdrawal of the fiscal stimulus measures.

Indeed, it is the view of government senators that the considerable weight of the evidence to this inquiry favours the continuation of the stimulus measures to provide appropriate support to the economy and employment.

The package of stimulus measures has built into it a staged withdrawal of the measures. This is a prudent design measure and we consider calls at this stage for immediate withdrawal of the stimulus would cost more jobs and threaten Australia's economic recovery.

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[39] Dr. Peter Burn, *op cit*, p.68

[40] Dr. Ken Henry, *op cit*, p.15

[41] Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p.15

In this regard, we note the following remarks of Dr. Henry:

> "Some commentators seem to have interpreted our peak unemployment rate forecast of 8½ per cent as a target. Apparently, if the forecast were then to be revised down to, say, seven per cent, we should revise the stance of fiscal policy in order to get our forecast back up to 8½ per cent. Needless to say, we find that sort of argument a little peculiar.
>
> "The effect of fiscal stimulus on growth likely peaked in the June quarter of 2009. We are beyond the period of peak impact of the fiscal stimulus. From that point, as stimulus is to be gradually withdrawn, the contribution to economic growth will subside and it will soon turn negative. Indeed, on our estimates, the fiscal stimulus package will make a negative contribution to GDP growth in every quarter in 2010—that is, commencing in just a few months time.
>
> "It is on the public record that the Treasury has advised the government that withdrawing the stimulus more quickly could risk stalling the economy and causing a steeper rise in the unemployment rate. To illustrate the point, if all the stimulus scheduled to impact in 2010-11 were cancelled, that would mean a further detraction of 1½ per cent from GDP growth and the loss of up to an additional 100,000 jobs. I say 'further detraction' because on our figuring the fiscal stimulus package, in the way it has been constructed, is already likely to detract about 1¼ per cent from growth in that year. It is unlikely that the recovery in private sector demand would be sufficiently strong for the economy to withstand such a sudden withdrawal of public sector activity without significant costs in terms of lost output and higher unemployment."[42]

Impact of spending measures on interest rates and taxpayer liabilities

Interaction of fiscal stimulus and monetary policy

It was pointed out by both Treasury and the Reserve Bank that the in-built withdrawal of fiscal stimulus will ensure that both arms of macroeconomic policy – fiscal and monetary – will be working in the same direction during the economic recovery.

The Governor of the Reserve Bank, Mr. Stevens, observed that interest rate rises would be the natural result of moving into a phase of economic expansion and that during this recovery phase both fiscal and monetary policy would be working consistently. He told the Committee:

> "In due course both fiscal and monetary support will need to be unwound as private demand increases. In the case of the fiscal measures, this was built into their design. The peak effect of those measures on the rate of growth of demand has probably already passed. The extent of support will tend to tail off further over the next year or so. In the case of monetary policy, the bank has already signalled that interest rates can be expected at some point to move off their current unusually low levels as recovery proceeds. These adjustments back towards more normal settings for both types of macroeconomic policy are what should be expected during the recovery phase of a business cycle. Our most recently released set of forecasts—the ones

[42] Dr. Ken Henry, *op cit*, p.3.

> released in August—assume that that occurs. Such an outcome would mean that fiscal and monetary policy would be acting broadly consistently, as they did when they were moved in the expansionary direction when the economy was slowing."[43]

ACCI also noted that rising interest rates were a product of the economic recovery:

> "Interest rates will go up as the economy recovers. That is quite separate from anything the government is doing with respect to fiscal stimulus."[44]

Government borrowing and crowding out

In evidence to the Committee, Governor Stevens rejected the proposition put by Coalition senators and Professor Sinclair Davidson that government borrowing would "crowd-out" private investment and raise interest rates. Governor Stevens made the point that Australia's debt level is low and manageable by international standards and that government borrowing occurs on global markets and therefore has no material impact on interest rates.

> "My point is that the Australian government borrows in a global market. There are free global capital flows here and long rate in Australia is driven more strongly by what happens in global markets than by what happens here, frankly, at the sorts of debt levels we are talking about."[45]

> "If we find that Government borrowing rates are a lot higher in the years ahead, I don't think it will be because of Australia's outcomes."[46]

Government finances

The Australian Government budget – like budgets of governments around the world – has been impacted by the global recession, which has resulted in sharp falls in expected tax revenues. The Government has had to borrow to meet the revenue shortfall caused by the global recession and to support economic activity and employment.

At Budget, it was made clear that early and decisive fiscal stimulus was "essential to support economic activity and jobs, along with investment in the economy's future productivity. Investment in nation building infrastructure and world-class universities and hospitals will position Australia to take full advantage of the global recovery."[47]

Notwithstanding the impacts of the global recession, the Australian government's balance sheet remains strong. The Australian government has lower debt and lower deficits than any of the major advanced economies and the Government's fiscal strategy will ensure that as the economy recovers, the budget will return to surplus, and government debt will fall.

While the United Kingdom, the United States and the Euro zone economies are expected to face public debt levels in excess of 80 per cent of GDP by 2014, and Japanese public debt

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[43] Mr. Glenn Stevens, *Proof Committee Hansard,* 28 September 2009, p. 4.

[44] Mr Greg Evans, ACCI, *Proof Committee Hansard*, 28 September 2009, p. 57.

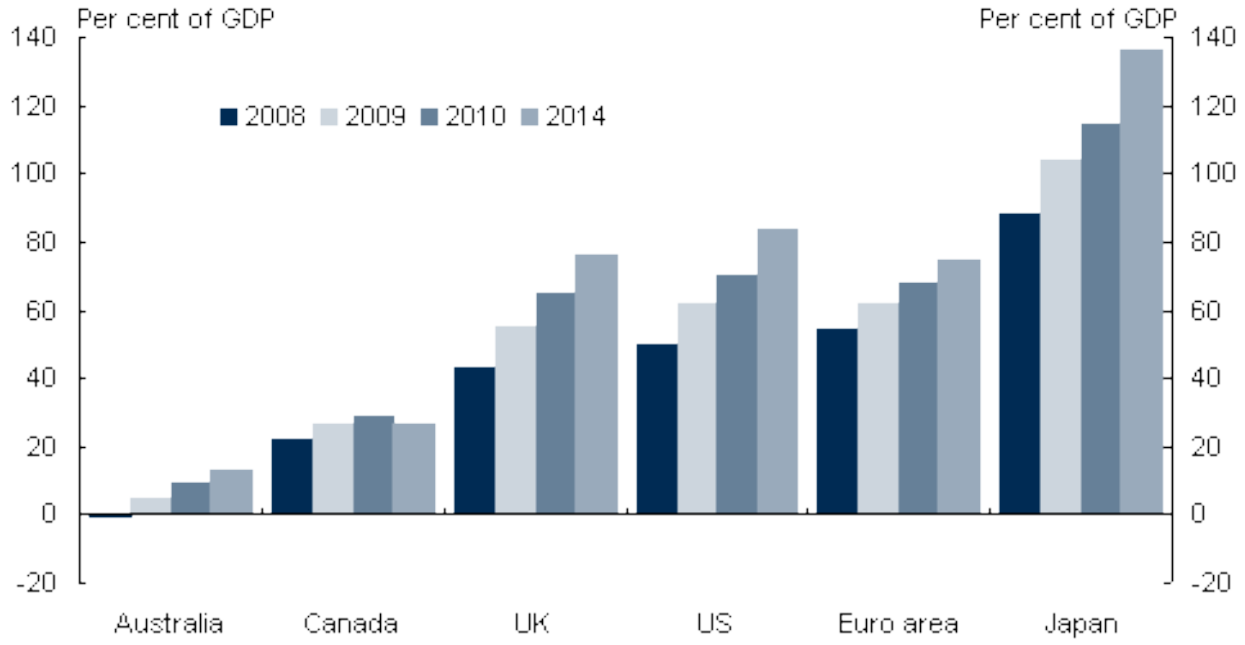
[45] Mr. Glenn Stevens, *op cit*, p.15

[46] *Ibid*, p.12

[47] Budget Paper No. 1 2009-10, p.1-51

will approach 140 per cent of GDP, Australian public debt 'will peak at 13.8 percent of GDP in 2013-14 declining to around 3.7 per cent in 2019-20.'[48]

Australia's net debt position relative to selected advanced economies over the period to 2014 is set out in the following chart:



Source: Budget Paper No. 1 2009-10, p.1-52

There can be no argument that the state of Australia's government accounts is superior to any other comparable economy. The evidence presented to the Committee was that the projected levels of government debt are small by international comparison and manageable.[49] These points were summed up by the testimony of the Reserve Bank Governor, who noted that:

> "I would have to say that I think the prospective debt that we are going to have—according to the budget outlook—for a country like Australia ought to be seen as quite manageable."[50]
>
> "There is not much argument that the state of the government accounts in this country is just so superior to virtually anybody with whom we would want to compete. "[51]

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[48] *ibid*

[49] Mr. Glenn Stevens, op cit, p.9; Mr. Neil Hyden, CEO, Australian Office of Financial Management, *Proof Committee Hansard*, 28 September 2009, p.32; Mr. Rory Robertson, Economist and Division Director, Macquarie Bank, *Proof Committee Hansard*, 28 September 2009, p.41; Dr Ken Henry, Secretary, Department of Treasury, *Proof Committee Hansard*, 9 October 2009, p.16; Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p. 34

[50] Mr. Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p.9

[51] Mr. Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p.16

The Government outlined in the Budget a clear fiscal strategy to return the budget to surplus and reduce debt. As the economy strengths, stimulus will be phased down by design, revenues will recover and the Government has committed to holding real spending growth to less than 2 per cent a year until the Budget returns to surplus. At Budget, it was estimated that this strategy would return the budget to surplus by 2015-16 and reduce the level of net debt as a share of GDP to 3.7 per cent by 2019-20.

Impact of fiscal stimulus on the exchange rate

During the course of the inquiry, there was some concern expressed over the impact of the stimulus package on exchange rates. Dr Gruen noted that in a global downturn, when every country is implementing fiscal stimulus at the same time, the exchange rate effects are muted, or non-existent.[52] Rather, Treasury observed that recent movements in the exchange rate were likely to be unrelated to domestic policy settings.[53] Dr Gruen noted that the Australian dollar is sensitive to changes in the global economy, especially to movements in commodity prices and the US stock market. Therefore, working out the impact of the stimulus package on exchange rates is a difficult task.[54] However, there can be little doubt that the floating exchange rate has allowed us to weather the economic storm better than might have otherwise been the case.

Environmental impact of spending measures

No direct evidence was placed before the Committee or submissions made on this term of reference. However government senators note that as part of phase 3 of the stimulus package, the government has committed $4.5 billion in the Clean Energy Initiative to assist Australia's transition to a low-pollution economy. This figure includes $1 billion in existing funds that will deliver a number of substantial measures aimed at enhancing innovation and investment in clean energy generation. There are three core elements to the Clean Energy Initiative:

- A $2.0 billion investment over nine years in carbon capture and storage (CCS) projects under the CCS Flagships program to support the development of industrial-scale demonstration projects for CCS technology in Australia. The projects are expected to include a carbon dioxide storage hub and projects to demonstrate a range of technologies to capture carbon dioxide from coal-fired power stations. The successful deployment of CCS will facilitate Australia's transition to a low-pollution economy, generate the low-pollution jobs of the future, and help preserve the value of Australia's coal exports.
- A $1.5 billion investment over six years in the Solar Flagships program that will demonstrate large-scale solar-thermal and solar photovoltaic technologies. The program

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[52] Dr. David Gruen, Executive Director, Macroeconomic Group, Department of the Treasury, *Proof Committee Hansard*, 9 October 2009, p.5.

[53] Dr. Ken Henry, op cit p.2.

[54] Dr. David Gruen, Executive Director, Macroeconomic Group, Department of the Treasury, *Proof Committee Hansard*, 9 October 2009, p.21.

will comprise up to four solar projects operating in the national grid, with an additional capacity of 1,000 megawatts. Together with the existing $100 million Australian Solar Institute, the Solar Flagships program will help position Australia as a world leader in solar energy generation with clear benefits for the environment.

- A new independent renewable energy innovation body, Renewables Australia, resourced with initial funding of $465 million over four years to support renewable technology research, commercialisation and deployment. Renewables Australia will support high priority research and investment with the ultimate aim of progressing new technologies to the market while also lowering the cost of existing renewable technologies. Renewables Australia will also support and advise government, industry and the community in the promotion and development of renewable technologies and relevant research and development in essential renewable-related systems, including renewable energy transmission infrastructure.

There is a clear need to persist with the climate change policy agenda despite the current economic circumstances. The Government is committed to tackling climate change and positioning Australia to prosper in a carbon constrained world. Government senators reject the argument put, not necessarily to this inquiry, but certainly elsewhere, that the global financial crisis means that climate change mitigation efforts should be curtailed or abandoned.

Government senators are of the opinion that there are clear environmental benefits to be derived from the investment the government is making in the programs described above and that any winding back of the stimulus would necessarily involve a significant reduction in those benefits.

Conclusion and recommendation

The series of events that began to unfold in the second half of 2007, the effects of which manifested themselves in most dramatic fashion in the last quarter of 2008 have had in many cases a catastrophic impact on many of the world's advanced economies.

Australia was never immune from the global financial crisis and the government took swift, decisive action to avert its worst effects on the Australian economy and the families who rely on secure, long-term employment for their financial security.

The great weight of the evidence on the effectiveness of the government's fiscal stimulus measures is that the government's approach has been the correct one.

Protracted economic downturns have long-lasting and in many cases, permanent detrimental effects on employment, skills, investment and productivity that can reduce the long-term capacity of the economy. The social and economic costs of recessions are pervasive and lasting.

The government's stimulatory response to the very real threats posed by the global financial crisis has been part of a globally coordinated response to the real-economy collapse that loomed in late 2008. The weight of the evidence put before this inquiry leads government senators to conclude that the government's fiscal stimulus was an appropriate response given the scale and severity of the global crisis.

The stimulus has been designed to have its maximum impact on growth and employment

quickly and then to gradually withdraw as private sector activity recovers and the economy strengthens. The design of the stimulus ensures that both arms of macroeconomic policy – fiscal and monetary policy- continue to work consistently during the recovery phase, as they did when the economy turned down.

Government senators are of the opinion that the inquiry demonstrates that in the absence of the fiscal stimulus measures, Australia's overall economic performance over the past year would have been far worse than would have been the case in the absence of any stimulus. Without fiscal stimulus of the scale and structure of that implemented in the past year, there is no doubt that Australia would have experienced a quite severe recession, with all its attendant effects on employment and Australia's longer term economic prospects.

Recommendation 1

Government senators recommend that the government's stimulus packages continue to be implemented to provide appropriate support to the economy and employment.

Senator Annette Hurley

Deputy Chair

Senator Louise Pratt

Senator Doug Cameron

Additional Comments
Senator Bob Brown, Australian Greens

1.1 The Australian Greens support the recommendations of the Committee for ongoing scrutiny of the fiscal stimulus packages.

1.2 The Australian Greens are satisfied with the evidence presented to the Committee by the Treasury Secretary Ken Henry that the Australian economy would have been in recession without the stimulus package.

1.3 In evidence to the Committee, Dr Henry said:

> Without this stimulus, we estimate that the economy would have contracted not only in the December quarter of 2008 but also in the March and June quarters of this year. Our estimates of these impacts are based on internal modelling informed by studies of the effects of fiscal stimulus by the International Monetary Fund, the OECD and a range of academic researchers. They are corroborated by ABS data, by private sector surveys on how the stimulus was spent and by an examination of the experience of countries that have not had such a large stimulus in place.[1]

1.4 We also note the evidence of the Governor of the Reserve Bank, Glenn Stevens when he said:

> If the intention was to support demand in the economy… my conclusion would be that those measures have supported demand quite materially over the last… nine or 10 months.[2]

1.5 The Majority Report details the different stimulus measures introduced by the Government. It is important to note that in negotiating the passage through the Senate of the $42b Nation Building and Jobs Plan, the Australian Greens achieved job-rich, environmentally sound and energy efficient changes to the package.

1.6 These changes provided for a $200m local jobs component in the Nation Building stimulus plan that included $50m for emergency relief and financial counselling for people affected by unemployment, $60m for heritage projects, $40m for bike paths and $10m for bioremediation of the lower Murray. The Greens also negotiated high level energy efficiency standards to be met by all new building

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1 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, pp 2-3.

2 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 6.

constructed under the stimulus package and secured fair and equitable access to a $550m infrastructure programme for all councils in Australia, regardless of their size or location. These measures helped to create thousands of green jobs in communities across Australia, and provide greater financial assistance and support for unemployed and low-income Australians.

Senator Bob Brown
Leader of the Australian Greens

Additional Comments by Senator Xenophon

Introduction

1.1 This inquiry was established to examine the economic stimulus initiatives announced by the Government since October 2008, including the efficacy of the spending measures and their environmental impact, the costs and benefits of continuing the measures, whether changed economic circumstances warrant changes to the initiatives and their impact on interest rates and taxpayer liabilities.

1.2 Following the shock collapse of international investment bank, Lehman Brothers, in September 2008, the global economic outlook deteriorated sharply, with many nations, including Australia, implementing various form of fiscal initiatives to stimulate their economies.

1.3 On 14 October 2008, the Australian government announced the Economic Security Strategy, which included combined expenditure of $10.4 billion through various cash payments, a boost to the First Home Owners grant and further investment through the National Building Funds.

This was further supplemented in November, when the Council of Australian Governments announced a $15.2 billion COAG funding package to address housing, hospitals and education.

A further $4.7 billion in stimulus expenditure – the National Building Plan - was announced in December 2008, followed by the $42 billion stimulus package, the National Building and Jobs Plan, announced in February 2009.

In total, Treasury calculates that around $79 billion in fiscal stimulus measures are "expected to impact on the economy over three years from 2008-09 through to 2010-11"[1].

1.4 The package also included measures targeted at the Murray-Darling Basin in respect of accelerated water buybacks, funding for stormwater harvesting, funds for communities to cope with drought and climate change, as well as improved irrigation exit packages.

Given the importance of the Murray-Darling Basin to Australia's economy as a key food producing area, these measures were essential to assist and provide stimulus to that region.

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[1] Dr Ken Henry, *Proof Committee Hansard*, 09 October 2009, Pg 2

1.5 In comparison, the United States of America injected US$789 billion into its economy, including $507 billion in spending programs, with more than $150 billion on public works projects for transportation, energy, and technology, and $282 billion in tax relief.

Meanwhile, China and Germany proposed economic stimulus plans of US$586 billion and $40 billion, respectively; Canada proposed a plan worth about US$24 billion; France unveiled a $34 billion plan; and Singapore, a $15 billion plan.

1.6 According to the OECD, Australia's fiscal package over the period 2008 to 2010 amounted to 4.6 percent of its 2008 GDP. Of the 30 OECD members, only the United States and Korea initiated larger fiscal stimulus packages.[2]

1.7 During the Committee hearings, it became apparent that there were two fields of thought regarding the need for and effectiveness of the economic stimulus.

Similarly, the key questions are whether the stimulus was necessary, or whether the markets would have rebounded naturally; and whether the stimulus was effective, or was it just a short-lived exercise which will have long-term consequences. And, finally, what should occur now that Australia's economy is improving?

Distribution of the economic stimulus

1.8 One of the key queries around the effectiveness of the economic stimulus was whether, particularly, the $900 voucher to individuals was spent, saved, or used to pay off debt.

In the quarter in which the payments were delivered, forty percent of respondents said that they spent the money they received from the household stimulus package.[3]

39.8 percent of respondents said they spent it on things other than bills or debts; 30.2 percent of respondents said they used it to pay bills such as utilities, medical and other services, and 18.7 percent said they saved it.[4]

The remainder used their stimulus to pay their credit cards, mortgage, invested it or didn't know where they spent it.[5]

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[2] OECD 2009, Pg 109-110
[3] Professor Andrew Leigh, *Submission 1*, Pg 4
[4] Professor Andrew Leigh, *Submission 1*, Pg 8
[5] Professor Andrew Leigh, *Submission 1*, Pg 8

1.9 While admittedly the economic situation in Taiwan was significantly different to Australia's in terms of the amount of their stimulus package, the government used a voucher redemption scheme whereby consumers were given shopping vouchers to encourage people to boost spending.

$88.73 billion (Taiwan dollars) in vouchers were issued to the public between 18 January and 31 March 2009, for spending in the wholesale, retail and food and beverage services, and as of 20 April, more than 78.26 percent ($65.53 billion) had been used by consumers and cashed by the businesses which received them.

$30.4 billion (Taiwan dollars) in vouchers, or 46 percent of the stimulus initiative, were spent at general merchandise retail outlets.[6]

1.10 A voucher system was also called for by the Australian Retailers Association "to ensure any stimulus funds are injected back into the economy"[7].

> "Cash bonuses from the Federal Government will put economic recovery in the hands of Australian workers who are failing to respond to positive economic conditions at the moment. We are seeing a trend towards saving and paying off debt which is not a bad thing – but for any economic stimulus package to do its job funds must flow through the supply channels."[8]

1.11 Given the lack of certainty around how Australians used or spent their stimulus payment, it is difficult to assess its efficacy to boost spending.

1.12 According to Roy Morgan Research, consumer confidence in September 2008 was 101.2 and has continually fluctuated between then and current day, but with a steady rise since February 2009[9], possibly as a result of the low interest rates and economic stimulus measures.

As at 22 October 2009, consumer confidence was 127.1.[10]

Effects of the economic stimulus

1.13 From the second quarter of 2008 to the second quarter of 2009, the Australian economy grew by 0.6 percent. This is compared to an average contraction across OECD economies of 4.6 percent.[11]

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[6] China Daily *Govt scheme helps ease drop of consumption*, 24 April 2009
[7] Australian Retailers Association, *Media Release: Retailers call for debit card stimulus to ensure funds flow*, 11 February 2009
[8] Australian Retailers Association, *Media Release: Retailers call for debit card stimulus to ensure funds flow*, 11 February 2009
[9] Roy Morgan research http://www.roymorgan.com/news/polls/consumer-confidence.cfm
[10] Roy Morgan Research, *http://www.roymorgan.com/news/polls/consumer-confidence.cfm*

Further, according to the International Monetary Fund, Australia will record modest growth of 0.7 per cent in 2009 and 2.0 per cent in 2010, making Australia will be the only advanced economy to record positive growth in 2009.

1.14 A private survey of consumer confidence in July 2009 recorded an increase of 9.3 percent on the previous this month, to reach a total a 109.4, meaning that those optimistic about the economy decisively outweighed the pessimists for the first time since December 2007.[12]

1.15 Unemployment was forecast to hit 8.5 percent as a result of the global economic crisis and, as at September 2009, it increased to 5.8 percent, up from 4.1 percent in August 2008, before the financial crisis.

It's been estimated that the economic stimulus 'saved' 150,000 to 200,000 people from losing their jobs.[13]

1.16 Professor Steven Kates from RMIT University stated during the Committee hearing that:

> "I think in the short term the unemployment rate might have gone to 6.1 percent instead of 5.8 percent had there not been a stimulus. I think it has saved jobs. But I think that the cost of saving those jobs has been so disproportionate to any of the good that it will do that it is a tremendous policy mistake to have done this.
>
> We can see now that everything has calmed down and we are moving towards a platform from which growth can occur. But within that we not have this unbelievably large debt that we are going to have to repay and we have higher interest rates than we otherwise would have had."[14]

1.17 Indeed, Australia's net foreign debt now stands at approximately $200 billion dollars in 2013/14, with a gross debt of approximately $300 billion, 13.8 per cent of GDP as a result of the economic stimulus packages implemented between October 2008 and February 2009.

Looking ahead

1.18 The government has announced that a coordinated wind-back of stimulus measures by G20 nations will take place once Australia's economic growth returned to a trend level of 3 percent.

1.19 However, economist, Professor Ross Garnaut argues:

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[11] ACOSS, *Submission 2*, pg 1
[12] Westpac-Melbourne Institute Consumer Sentiment Index 2009
[13] OECD 2009, *Employment Outlook*
[14] Professor Steven Kates, *Proof Committee Hansard*, 21 September, Pg 9

> "It was appropriate to have a big fiscal stimulus, so I don't fault the scale of the stimulus that was given. But once there are signs that the economy is recovering faster than had been anticipated, then it's appropriate to pull back that stimulus at a faster rate."[15]

1.20 Indeed, Secretary for the Department of the Treasury, Dr Ken Henry, admitted during the Senate Committee hearing that:

> "We are beyond the period of peak impact of the fiscal stimulus. From that point, as stimulus is to be gradually withdrawn, the contribution to economic growth will subside and it will soon turn negative. Indeed, on our estimates, the fiscal stimulus package will make a negative contribution to GDP growth in every quarter in 2010…" [16]

1.21 Reserve Bank of Australia Governor, Mr Glenn Stevens agreed that the stimulus should be wound back, but said:

> "I think it is a bit hard to claim that as of this moment there is too much growth in the economy. I have not had a serious problem with what has occurred on the fiscal front thus far. The presumption we are making is that things will be delivered and then wound back more or less on the schedule that is set out in the budget…I am not sure that I would say that that outlook is a terribly worrying outlook really. This has been a good episode for Australia. We have come through this well. We are in recovery now, I think. It is important that these measures be wound back over time, but they are on track to be so.".[17]

1.22 However, Mr Stevens said he would not support further fiscal stimulus.

> **Senator XENOPHON** — Going to your evidence before the House of Representatives Economics Committee on 14 August, you said, 'I am not terribly worried that there was too much fiscal stimulus.' You went on to say:
>
> > "If someone wanted to make the argument that there is a need for more fiscal stimulus from here, I do not think I would agree with that, based on the outlook as we see it, anyway."
>
> That was 44 days ago. There are newspaper headlines today saying that there is going to be a $10 billion turnaround in terms of the budget deficit. There have been a number of economic indicators since that time. Has your level of worry or otherwise changed since you made that statement before the House of Representatives committee?

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[15] ABC, *The 7:30 Report: Professor Ross Garnaut*, 12 October 2009
[16] Dr Ken Henry, *Proof Committee Hansard*, 9 October 2009, Pg 3
[17] Mr Glenn Stevens, *Proof Committee Hansard*, 28 September 2009, Pg 7

> **Mr Stevens**—What I was saying then was that the measures that have been implemented and that were in prospect on the plan that was set out earlier by the government is built into the outlook. I was not troubled by that outlook. In fact, I think that it is a rather pleasing one, because it is an economy that has had a pretty shallow downturn and has reasonable prospects for recovery. What I was saying was that if someone came up with a whole lot of new plans now to do more, I do not think that I would agree with that. I still would not. That is what I was saying.[18]

1.23 Indeed, Professor Garnaut warns that once people come to expect the government to intervene in the economy, it becomes hard to stop doing so.

> "…entrenching rationalisations for much more widespread state intervention in markets. This would impose persistent high costs on the integrity of our democracy as well as on our market economy."
>
> "Such attitudes are creating a generalised justification for increased government intervention in the economy."[19]

Conclusion

1.24 In many ways, the full extent of the effectiveness of the government's stimulus measures, in particular the $900 cash handouts to households, will be difficult to precisely quantify, as it occurred simultaneously with low interest rates.

Further how the money was spent is not clear – whether the actual $900 was used in retail or whether it provided families with a buffer to have extra spending money at a later stage. However, it was clearly a factor in bolstering consumer confidence.

1.25 More importantly, and given Australia's current positive economic outlook, focus needs to be given to an exit strategy to reduce inflationary pressures and ensure interest rates do not rise unnecessarily.

Recommendations

Recommendation 1
That the government advise the Committee its plans and timeline for a scale back of economic stimulus measures, with and/or without a coordinated approach by G20 nations. Further, that the Government advise what consultation will occur to prepare a clear and effective exit strategy.

[18] Mr Glenn Stevens, *Proof Committee Hansard*, 28 September 2009, Pg 19
[19] Weekend Australian, *Garnaut cool on stimulus*, 10 October 2009

Recommendation 2
Further to the Committee's majority report, that an urgent independent report is conducted, it is recommended that this report include review of the method in which household stimulus incentives are distributed, with a view to assess future options to distribute funds, if needed, via a debit card or voucher system.

NICK XENOPHON
Independent Senator for South Australia

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	Professor Andrew Leigh
2	Australian Council of Social Service (ACOSS)
3	Professor Sinclair Davidson and Ashton de Silva, Institute of Public Affairs
4	Henry Ergas and Alex Robson, Crawford School of Economics and Government, Australian National University
5	The Australia Institute
6	Mr Peter Brohier
7	Welfare Rights Centre
8	CPA Australia
9	Dr Steven Kates, School of Economics, Finance and Marketing; RMIT University
10	Mr Alun Breward
11	Professor Anthony Makin, Griffith Business School, Griffith University
12	The Australian Industry Group
13	Mr Rory Robertson
14	Mr Derek Smith
15	Professor Warwick McKibbin
16	Mr Jim Heslop, HillSide Christian School
17	Mr David Allen
18	Mr Matt Mushalik

Additional Information Received

- Received on 15 October 2009 from Treasury. Answers to Questions taken on Notice on Friday 9 October 2009.
- Received on 19 October 2009 from Treasury. Answers to Questions taken on Notice on Friday 9 October 2009.
- Received on 15 October 2009 from Treasury. Answers to Questions taken on Notice on Friday 9 October 2009.

- Correspondence received by the Committee from the Secretary to the Treasury, Dr Ken Henry, dated 17 September 2009.

- Treasury briefing paper prepared for the Inquiry, received 2 October 2009.

APPENDIX 2

Public Hearing and Witnesses

CANBERRA, MONDAY 21 SEPTEMBER 2009

DAVIDSON, Professor Sinclair,
RMIT University and Institute of Public Affairs

DENNISS, Dr Richard, Executive Director,
The Australia Institute

KATES, Dr Steven Ian,
Private capacity

LEIGH, Professor Andrew Keith,
Private capacity

MAKIN, Professor Tony,
Private capacity

SYDNEY, MONDAY 28 SEPTEMBER 2009

BURN, Dr Peter, Associate Director, Public Policy, Australian Industry Group

EVANS, Mr Greg, Director, Economics and Industry Policy,
Australian Chamber of Commerce and Industry

HYDEN, Mr Neil, Chief Executive Officer,
Australian Office of Financial Management

JOHNSON, Mr Andrew, Head, Compliance and Reporting,
Australian Office of Financial Management

MELVILLE, Mr Anthony, Director, Public Affairs and Government Relations,
Australian Industry Group

ROBERTSON, Mr Rory David, Economist and Division Director,
Macquarie Bank

STEVENS, Mr Glenn Robert, Governor,
Reserve Bank of Australia

FRIDAY, 9 OCTOBER 2009

GRUEN, Dr David, Executive Director, Macroeconomic Group,
Department of the Treasury

HENRY, Dr Ken, Secretary,
Department of the Treasury

McDONALD, Mr Tony, General Manager,
Department of the Treasury

McKISSACK, Mr Adam, Principal Adviser, Forecasting,
Department of the Treasury

MORLING, Dr Steven, General Manager,
Department of the Treasury

PARKER, Mr David, Executive Director, Revenue Group,
Department of the Treasury

APPENDIX 3

Composition of stimulus measures

Composition of the Economic Security Strategy

The Economic Security Strategy (ESS) package was announced on 14 October 2008. The combined value of announced measures was $10.4 billion.

Payments to pensioners

Through the ESS, single pensioners became eligible for one-off payments of $1400, while pensioner couples received $2100. Qualifying pension categories were:

- Age Pensioners;
- Disability Support Pensioners;
- Carer Payment recipients;
- Wife and Widow B Pensioners; Partner, Widow and Bereavement Allowees;
- Veterans' Affairs Service Pensioners;
- Veterans' Income Support Supplement recipients;
- Veterans Affairs Gold Card holders eligible for Seniors Concession Allowance;
- those of age pension age who receive Parenting Payment, Special Benefit, or Austudy; and
- Eligible Self Funded Retirees holding a Commonwealth Senior Health Card.[1]

In addition, individuals who claimed the Carer Allowance also received $1000 for each eligible person in their care.

Payments to recipients commenced on 8 December 2008, with the majority of payments made by 19 December 2008.

Payments to families

The ESS included $3.9 billion worth of lump-sum payments to eligible families for each child in their care. Eligibility was granted to families that received Family Tax Benefit A and families with dependent children that received Youth Allowance, Abstudy or a benefit from the Veteran's Children's Education Scheme. Families received $1000 for each child in their care.

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1 The Hon Kevin Rudd PM and the Hon Wayne Swan, Treasurer, *Joint Press Release, Economic Security Strategy*, 14 October 2008.

Increase of the First Home Owners Bonus

The ESS boosted the First Home Owners Bonus from $7 000 to $14 000 when buying an established home and to $21 000 for first home owners buying a newly-constructed home. Under the ESS, this boost would remain in place until 30 June 2009. However, the 2009–10 budget extended this measure for a further three months at the increased level and three more months after that at the original grant level.[2]

Increased funding for job training

The Productivity Placements Program (PPP) received an additional $187 million for the 2008–09 financial year. This expanded the number of places in the programme from 57 000 to 113 000, including 10 000 Structural Adjustment Places for retrenched workers to retrain.

Fast-tracking of the Nation Building Program

As part of the ESS, the government announced that it would bring forward the implementation of the three Nation Building Funds to 2009:

- the Education Investment Fund;
- the Health and Hospitals Fund; and
- the Building Australia Fund (transport and communications).

Composition of the COAG Funding Package

On 29 November 2008, the Commonwealth Government announced a $15.2 billion funding package for initiatives to be undertaken through COAG over five years. Table A3.1 gives a detailed breakdown of the package by measure and financial year.

Funding for the 2008–09 financial year was $3.5 billion, but is approximately half that in 2009–10 and then gradually increases to $4.1 billion in 2012–13.

Health initiatives

The bulk of the November COAG package is expenditure on health initiatives. The single biggest item in the package is an increase in the base Special Purpose Payment (SPP) to states and territories of $4.8 billion as a result of the renegotiated National Healthcare Agreement. In addition to this general increase in funding for health and hospitals, the government agreed to provide $750 million as a one-off payment for improvements to emergency departments in hospitals. Other significant measures included $1.1 billion for health workforce training and $448 million for various preventative health measures.

2 The Hon Wayne Swan, MP, Treasurer, *Budget Speech 2009–10*, 12 May 2009.

Education initiatives

In total, the COAG funding package included $3.5 billion for education initiatives. Approximately $1.9 billion is provided as a result of changes to the Schools SPP. The increase in funding is due to a Commonwealth agreement to align funding rates between primary and secondary schools and to change the indexation rate for government schools. Also included in the SPP is an agreement to provide $0.8 billion to assist in implementing the National Secondary Schools Computer Fund.

The remainder of the education funding, $1.7 billion, is provided through National Partnerships aimed at improving the quality of teachers and addressing the needs of disadvantaged schools. Funding for an additional National Partnership aimed at improving literacy and numeracy was announced prior to the November package.

Table A3.1: COAG expenditure package, 29 November 2008 ($m)

	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**Total**
Healthcare SPP- additional base and indexation	500	675	914	1,191	1,500	4,779
Healthcare NPs	1,287	212	401	566	594	3,060
Hospitals & health workforce reform	*537*	*166*	*295*	*380*	*376*	*1,753*
Preventative health	-	*18*	*67*	*145*	*218*	*448*
E-health (NEHTA)	-	*29*	*39*	*41*	-	*109*
Emergency departments	*750*	-	-	-	-	*750*
Schools SPP	868	171	213	268	334	1,855
Additional indexation	-	*41*	*74*	*121*	*177*	*412*
10% AGSRC primary schools	*61*	*131*	*139*	*148*	*157*	*635*
Digital education revolution	*807*	-	-	-	-	*807*
Productivity agenda NPs	33	192	265	618	549	1,657
Smarter schools – quality teaching	*22*	*40*	*60*	*243*	*185*	*550*
Smarter schools – low SES schools	*11*	*152*	*205*	*375*	*364*	*1,107*
Skills & workforce development SPP	-	4	10	11	11	37
Disability services SPP	70	23	71	101	143	408
National affordable housing SPP	-	1	7	15	23	46
Affordable housing NPs	200	275	105	110	110	800
Homelessness recurrent	-	*75*	*105*	*110*	*110*	*400*
Social housing	*200*	*200*	-	-	-	*400*
Indigenous reform NPs	440	214	245	494	574	1,967
Indigenous economic development	*15*	*40*	*40*	*39*	*40*	*173*
Indigenous health	-	*83*	*157*	*248*	*318*	*806*
Indigenous remote service delivery	*25*	*31*	*32*	*33*	*33*	*154*
Indigenous housing	*400*	*60*	*16*	*174*	*185*	*835*
Business regulation & competition NP	100	-	-	200	250	550
Total COAG funding package	**3,497**	**1,768**	**2,231**	**3,575**	**4,088**	**15,158**

Source: *COAG Communique*, 29 November 2008.
SPP: specific purpose payment, NP: National partnership.

Indigenous reform initiatives

Almost $2 billion over five years was provided for four Indigenous Reform National Partnerships aimed at furthering the government's 'Closing the Gap' targets. The majority of this funding is targeted at health and housing outcomes with over $0.8 billion for each issue. The package also provides funding for initiatives aimed at Indigenous economic development and remote service delivery.

Other initiatives

The COAG package also includes increased funding through SPPs for workforce development, disability services, social housing and deregulation for the business sector.

Composition of the December Nation Building Package

On 12 December 2008, the Australian Government announced a third stimulus package, entitled the 'Nation Building Package'. The Nation Building Package was worth $4.7 billion and was split evenly between infrastructure development, education and changes to the taxation system.

Infrastructure measures

The package contained a provision to inject $1.2 billion in equity into the Australian Rail Track Corporation to finance 17 rail projects across Australia.

The government provided $711 million to bring forward construction on key road development projects, to be balanced by reductions in later years. It announced that $60 million would be provided for black spot accident reduction projects and $195 million for investment in agricultural and social infrastructure in the East Kimberley.[3]

Education measures

The package included an announcement of $1.6 billion for 13 education projects. Of this figure, $580 million was to be invested in 11 research facilities at various universities. The government announced $500 million for a Teaching and Learning Capital fund, a one-off funding round targeting capital expenditure in universities. Finally, $500 million was used to set up a Teaching and Learning Capital Fund for Vocational Education and Training. This fund is similar to the university fund, but targeted at TAFE institutes and other non-university tertiary education providers.

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3 In the accounting used in measuring the overall size of the package, the road, black spot and East Kimberley initiative tally to $0.4 billion rather than $0.96 billion. It is assumed this is because the $711 million for road projects brings forward some previously announced projects in time. Department of Prime Minister and Cabinet, *Nation Building: Rail, Road Education & Research and Business*, December 2008, p. 4.

Investment Allowance

An additional tax deduction for businesses was included in the package. The deduction took the form of an investment allowance for tangible depreciating assets that cost more than $10 000. Businesses were able to claim a tax deduction of 10 per cent of the value of assets purchased, held under contract or constructed between the date, the package was introduced and 30 June 2009. It was estimated that the cost of this measure to the Commonwealth would be $1.6 billion.

Temporary changes to taxation

The Nation Building Package included an announcement that the pay-as-you-go payment required from businesses with turnover of less than $2 million per year would be cut by 20 per cent for the December 2008 quarter. It was expected that this would cost the Commonwealth about $440 million in 2008–09, but that as it represented a bringing forward of the expected lower revenue from small business in 2009–10, the cost of this measure would be neutral over the forward estimates period.

Composition of the Nation Building and Jobs Plan

The Nation Building and Jobs plan remains the largest of the various stimulus packages at a combined value of approximately $42 billion. The package consisted of six bills, passed by the Senate on 13 February 2009:

- Appropriation (Nation Building and Jobs) Bill (No.1) 2008–2009;
- Appropriation (Nation Building and Jobs) Bill (No.2) 2008–2009;
- Household Stimulus Package Bill 2009;
- Commonwealth Inscribed Stock Amendment Bill 2009;
- Tax Bonus for Working Australians Bill 2009; and
- Tax Bonus for Working Australians (Consequential Amendments) Bill 2009.

Appropriation (Nation Building and Jobs) Bill (No.1) 2008–2009

This bill appropriated $89 million, with $39 million for the Department of Environment, Water, Heritage and the Arts to administer the energy efficiency programmes and $50 million to allow the Australian Tax Office to administer the tax bonus payments.

Appropriation (Nation Building and Jobs) Bill (No.2) 2008–2009

This bill appropriated $1.7 billion, with $987 million for the Building the Education Revolution program, $260 million for social housing construction, and $480 million for various road construction and safety initiatives.

Household Stimulus Package Bill 2009

The bill provided for a series of one-off cash payments to individuals who received various forms of welfare from the Commonwealth. The nature of the payments is discussed below.

Commonwealth Inscribed Stock Amendment Bill 2009

This bill amended the *Commonwealth Inscribed Stock Act 1911* to allow the Treasurer to declare that a certain circumstance exists which justifies an increase in the cap of Commonwealth Government Securities (CGS) on issue. The bill allows the Treasurer to issue an extra $125 billion on top of the existing $75 billion cap, allowing for the issue of $200 billion of CGS.

Tax Bonus for Working Australians Bill 2009 and Tax Bonus for Working Australians (Consequential Amendments) Bill 2009

This bill enabled one-off lump sum payments to individuals that had a taxable income of up to $100,000 in the 2007-08 financial year.[4]

Programmes and Initiatives under the Nation Building and Jobs Plan

The various initiatives under the Nation Building and Jobs Plan took the form of both cash payments and direct government expenditure:

- cash payments to taxpayers (Tax Bonus);
- cash payments to certain categories of welfare recipients (household stimulus payments);
- Building the Education Revolution—school building construction and refurbishment;
- Energy Efficient Homes program, including rebates for insulation and solar hot water systems;
- social and defence housing construction;
- investment in highways and road safety (black spots and boom gates); and
- regional and local community infrastructure program.

Cash payments to taxpayers and certain welfare recipients

Cash payments were made to two broad categories — through a one-off tax bonus, and through a one-off additional payment to recipients of certain welfare payments.

4 The bill authorises the Commissioner of Taxation to pay the tax bonus to eligible taxpayers. The Consequential Amendments bill made amendments to the various acts relating to taxation to ensure that the payments themselves were exempt from tax.

The package created a tax bonus for taxpayers who had an adjusted tax liability and a taxable income of under $100 000 in 2007–08. Any taxpayer that had a net tax liability after taking into account tax offsets and franking credits, meaning they paid tax, in 2007–08 was eligible, if they earned under $100 000.

Taxpayers who earned under $80 000 in 2007–08 were eligible for a $900 payment. This dropped to $600 for those in the $80 000–$90 000 bracket and $250 for those who earned between $90 000 and $100 000.

The estimated total cost of the tax bonus was originally expected to be $8.2 billion, assisting 8.7 million taxpayers. However, amendments to the package marginally reduced the size of the payments by $50 at each level of the payment (i.e. from $950 to $900, $650 to $600 and $300 to $250). This suggests that the revised cost would be in the order of $7.5–$8 billion.

The Household Stimulus Package Bill 2009 created a series of one-off $950 cash payments to certain categories of welfare recipients. These included:

- Training and Learning Bonus—For senior secondary or tertiary students receiving a range of education assistance payments including:
  - Youth Allowance;
  - Austudy;
  - Sickness Allowance;
  - Special Benefit; or
  - Family Tax Benefit Part A (aged 21 to 24 years).
- Farmers Hardship Bonus—For individuals receiving:
  - Exceptional Circumstances Relief Payment;
  - Farm Help Income Support;
  - Transitional Income Support; or
  - Interim Income Support.
- Education Entry Supplement— For individuals receiving an Education Entry Payment between 1 January 2009 and 30 June 2010. The qualification period for receipt of Education Entry Payment was reduced from 12 months to four weeks of continuous receipt of an income support payment during the period 1 January 2009 until 30 June 2010. Eligibility for the Education Entry Payment was also extended during this period to Youth Allowance recipients who are not full–time students.
- Back to School Bonus - For each child aged 4 to 18 years who qualifies for Family Tax Benefit Part A on 3 February 2009. Those who received a Disability Support Pension or Carer Payment who were aged under 19 years on 3 February 2009 are also eligible.

Building the Education Revolution (BER) Program

The BER program had three main elements:

- Primary Schools for the 21st Century provides $12.4 billion over three years for upgrading or building major infrastructure such as multipurpose halls and libraries. Both government and non-government primary schools are eligible to compete for the available funds, with priority being given to those schools building new facilities;
- Science and Language Centres for 21st Century Secondary Schools provides $1 billion over three years for the construction of up to 500 science laboratories or language learning centres. Both government and non-government schools are eligible to apply for this funding, which is allocated on the basis of demonstrated need and capacity to complete the project by 30 June 2010; and
- Renewing Australian Schools allocates $1.3 billion for all Australian schools to undertake maintenance and minor building works. Funding caps were to be determined by school size.

Social and Defence Housing

Under the Commonwealth Social Housing Initiative, up to $6 billion is provided for the construction of approximately 20 000 dwellings by December 2010. Around $400 million was also allocated for the repair of currently uninhabitable public housing.

Energy Efficient Homes Program

Under this programme, which applies from 1 July 2009 until 31 December 2011, the Government has offered to install ceiling insulation of up to $1600 in value in all uninsulated owner-occupied homes. According to the Minister's Second Reading Speech, this will invest $2.7 billion in housing modernisation by the end of 2011 and result in the insulation of almost all Australian homes.

As a further part of the Energy Efficient Homes program, two pre-existing energy efficiency programs were enhanced through the Nation Building initiative:

- under the Low Emissions Plan for Renters, there was an increase in the maximum rebate (from $500 to $1000) until 30 June 2011 for landlords installing insulation in an uncapped number of rental homes. The Government provided additional funding of $612.5 million under this new arrangement; and
- the Solar Hot Water Rebate was increased from $1000 to $1600 for those households that do not access the insulation program and that replace existing electric hot water systems with a solar and heat pump hot water system before 30 June 2012. Means-testing for rebate eligibility was also removed. Additional funding for this program was $507 million.

Road and transport safety initiatives

The land transport initiatives included additional funding for highway linkages, the installation of boom-gates at rail crossings and additional funding for the Black Spot road safety program.

Community Infrastructure

An additional $500 million was provided over two years to support large local government strategic projects. Examples include community infrastructure such as halls, community centres and sport and recreation facilities.

Nation Building Infrastructure measures in the 2009–10 budget

Within the context of the national budget, it is difficult to assess which measures should be considered as stimulus initiatives. Technically, the overall size of the budget deficit (or surplus) reflects the ultimate position of government fiscal policy. The projected underlying cash deficit for 2009–10, as at May 2009, was $57.6 billion. It is possible, in light of better than expected economic performance, that the budget deficit will also be lower than projected.

As the Treasurer indicated in his Budget Speech that the Nation Building Infrastructure measures represented a 'third phase'[5] of the fiscal stimulus programme, the committee includes them in the government's stimulus initiatives.

Composition of the Nation Building Infrastructure measures

Initiatives categorised in the 2009–10 budget as 'nation building infrastructure' amounted to total new investment of $22.4 billion. The majority was devoted to roads, rail and port development, with significant funding for the National Broadband Network, clean energy, education, health and hospitals.

Roads, rail and ports

Projects for the improvement of metropolitan rail networks in Sydney, Melbourne, Brisbane, Perth, Adelaide and the Gold Coast will receive $4.6 billion of funding. The single biggest item in this category was $3.2 billion for the Regional Rail Express in Victoria.

The package also includes $3.4 billion worth of major road improvements. The focus of the development is the Network 1 route linking Melbourne to Cairns. The single biggest item of expenditure to accomplish this is $1.45 billion for the Hunter Expressway in NSW.

5 The Hon Mr Wayne Swan, Treasurer, *Budget Speech 2009–10*, p. 5.

Finally, $389 million has been included for development of Oakajee Port in West Australia and Darwin Port in the Northern Territory.

National Broadband Network

An initial investment of $4.7 billion for the National Broadband Network is included in the 2009–10 budget.

Clean energy initiatives

Approximately $3.6 billion has been provided for the establishment of a new renewable technology innovation organisation, Renewables Australia, investment in Solar Flagships projects and in Carbon Capture and Storage demonstration plants and for energy efficiency programmes.

Education measures

Education investment of $2.6 billion is included in the 2009–10 budget. The single largest item is $901 million to build capacity in future industries including space, marine, climate and nuclear science. Other measures include funding for higher education and vocational education projects.

Health and hospital measures

A total of $3.2 billion has been allocated to health initiatives. Of this, $1.5 billion is to fund various upgrades to medical facilities around Australia. $1.3 billion will be invested to improve cancer treatment through the establishment of cancer treatment centres and upgrades for screening equipment. Finally, $430 million will be invested in research and training programmes around Australia.