COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Government economic stimulus initiatives

MONDAY, 21 SEPTEMBER 2009

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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

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 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 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, 40.5 per cent of our recipient respondents said they spent it, 24 per cent said they saved it, 35.5 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 I 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 you a 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 that 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 70 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 survey 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, although 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 lives 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 alternative 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 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 economically 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 irony that if you avoid a technical recession 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 its 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 bound 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