SCHOOL OF ECONOMICS, FINANCE & MARKETING

Submission to the
Senate Economics References Committee on its
Inquiry into the Economic Stimulus

Dr Steven Kates
RMIT University
Melbourne

Contact

steve.kates@rmit.edu.au

Phone: 03 9925 5878
Mobile: 042 7297 529

Submission to the
Senate Economics References Committee on its
Inquiry into the Economic Stimulus

Dr Steven Kates
RMIT University
Melbourne

The standard theory on recession and how to deal with recession is profoundly wrong. The use of Keynesian demand-side theories to restore growth to economies in recession is totally misconceived. Only if the natural strengths of the market economy are strong enough to overcome the damage caused by a Keynesian stimulus will an economy recover. As for the stimulus itself, it is in aggregate far more likely to do harm than any conceivable good.

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.

1) The State of the National Economy demonstrating 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.

2) The Impossibility of Quantifying the Effect of the Stimulus showing that 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.

3) The Harm Done by the Stimulus which includes:

   - noting that there is no justification for the introduction of a stimulus other than its effects on employment whose effects have been minimal at best

   - the distortions in the structure of production which occur as a result of the stimulus which directs the economy into unproductive activities

   - the loss in real economic growth because the stimulus measures have competed resources way 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 needed to have done

- the effect on taxation which will need to rise to a greater extent than it otherwise would have needed to in order to repay the costs associated with the stimulus

- the potential effect on inflation which may become an important medium-term economic issue as the recovery gathers some momentum.

4) The Fundamental Structural Flaws in Keynesian Economics which wrongly argues that increases in unproductive forms of public spending and in budget deficits are capable of generating economic growth.

5) A Discussion of the Theory of the Cycle which made it clear that economies are subject to periods of rapid growth and periods of recession.

1) The State of the National Economy

Much has been made of the supposed fact that the Australian economy has avoided recession. The avoidance is supposed to be demonstrated by the fact that Australia has not experienced two consecutive negative quarters of GDP.

A closer look at the data, however, tell a quite different story. These show trend movements in the level of GDP, and these are placed first in the publication because the trend measure, at least according to the ABS, is the most accurate if one is interested in the direction of the economy. The trend figures were also the datasets I used when presenting economic submissions to the National Wage Case. They are the best set of data if one is interested in the direction that the economy is taking.

As the ABS states in its publication (Explanatory Notes 13) under the heading "Trend Estimates":

> "Given the qualifications regarding the accuracy and reliability of the quarterly national accounts, the ABS considers that trend estimates provide the best guide to the underlying movements, and are more suitable than either the seasonally adjusted or original data for most business decisions and policy advice."

And what is significant is that these data show, even using the "technical" definition that the Australian economy has been in recession, that is, there have been two consecutive quarters of falling GDP.

The movement in the September quarter 2008 was negligible but unquestionably negative. In the December quarter 2008 the fall was somewhat larger but again negative. Thus using even the "technical" definition, on the best measure we have of the movements in GDP, the economy contracted for two consecutive quarters.

Trend Growth in Real GDP

	$m	%
Jun-2008	273521	
Sep-2008	273507	-0.0
Dec-2008	273341	-0.1
Mar-2009	273662	0.1
Jun-2009	274354	0.3
Growth Jun to Jun (%)	0.3	

Source: ABS - National Accounts Table 1

But it should not matter whether there were actually two consecutive quarters of falling GDP for us to declare that the Australian economy is in recession. The

existence or otherwise of recession should not be determined over a rounding error of plus or minus $14 million in any one quarter.

If across a four quarter period, the growth rate has been 0.3%, then the economy is in recession. To pretend otherwise is simply to deny a reality that really cannot be denied.

Perhaps more pertinent still are the market sector data which are the closest measure we have to private sector activity. The public sector is to a large extent shielded from the vicissitudes of the cycle. Where the brunt of the economic downturn will be felt is within the business community. The data below show the figures on the level of activity within the market sector.

Trend Growth in Real GDP
Market Sector

	$m	%
Jun-2008	177730	
Sep-2008	177832	0.1
Dec-2008	176915	-0.5
Mar-2009	175619	-0.7
Jun-2009	174215	-0.8
Growth Jun to Jun (%)	-2.0	

Source: ABS - National Accounts Table 1

Here the fact of recession is not a matter of question. To act as if an economy is not in recession when its private sector has contracted by 2.0% across the year, and in which not only have there been more than two consecutive quarters of falling GDP, but the fall has been accelerating.

There are also a number of income measures in the national accounts, each one of which shows a falling level of personal income. All of the published measures show a fall in the real level of incomes, but the most revealing are the data on Real Net National Disposable Income Per Capita.

Spendable income per head of population has fallen, and has fallen more rapidly since the introduction of the stimulus than it had fallen before. In the June quarter alone, there was a fall of 2.6% and over the whole of the year, the fall was 5.0%.

Although not a great deal can be made of this, it is perhaps worth noting that the decline in per capita income has been accelerating. The evidence is that irrespective of whether the stimulus package is adding to the number of jobs, it is not adding to the level of purchasable output within the economy.

Real Net National Disposable Income Per Capita

	$	%
Jun-2008	10621	
Sep-2008	10726	1.0
Dec-2008	10600	-1.2
Mar-2009	10361	-2.3
Jun-2009	10091	-2.6
Growth Jun to Jun (%)	-5.0	

Source: ABS - National Accounts Table 1

The phenomenal fall in the level of national saving is also quite disturbing. Savings have diminished to half the level they were at a year before. In the June quarter 2009, there was a fall of one-third in just that period alone.

Moreover, in June 2009, the saving ratio has descended into negative territory, being recorded at -0.4. The ABS defines this concept as "the ratio of national net saving to national net disposable income." The notion that the stimulus has been tucked away into additional savings is belied by these figures.

National Net Saving and Saving Ratio

	$m	% Change	Savings Ratio
Jun-2008	25599		0.9
Sep-2008	27695	8.2	1.4
Dec-2008	24617	-11.1	1.2
Mar-2009	18748	-23.8	0.4
Jun-2009	12959	-30.9	-0.4
Growth Jun to Jun (%)	-49.4		

Source: ABS - National Accounts Table 1

The labour market is also in sharp decline according to these same national accounting estimates. The measure used to gauge labour market activity are the data for hours worked, provided for both the total economy and for the market sector.

Across the economy, there has been a fall during the past three quarters with the aggregate decline estimates at 2.1%. This is a decidedly rapid decline in the level of economic activity.

In the market sector, the private sector proxy, there has been an actual decline in each of the four quarters, with the aggregated fall having been measured at 2.8% over the four quarters to June 2009.

Hours Worked
Total Economy and Market Sector

	Total Economy	% Change	Market Sector	% Change
Jun-2008	103.7		103.5	
Sep-2008	103.7	0.0	103.4	-0.1
Dec-2008	103.2	-0.5	102.6	-0.8
Mar-2009	102.4	-0.8	101.5	-1.1
Jun-2009	101.5	-0.9	100.6	-0.9
Growth Jun to Jun (%)	-2.1		-2.8	

Source: ABS - National Accounts Table 1

Lastly, what follows is a reprint of the text of an article published in *The Australian* on Monday, September 13 which looked at the different measures used to calculate GDP. The data used were the seasonally adjusted series since those are the figures that are typically used in discussions of the national accounts in the press.

> The fact that Australia has managed to avoid a "technical" recession by not having had two consecutive quarters of negative GDP growth is very much an artefact of the data sets we use. The GDP figure that is published is an average of the three measures used to calculate GDP. Looking at the three series individually tells a very different story.
>
> The most commonly used set of numbers is the expenditure series which measures GDP through adding up the total spending in the domestic economy and then subtracting the level of imports. It is the expenditure series that would, of course, be most directly affected by increased public sector expenditure which is included in GDP at cost. A dollar spent is a dollar that goes directly into recorded growth.
>
> The second measure of GDP is calculated through adding up all of the ways in which business receipts are distributed. This includes not only wage earners and those who earn profits, but also includes governments for which indirect taxes are an important source of revenue.
>
> The third measure is the production series which is a direct calculation of value added at the industry level.
>
> All three measures are designed to measure the same thing, and in a world of perfect statistics, all would return exactly the same result.

	GDP S/A		
	Expend	Income	Prod
Jun-2008	272618	273532	274318
Sep-2008	274361	273172	275538
Dec-2008	275091	268494	273637
Mar-2009	278522	270992	270947
Jun-2009	280521	272499	272508
	2.9	-0.4	-0.7

Yet as may be seen in the table which presents the three measures of seasonally adjusted GDP, over the past year there is a vast difference between the various measures. The expenditure series has shown consistent and continuing growth throughout the past year. At no stage has there been a fall in the level of GDP in even a single quarter. The aggregate movement in the level of output has been a quite astounding 2.9% during what has in pretty well every other respect been a generally dismal year economically.

The income series, on the other hand, indicates a pretty minimal year all round. Both the September and December 2008 quarters showed an actual fall in the level of output, the very definition of a technical recession. Over the year, the level of GDP has fallen 0.4%, by no means as bad as elsewhere, but more in keeping with the general experience across the economy.

The third measure shows the changes in GDP according to the production-based data. Here, too, we have the ingredients for a technical recession, with an actual reduction in the level of output in both December 2008 and March 2009. Across the year, GDP has fallen by 0.7%.

The national accounts are the national accounts and the ABS can be relied on to accurately repeat, quarter by quarter, the methodology they use in gathering their data.

Nevertheless, given the wide discrepancies between the expenditure series, in which the increased levels of public spending are far more likely to show up, and the other two series which show results more in keeping with the subdued nature of the economy, it is worth reflecting that we may have technically avoided recession because of the way we define recession, but the reality has been very different.

Australia is in recession. While the stimulus package appears to have been able to distort one of the three sets of national accounting measures we use, beneath it all the Australian economy, in keeping with the rest of the developed world, has gone through a recessionary phase from which it is only now beginning to emerge.

Should there be some concern that the seasonally adjusted series was chosen because it would show a more negative result than the trend data, the trend series is shown in the table below. The data, if anything, show a far more negative set of estimates than the seasonally adjusted series. The expenditure-based data have a slightly lower growth rate across the four quarters while both of the other measures, the income-based estimate and the production-based estimate, show an even larger decline in the level of GDP.

In trend terms, as already shown, there was a minimal increase in economic growth when the average of the three measures was used, but there was also an actual two-quarter decline in the level of output giving us the technical definition of recession.

GDP
Trend Series

	Expend	Income	Prod
Jun-2008	273042	273054	274589
Sep-2008	274005	271927	274713
Dec-2008	275854	270773	273519
Mar-2009	278092	270704	272313
Jun-2009	280324	271456	271405
	2.7	-0.6	-1.2

Source: ABS - National Accounts Table 1

Indeed, if the trend data are used, the income-based estimate shows three consecutive quarters of falling GDP, with declines in September and December 2008 and again in March 2009 but with an improvement in June 2009. The production-based figures also show three consecutive falls in GDP, but these figures show a reduction right up to the most recent quarter.

It cannot be emphasised enough that each of these figures has equal status as a measure of GDP growth. We only take the average and publish it as the official GDP figure because there is no means to pick and choose between the three estimates in normal times.

But given that there has actually been a stimulus package applied to the Australian economy, and given that these additional levels of public expenditure would be most directly shown by the expenditure-based series, there is more than usual reason to focus on the other two estimates. And what they show is a very depressed economy that has in no way escaped the full effects of the international recession.

More importantly, what these figures show, as do all of the other data shown above, is that the stimulus package has done the Australian economy very little apparent good. Growth is down, employment is down, incomes are down and savings are down. Indeed, if anything, these figures could be used to argue that the economy may actually have been harmed by the increased levels of public spending.

Data on their own, of course, are not able to demonstrate one way or the other whether the stimulus has achieved any of its purposes. But what the data do make clear is that the effect of the stimulus package has been minimal at best, even in the short term. And as will be argued below, if one abandons the Keynesian theories that have underpinned the application of the stimulus to the Australian economy, there are good reasons for believing that the stimulus has actually caused positive harm.

2) The Impossibility of Quantifying the Effect of the Stimulus

One frequently hears statements that the stimulus package led to a lower level of unemployment or that it contributed to a higher level of GDP growth than would have occurred had no stimulus package been introduced. The notion is that as bad as our economic circumstances are already, economic conditions would have been worse had the stimulus not been introduced.

Such statements cannot, however, be substantiated. Since it is the same Keynesian model that has been the basis for the stimulus package that is also the basis for the modelling that has been undertaken to provide the counterfactual, the result is that all that has been shown is that the model predicts that any policy based on its own structural design will be successful.

The actual world of events has not unfolded in two modes, one with a stimulus package and the other without. We do not know in any realistic way what would have occurred had the stimulus package not been introduced, or what would have occurred had some other set of economic policies been applied.

What is normally done in such circumstances is, to state the technique in its simplest terms, run a counterfactual model in which a baseline estimate is created which examines what would happen if no policy changes were adopted and then the model is run a second time with various policy changes introduced. One can then say, based on the model's results, that the policy would have a particular set of effects.

That is the way in which policy options are generally assessed. But it is only a genuine test of the policy if either the model actually does replicate the way in which the world operates or, and this is much weaker, if everyone who uses the model agrees on its structure and is willing to accept its conclusions.

In this case, however, critics of the Keynesian approach to modelling the economy are very unlikely to accept the conclusions from a Keynesian model. The modelling used by Treasury and most others in Australia build in Keynesian parameters in which a stimulus will provide positive results.

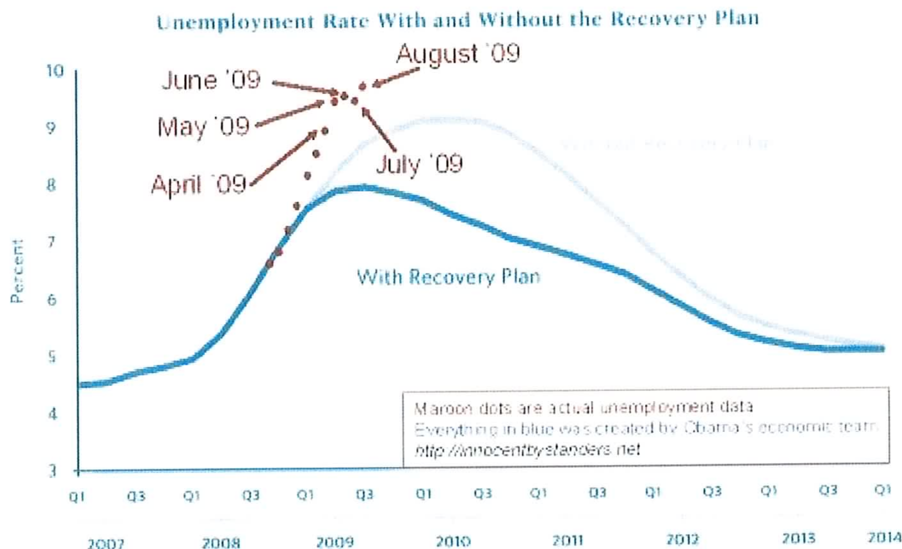
Therefore, when Treasury argues that the stimulus has had a positive effect on the economy irrespective of the deterioration in the actual data being released by the ABS, what is being said is that their modelling has shown that against the baseline projections, the economy should have had a positive response and our actual economic results would have been worse than those published.

But for all that, there is no outside form or authentication that can be applied. And while it can be argued that the parameters on which the model was built are based on the actual previous contours of the economy, the fact remains that our present set of circumstances are so unique that no model can have had its underlying structure based on the situation we now find ourselves in.

Nor is it valid to state that the first set of projections suggested that the economy would have a much lower rate of growth than has actually eventuated. Such an argument would itself indicate from the start that the models on which the original projections were based are incorrect. To compare the present actual state of the economy and argue that the stimulus has worked because earlier modelling suggested that our rate of growth might have been worse than it is, merely underscores the dangers of relying on such models in the first place.

An important instance of such wrong forecasting is found in the United States, where in this instance the effect has been to overestimate the effect of its stimulus package. The Obama Administration provided early on a comparison of the rate of unemployment that would be reached if no stimulus were applied (the baseline case) and then the outcome if a stimulus was applied.

The Innocent Bystanders blog has been comparing the actual unemployment rate with the original baseline projections and the projections made by the Obama "economic team". These are shown in the chart below.



http://michaelscomments.wordpress.com/2009/09/04/august-unemployment-data/

The pale line are the unemployment projections made by the Obama administration if no stimulus plan were introduced. The unemployment rate would then have been projected to reach 9.0%.

The darker line shows the projected unemployment rate after the introduction of the stimulus plan. In that instance the unemployment rate would have reached around 8.0% and would by now have been heading down.

The set of dots shows the actual unemployment rate in the United States. What is clear is that the unemployment rate not only has not fallen, but it is well above the rate that was projected to occur even had there been no stimulus plan at all. The

unemployment rate reached 9.7% in August and appears from the trend to be continuing to move higher.

Two conclusions should be drawn from this. Firstly, such projections are merely the results of a set of models that are built according to the economic concepts of those who write the programs. In this instance, they are Keynesian models. They therefore cannot be used to test the validity of their own basic structure if the core question is whether that structure is valid in the first place.

Nothing is proven by saying that the model upon which someone is basing their decisions to apply a stimulus package showed that things would have been worse had that stimulus not been applied. This is circular reasoning and invalid.

The second point is the more important point. The Obama Administration indicated in advance the positive effects that its stimulus package would provide. The stimulus has shown itself not to have worked, as least so far as its original projections are concerned. The Obama Administration has stated that conditions had actually been worse than they originally thought, but that is only an after-the-fact rationale.

It is just as plausible if not more plausible to argue that the stimulus has not only not worked but may have made conditions worse than they would have been had no stimulus been applied. This is a genuine consideration which, based on my own theoretical understanding of the manner in which economies work, would have been the expectation I would have had.

3) The Harm Done by the Stimulus in Australia

a) Employment

A stimulus package has two major justifications: the positive effect it has on the level of production and the positive effect that it has on the rate of unemployment.

Following Keynes, however, the attitude to such stimulus packages is well towards a spend-money-on-anything approach. None of the major expenditure outlays has been costed in any serious way to demonstrate that they will create more value when in place than the value that has been eaten up in their production.

Both the outlays on schools and on insulation. Both are extremely expensive but neither can be justified on a cost-benefit basis. And even if they could be so justified, no one has made an attempt to do so.

The major effect of the stimulus package is intended to be felt within the labour market. It is to save jobs that the stimulus package has been applied with the only economic consideration being given to increasing the level of aggregate demand. All of the side effects of such expenditure, which will be considered below, are ignored. The one and only consideration has been to preserving jobs using a Keynesian stimulus which is applied through the application of an outlay package which has been costed at $43 billion, an amount equivalent to around four percent of the entire output of the Australian economy in a full year.

Thus every other possible use of these funds has been precluded by the decisions made to increase the level of public spending and to increase debt levels to provide jobs through just those particular programs.

There are many ways in which the use of these funds can be gauged with one set out below. It is based on the most recent unemployment data and attempts to estimate the cost per additional employed person based on different projected levels of the unemployment rate.

Since the actual unemployment rate in August 2009 was 5.8% on trend estimates, and since the labour force was 11,439,000 at that time, it is possible to project the additional number of persons who would have been unemployed had the unemployment rate reached such higher numbers. These figures are shown in the table below.

Thus, suppose the unemployment rate would have been 5.9% without the stimulus, then the number of unemployed would have been 674,901 rather than the 668,700 which was the number actually recorded. This would have been an increase in the number of unemployed persons of 6,201.

Given that the stimulus package is estimated to have cost $43 billion, dividing the $43 billion by the 6,201 additional employed persons who are in jobs as a result of this stimulus gives a cost per additional job of $6,934,365.

Estimated Cost Per Additional Employed Person Due to the Stimulus

Labour Force August 2009	If the U/R were this ...	the number of unemployed would be	Additional Unemployed	Cost of Stimulus Per Additional Employed Person
	(%)			($)
11,439,000	5.8	668,700		
11,439,000	5.9	674,901	6,201	6,934,365
11,439,000	6.0	686,340	17,640	2,437,642
11,439,000	6.1	697,779	29,079	1,478,730
11,439,000	6.2	709,218	40,518	1,061,257
11,439,000	6.3	720,657	51,957	827,607
11,439,000	6.4	732,096	63,396	678,276
11,439,000	6.5	743,535	74,835	574,597
11,439,000	6.6	754,974	86,274	498,412
11,439,000	6.7	766,413	97,713	440,064
11,439,000	6.8	777,852	109,152	393,946
11,439,000	6.9	789,291	120,591	356,577
11,439,000	7.0	800,730	132,030	325,684

And so on through the table looking at the different unemployment rates without the stimulus. Even if the unemployment rate would have reached seven percent had no stimulus been applied, an entirely improbable number given how rapidly stability returned to the economy, the cost per additional employee will have been $325,684. Such stimulus packages do not come cheap.

And it should also be borne in mind that the stimulus may not have added a single additional job. Because of the actions taken to employ builders in both the school auditorium projects and in installing insulation, costs of production around the economy have been kept higher. In addition, interest rates are higher because of the stimulus than they would otherwise have been. And in addition, since much of the resilience of the Australian economy is related to a rapidly improving Chinese economy which is totally unrelated to any of the actions undertaken here in Australia.

Thus, if the stimulus had contributed nothing to the rate of unemployment, the cost has been $43 billion with no net gain in employment. There is no *a priori* reason that the effect of the stimulus in Australia has not been similar to the effect on employment in the United States.

b) The Effect on the Structure of Production

Supply chains are often the forgotten element in macroeconomic theory. There is so much concentration on final demand that the intermediate goods that make up the bulk of the economy are ignored. Yet it is the supply chains, the structure of production for the entire economy, that constitutes the ability of an economy to create value adding goods and services.

The stimulus package has created supply chains through the economy that have allowed our resources to produce the government's production agenda which is built largely on political calculation and not on any estimates of profitability or value added. The economy as a result becomes less productive overall because its resources are being used in a sub-optimal way.

There are many goods and services that are produced by governments and are necessarily produced by governments. But the stimulus package is not built on any such calculation. It is built on estimates which will, according to a Keynesian model, reduce the level of unemployment.

Thus the effect on the economy is not transient but more lasting. It is not a set of expenditures which occur so long as the crisis lasts, but are a set of enterprises to which government funds flow but which could not survive if they depended on private sector demand.

We thus weaken the economy's economic structure and reduce our ability to raise living standards and real wages over the longer term.

c) Misdirected Production

While stimulus funds are spent largely within the private sector, the structure of production that emerges is based on government preferences rather than market preferences. The outcomes are therefore not designed to accommodate the preferences of consumers for goods and services but are mediated through the preferences of the public sector. These are not the same.

With $43 billion of resources being used at the government's direction, there is a loss to the economy of as much as $43 billion in productive activity that could have instead gone towards value adding output that would have directly responded to the specific needs of consumers.

It is one of the fables of Keynesian economics that it is only government spending with its multiplier effects that keeps an economy growing and unemployment low. In actual fact, the government through its ability to tax, borrow and run deficits diverts the resources that could have been used by private sector firms into projects some of which are high value adding but others of which provide little or no value to the economy.

The core Keynesian belief that demand will drive an economy in productive directions could not be more mistaken. Without proper analysis, the virtual certainty is that the value of output generated will be less than the value of the output used up in the production process.

Government spending beyond a certain limit is therefore more likely to lower our future growth rates than increase them because our resources will end up being used wastefully rather than productively.

d) Growth and Real Incomes

Real incomes and higher living standards are a result only of productive efforts which are aimed at satisfying the specific needs and wants of consumers. Resources used wastefully – either by governments or business – reduce the ability of the economy to improve real incomes.

Private sector firms which use a nation's resources unproductively go out of business. Public sector activities which do not even initially examine carefully the ability of the venture to satisfy community demands have no inbuilt mechanism for containing such expenditures even where they create little or no net value.

The stimulus package has taken resources that could have been used to build productive enterprises here in Australia and used them in ways that will provide no net return to the community. The end result will be lower living standards than would otherwise have been the case.

e) The Effect on Interest Rates and Other Production Costs

Interest rates beyond being the price of money is the price those who borrow pay to those who save for the use of the resources represented by those funds. There is only so much saving in an economy and those savings are themselves a precious resource. Using savings wastefully will lower the ability of the economy to expand.

Public spending, whether based on taxation, borrowing or deficit finance, is a use of the community's savings. By spending it takes funds away from others. With the pool of savings diminished relative to the level that would have occurred had public spending been lower, the cost of the remaining savings to the private sector must be higher since their supply is lower.

These higher interest rates are a reflection of the diminished pool of savings available to be borrowed by business firms. The cost of funds is an important consideration for firms. Firms seeking additional funds can only secure those funds by paying the additional costs.

The effect of the stimulus package has been to raise the cost of funds to levels higher than would otherwise have been the case, and is ensuring that interest rates are on the

rise, even within an economy in which the latest recorded rate of GDP growth across the year has been 0.3%.

Moreover, the debt that the government has contracted will remain an important element in the government's future need for savings. It will need to find the funds, again either through taxation, borrowing or the printing press, to repay the interest on this debt. This will keep interest rates higher long term.

Nor are interest rates the only cost of production affected by the stimulus. The cost of all resources are affected, whether land, labour or capital. The cost of each of these as a productive input will have been pushed upwards in producing the products that have been included in the stimulus package.

The stimulus, by increasing public sector activity, has thus reduced private sector activity. Business firms are less likely to expand because the government has commandeered the necessary funds for its own purposes.

f) The Potential Effect on Inflation

Possibly the largest danger of the stimulus is the potential for a significant rise in inflation. Too much money chasing too few goods is the classic definition of an inflationary spiral.

The stimulus package is paying out incomes for the production of goods and services that will never appear on the market for purchase. There is therefore no actual produce that is being produced that can absorb those funds.

The potential is therefore quite large that the stimulus will touch off an inflationary spiral. The long term damage should this occur is incalculable, and as our last episode in inflation showed, would take many years to again bring under control.

The cost of the minimal improvement in employment will then have been paid for through the enormous loss in output and jobs that the containing of inflation would eventually entail. If one puts the risk of such an inflationary spiral into the calculation of costs and benefits, the bias against such a strategy should become overwhelming.

The surprising strength of the housing market and the price of housing may be an indication of the potential for prices generally to take off if nominal incomes earned turn out to rise much more rapidly than the ability of the economy to produce.

4) The Fundamental Structural Flaws in Keynesian Economics

The following is a discussion of the theoretical issues that need to be taken into consideration in understanding the public policy issues. Keynesian economic theory is the basis for the stimulus policy. Keynesian economics is, however, a deeply flawed guide to government action. The theoretical work has been presented in my 1998 publication, *Say's Law and the Keynesian Revolution: How Macroeconomic Theory Lost its Way* (Edward Elgar). Because of its contemporary relevance it has been reissued this year as a paperback. The following comments are based on the research undertaken in writing this book.

Some Thoughts on our Keynesian Legacy

What we call "Keynesian" economics is not some minor sub-division of economic theory but is the very essence of macroeconomics itself. Keynes in 1936 had one central idea in writing his *General Theory*, and that was to demonstrate that demand deficiency could cause recession and that therefore some kind of demand-side stimulus could and should be used to cure the problem of unemployment. Thus, to the extent that macroeconomics is infused with notions of aggregate demand, it is Keynesian. Indeed, for 90-plus percent of economists, so far as macroeconomic issues are concerned, that is all they know. They do not think in any other way, and if asked to do so, would not know how.

This is the tragedy of modern macroeconomic theory and of economists in general. Economists simply do not know any better. They automatically prescribe increased public spending during recessions because that is what they have been taught for something like four generations. An important part of the reason for the economic mess we are in is due to the failings of economic theory itself.

Aggregate demand is the conceptual contaminant that has permeated the subject, and no amount of policy failure appears capable of making a difference. Neither the stagflation of the 1970 nor the lost decades of Japan since the 1990s seem to have made the slightest dent. One can only hope that the looming macrofailures of the current series of stimulus packages now being applied across the world will help lift the fog of unknowing about the dangers that this Keynesian legacy has left behind.

Until Keynes came along, economics was decidedly supply side. Creating value was the aim of economic activity and it was understood to be immensely difficult. Value adding activity was therefore largely left to the business community. Market forces were recognised as a trial and error system in which those who could create more value than was used up in production were allowed to continue in business. Those who could not were encouraged to find some other way to make a living. Free markets and competition were amongst the most important institutional elements designed to reward success while removing from the direction of capital those who could not use the nation's resources in a productive way.

This form of understanding has now been replaced by a theory which places demand at the centre of macroeconomic activity. It is buying that supposedly drives an economy forward, not producing. It is from stimulating demand that recovery is expected to find its way, not from encouraging value adding production. Thus, instead of recognising the necessity for the painstaking efforts required to craft a business enterprise, so that the value of output is greater than the value of the resources used up during production, we now pretend that we can get the same result by governments just spending money on whatever seems to be most politically convenient.

Only one in a hundred, if that, can run a truly successful business. On the other hand, anyone can spend from now until the end of time if given the licence to tax or print money. We now appear to believe that governments spending money will stimulate growth when in times past it was perfectly well understood that it was almost entirely the management of successful business enterprises alone that pulled an economy forward.

Here is the fundamental error of Keynesian economics. In the domestic economy there are three elements of demand identified by macroeconomic theory: consumption (represented by the letter "C"), private investment (I) and government spending (G). The equation found in economic texts round the world is that output equals the total of C+I+G. To increase output, therefore, what is required is to increase any one of C, I or G.

From the theoretical point of view, it makes no difference whether money is spent by consumers on final goods and services, by governments on politically driven wasteful expenditures, or by businesses on value adding forms of investment. All provide demand and therefore all are equivalent so far as macro theory and policy are concerned.

There was a time when we knew better, and economists were there to say so. But that time is long gone. Until that Keynesian incubus is finally removed, macroeconomic theory will remain incapable of reliably providing the kinds of sound advice needed. A large proportion of the economics community will, instead, continue to recommend expenditure on one dubious project after another until the dead weight of such spending finally forces governments into doing what they ought to have been doing from the start.

To paraphrase Margaret Thatcher, the trouble with Keynesian economics is that eventually you run out of other people's money. By waiting until that day of reckoning, we postpone the inevitable. But as the very meaning of the word clearly states, the inevitable inevitably arrives.

Lessons to be Learned from the Stimulus

The doubts now being expressed more widely about the value of continuing with the public spending approach to recovery seem to miss the point. There is, as we find from the media, growing recognition that the downturn is not going to be as bad as

originally supposed and that the stimulus should be wound back sooner rather than later.

For what it's worth, in my April *Quadrant* article I wrote:

> "What the present recession will share with all of its predecessors is that one day, and not all that long from now unless we really do mismanage the downturn, even this current recession will also be a creature of the past while everyone busily gets on with re-building their wealth."

So let us begin with this. Economies are cyclical. There will be downturns every so often but to treat each and every one as the end of the world as we know it is a form of short-term lunacy.

The lead in this public spending frenzy was given by the unbelievably incompetent Obama Administration who have decided not to let this crisis go to waste through a $787 billion stimulus that will potentially hobble the US economy for years to come.

That Australia mindlessly followed suit is just an unfortunate consequence of the Prime Minister's poor grasp of economics. His article in the February issue of *The Monthly* is a treatise that ought to be examined closely. It was, of course, hammered from pillar to post as the threadbare piece of nonsense that it was, but that is no reason to ignore it for the lessons it can teach.

Because reading through this article, and others that the PM has put his name to, offers a kind of protection from further excursions along the directions he outlined. The lessons that should be learned by our senior public servants in economic portfolios, along with the members of the Cabinet and the community itself, is that this is a PM whose economic judgement is faulty to the core.

Barack Obama's is far worse, but there's not much we here in Australia can do about that. But what we can do is protect ourselves from the anti-market fundamentalist beliefs of Kevin Rudd who has shown himself to be no kind of economic conservative whatsoever.

The other point to make is that if we are walking away from the stimulus packages as useless or worse, there is a tacit – definitely not explicit – recognition that the money that was spent – and is being spent – provided no added value to the economy. These are wasted funds which means we have wasted our scarce resources. We are undertaking projects whose social and economic return is far below their cost. We will take on debt that the projects themselves can never contribute to their repayment. They are just a dead weight cost to us all.

Economists have supported increased public sector spending during recessions going back to a time before Keynes was even born. The *General Theory* had no influence on that. What it argued that was different from that past was, firstly, that deficits did not matter and then, secondly, that the public spending could be on anything at all

because the "multiplier" effects on secondary expenditures would push the economy forward. Both of these are identifiably wrong, and the present experience, even here in Australia never mind in the United States, ought to have now made it abundantly clear that this is the case.

There would be no reason to withdraw the stimulus if it were actually doing some good. That with recovery the pressure is now on to wind these expenditures back is a reminder that they were never value adding in the first place. They were just forms of welfare payments, and very expensive forms at that.

The equation of every classroom, the C+I+G of that ubiquitous Keynesian macro model, should now be put to rest along with other relics from the economist storehouse of discarded ideas. To believe that you can replace private sector investment with increased government spending on anything at all will one day be looked upon as an idea so absurd that it will be a wonder to the future how anyone could have ever believed it was actually true.

Keynes Versus the Classics – the True Story

The word is getting out that Keynesian economics is worthless as a guide to policy. Criticisms of public spending are found more and more frequently and the deficits we now face are recognised as major impediments to a robust return to higher rates of growth and rising real incomes.

Here in Australia, the growth in GDP is, of course, in part an artefact of the Government's expenditure programme. We were anyway not as badly placed as most others, and in many ways we are beneficiaries of China's own stimulus package.

Whether we have permanently dodged recession is still an unknown although given the definition of recession we use, we probably have. The ridiculousness of choosing two successive negative quarters of GDP growth as the definition of recession is quite good for governments since it puts the bar on bad economic management at an astonishingly low level.

There was a time when growth rates under three per cent per annum meant recession. Now we can have an increase of 0.1 per cent and everyone is grateful to see the economy continue to grow.

Nonetheless, what we have definitely done is create the impression of economic growth since public spending goes straight into the national accounts at cost. We shall see which hollow logs the government will start looking to for more cash as the bills come due in the years ahead.

Deficits must be paid for so unless future growth is so strong that tax revenue just naturally rises to pay off our debts, we will see raids on every part of the economy to find the money the government needs to repay what they have now blown in one useless project after another.

What remains unfortunate is that there is still no apparent recognition just where the problem lies with the Keynesian apparatus that is now the common language of macroeconomics.

To understand the nature of the problem, one must go back to 1936 – the year the *General Theory* was published – and look at, really look at, the economics that Keynesian theory replaced. Part of Keynes's genius was to set up an utterly false caricature of "classical theory" – the term he took from Marx to describe the economic theories of his predecessors – which he could then ridicule as an entirely inappropriate framework in which to understand how economies work.

Keynes thus not only sold the entire economics community on his own new theory (which was in fact a very old and much discredited theory which had been rejected time and again for more than a hundred years before the *General Theory* was published). But also while presenting his own theory of recession, he wrote into the history of economics his own version of what economic theory had been before he had developed his own.

He thus created a version of classical economic theory that has now been accepted across the economics world as the genuine article. And straw man though it is – indefensibly wrong in almost every detail – wherever the story of the Keynesian Revolution is told, this is almost invariably the version of pre-Keynesian economics that is taught.

The phrase that matters in understanding Keynes's ability to discredit his predecessors was this: that if classical economic theory is valid, "there is," as he put it, "no obstacle to full employment". That is, anyone who accepts classical theory is really accepting that unemployment is a theoretical impossibility. Such economists, he argued, cannot account for what was actually happening before their eyes.

There was, Keynes wrote a "category of unemployment, namely 'involuntary' unemployment in the strict sense, the possibility of which the classical theory does not admit." So far as economic theory is concerned, he argued, no one is ever unemployed against their will.

Therefore, as he quite logically concluded from his wildly inaccurate characterisations, since "the classical theory is only applicable to the case of full employment, it is fallacious to apply it to the problems of involuntary unemployment". That is, it is fallacious to apply classical economics to any problem related to the kinds of unemployment that had existed during the Great Depression, or which exist in economies around the world today.

It is something of an open question, even today, whether Keynes knew much at all of the economics of his own time or whether he lied outright to gain attention for his own approach. Because whatever else economists did or did not have in 1936 when Keynes's own theory was published, what they most certainly did have were theories

that explained the causes of recession and why high levels of unemployment frequently occurred.

The very idea that economics could have been developing since the late eighteenth century – with recessions and mass unemployment amongst the most visible aspects of the economy – without economists having written major theoretical works to explain what everyone sought to understand, is an example of the overpowering role of authority in overriding common sense.

And what is even more astonishing, it was those very classical theories which had been applied by the British Treasury to bring the Great Depression to its end.

Classical works on unemployment and depression were banded together under the heading of the theory of the business cycle. It is this theory that, with the coming of the Keynesian Revolution, has for all practical purposes disappeared from within mainstream economic thought.

Today, following Keynes, economists almost always begin their analysis of recessions from the premise that the downturn has been caused by some kind of fall in demand. And clearly, once you start from there, the solutions that will inevitably come to mind will centre around doing things that will restore the demand that has somehow been lost.

It is for this reason that economists have almost no collective understanding of how recessions begin or what to do about them when they do. Lack of demand followed by more spending by governments is what they know. And what they know does far more harm than any conceivable good.

It is an understanding and further development of the classical theory of the cycle that will restore some kind of sense to a macroeconomic theory that has gone dangerously wrong and is causing so much damage.

5) The Theory of the Cycle

The theory of the cycle was the alternative to the macroeconomics that Keynes introduced with the publication of his *General Theory* in 1936. The panic in public policy circles that followed the Global Financial Crisis at the end of 2008 and the start of 2009 were based on a Keynesian judgement that an economy in recession will only return to strong rates of growth through a strong and persistent public sector reaction.

Keynesian analysis assumes that economies will reach an equilibrium and high rates of unemployment and will thereafter not change. The theory of the cycle assumed the reverse, which was that a recovery would follow a recession. There were actions that could be taken but a increased public sector spending would be only one aspect of such policies, and generally a minor aspect.

The chart on the following page shows the various contours that a cycle might take.[1] The first (marked I) is based on the experience of the Great Depression in the United States in which public sector spending played a large role.

The pattern of the present recession appears to be most closely patterned after either the fifth (marked V) or the last of these (marked VI). A brief slowdown followed by a resumption of growth. The question that now lies before us is whether the actions that have been taken to diminish the effects of the recession will now prolong it.

What one does is, of course, typically built around what one believes. This is as true of economic policy as of anything else.

If it is believed that Keynesian economics is valid, and that it provides sound guidance on what to do when recessions occur, then during recessions high levels of public spending and deficit finance make perfect sense. If, however, one takes the view that such deficit spending will create lasting debts whose repayment costs will be a burden on the recovery process, then something else would be done instead.

In recent discussions the statement is often made that the opposite to demand stimulation is to do nothing. It is put that either governments increase spending on their own list of projects and go into deficit, or they do nothing at all while the economy burns to the ground around us. Increased demand is, in the view of many, the only viable option. And so it is if the only theory you know is Keynesian.

There was a time when economists understood that an economy at the macro level was based on exchange and that the cause of recession was related to the exchange mechanism breaking down.

The reasons why such breakdowns might happen were many and varied, but the essence of such explanations were mistaken market-based decisions – often cause by

---

[1] Taken from Flamant, Maurice and Jeanne Singer-Keral. 1970. *Modern Economic Crises*. London: Barrie and Jenkins, 9.

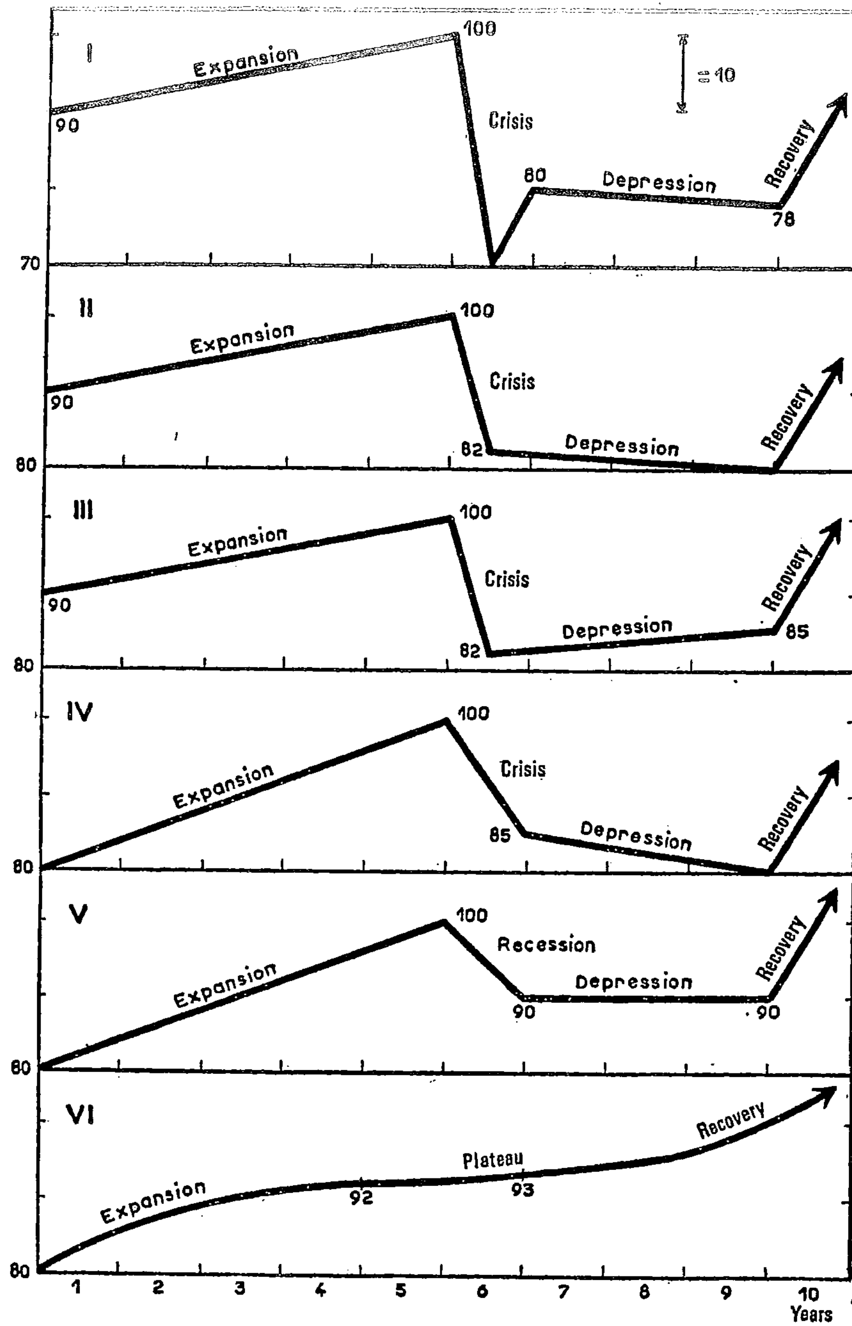


Fig. 1. Cyclical patterns

badly designed market regulations and government decisions. These are, for example, the kinds of things that have caused the actual recession we are in the midst of today.

The crucial issue was this. Keynes argued that when an economy went into recession, unless government action was taken, an underemployment equilibrium would be reached. The economy would remain locked into high rates of unemployment from which it would emerge either slowly or not at all unless some kind of public spending stimulus was applied aimed at raising the level of aggregate demand.

The theory of the cycle, by contrast, was built around the recognition that economies from time to time go into recessions and then, sooner rather than later, those recessions come to an end.

Cycles are cyclical. An upturn follows a downturn, and relatively quickly unless something is done to hold the economy down.

Business cycle theory revolved around a recognition that all business decisions are aimed at a future that is profoundly unknowable. The goods and services sold today are the product of past decisions to produce, often being decisions made many years before.

Such decisions, when they were made, seemed like a good idea at the time. They were made by individuals or business concerns because the expectation was that the results of those decisions would make them money. That is why the costs were incurred, almost always in advance of the payments that would cover their outlays.

Within such an economic structure, with the future so uncertain, the potential for things to go wrong are obviously large. And every year, even in strongly growing economies, there are business decisions that lead to closure and loss. Some decisions will just go wrong.

Recessions, however, occur when there are wholesale mistakes made across the economy that go well beyond the normal. Moreover, starting from these mistaken decision, the major transmission mechanism is often a loss of business confidence that causes firms across the economy to slow their expansion plans, diminish their orders from others and reduce the number of people they employ.

The cumulative effects are experienced as a recession which shows up in our national statistical collections as a fall in the level of output and a rise in the rate of unemployment.

In a Keynesian model, as soon as an economy enters recession, a new under-employment equilibrium is reached from which the economy will not emerge without government action.

In the classical theory of the cycle, there are continuous changes that take place automatically that move the economy towards recovery. The owners of every income-

earning asset within the economy are individually and collectively taking whatever actions they can think of to ensure that what they own – their capital equipment or their labour, for example – is used in ways that will earn the highest return.

Once the crisis has passed, when the dust has settled and the initial panic has subsided, the opportunities to use one's resources productively become more apparent. The rise in business confidence occurs naturally as the rhythm of economic activity again gathers momentum. With rising confidence comes rising activity and a return to higher rates of employment.

Crucially, the improvement is based on decisions on which forms of production will increase value adding activity to the greatest extent. Each business, acting in its own best interests, will ensure that higher growth is the result.

To think that the judgement of governments can be substituted for the judgements made by business may be the largest single mistake that Keynesian economists make.