Chapter 3
Policy responses

Fiscal policy and monetary policy

3.1 There are two broad actions that can be undertaken to intervene in an economy that is facing a downturn. Monetary policy refers to action by the central bank to lower interest rates, encouraging higher rates of borrowing and investment, and improving cash flows for debtor households and firms as the size of repayments decreases.

3.2 The other approach is for the government essentially to pump money into the economy by running or increasing budget deficits. This can take many forms including tax cuts, tax rebates, or direct government spending such as government-funded construction of infrastructure, but all borrowed expenditure has to be repaid in the future. The various economic stimulus measures that are the focus of this inquiry include a mix of cash payments, some tax breaks and various forms of infrastructure expenditure.

Keynesian policies

3.3 One of the 20th century's pre-eminent economists, John Maynard Keynes famously wrote:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribblers of a few years back.[1]

3.4 But even he may have been surprised at the frequency with which his ideas were lauded and contested during this inquiry, over 60 years after his death. His name has become synonymous with the idea that in a recession, when there is a deficiency in private demand due to low business confidence, the government can usefully stimulate total spending in the economy by either increasing payments to households or cutting their taxes so that they will spend more, or directly spending money itself on infrastructure payments. This, it is said, will reduce the extent to which lower demand leads the economy to operate below capacity with increased unemployment, with both commensurate social and economic costs.

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1 John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936, Chapter 24.

3.5 Keynes expounded the case for an 'activist' fiscal policy, most notably in his influential book, the *General Theory*.[2] It became the economic orthodoxy of the post-war years up until the 1980s, when classical monetarist theory began to prove itself. The basic approach to managing the business cycle was adopted by most governments. Even Richard Nixon said "we are all Keynesians now".[3]

3.6 The Keynesian approach was widely adopted worldwide to stave off the effects of the global financial crisis and was enthusiastically applied by the Government in Australia.

3.7 But not all witnesses accepted the basis of the Keynesian approach:

> The standard theory of recession is wrong. That is my conclusion from a number of years of research on these issues. The use of Keynesian demand side theories to restore growth to economies in recession is misconceived... Keynesian stimulus, as we have had here in Australia and in America and elsewhere, is actually an obstacle to returning to economic growth and full employment rather than being any kind of assistance.[4]

> …we have actually gone back into a world where, rather than letting the economic institutions—the market and those government instrumentalities such as the Reserve Bank and what have you—actually operate and let the automatic stabilisers operate, an activist fiscal policy has been adopted. I think that is very much a backward step.[5]

3.8 One aspect of this is to assert that business cycles are inevitable and nothing should or can be done, at least through fiscal policy, to moderate their size:

> …economies are subject to periods of rapid growth and periods of recession and therefore the overreaction to the downturn at the beginning of this year has been wrong. We have not had the need for this kind of stimulus to be taken because the business cycle would actually have covered most of the change that we need to have anyway.[6]

3.9 Other witnesses espoused an alternate view that accepts the idea that fiscal policy can be effective and should be employed:

> …there is a logic, when the private sector suddenly does not want to borrow and wants to contract and de-leverage, for someone who has a strong balance sheet to come in and temporarily go in the other direction, not

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2 The full title is *The General Theory of Employment, Interest and Money* (1936).

3 President Nixon made the statement when taking the United States off the gold standard in 1971. In some accounts the quotation is "I am now a Keynesian". A similar quotation has been attributed to Keynes' rival as the 20th century's greatest economist, the free-market monetarist Milton Friedman.

4 Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, p 2.

5 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 51.

6 Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, p 3.

> permanently but just for a temporary period. That is a stabilising thing to do…[7]
>
> …it is important, where government can, to try to smooth the economic cycle and not simply to see this additional two percentage points of unemployment as being a statistic but as being many young people whose livelihoods will be better if they do not spend a scarring period of unemployment early in their careers.[8]
>
> Some people seem to be suggesting that the stimulus has had no impact on the economy. To take up that point, I would just ask: where did the money go? If you pump billions of dollars into the economy and we have not observed any inflation, it has gone somewhere. It has obviously created jobs, employment and income for the people who received that money.[9]
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> The prescription from economic analysis is clear, that major fiscal expansion is warranted in response to deficient demand. The concerted expansion in many countries is easing recession.[10]

Fiscal multipliers

3.10 Treasury argued that the debate on the efficacy of fiscal policy is a debate about the size of the 'fiscal multiplier'. This is the ratio of the consequent increase in GDP to the size of the fiscal stimulus.

3.11 Treasury provided fiscal multiplier estimates from the OECD and IMF, reproduced in Table 3.1.

Table 3.1: OECD and IMF estimates of fiscal multipliers

	OECD				IMF
	Australia		United States		G-20
	Year 1	Year 2	Year 1	Year 2	
Infrastructure	0.9	1.1-1.3	0.9	1.1-1.3	0.5-1.8
Government consumption	0.6	0.7-1.0	0.7	0.8-1.1	
Transfers to households	0.4	0.7-0.8	0.5	0.8-0.9	

Source: *Treasury briefing paper*, p 4.

7 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, pp 27-8.

8 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 28.

9 Dr Richard Denniss, Australia Institute, *Proof Committee Hansard*, 21 September 2009, p 62.

10 Professor Ross Garnaut, *The Great Crash of 2008,* Melbourne University Press, October 2009, p 211.

3.12 A recent study by Ilzetzki, Mendoza and Vegh was discussed during the Committee's final hearing.[11] It concludes:

> Relatively closed economies have long-run multipliers of around 1.6, but relatively open economies have very small or zero multipliers.[12]

3.13 Treasury argued that the Australian economy is in the former category, and so likely to have a higher multiplier:

> They break their sample into those countries that have a high trade share and those countries that have a low trade share, and the criteria they use is that your exports plus your imports have to be greater than 60 per cent. We are very clearly in the category of countries with a low trade share. Our trade share—exports plus imports—is about 40 per cent.[13]

3.14 The multiplier effects may well be higher when Australia acts at the same time as a number of other countries:

> …if there is a global downturn and everyone responds with fiscal policy then the exchange rate effect is much less important because everyone is stimulating their economies. If you like, you can think of the whole globe as a closed economy and in that world the relevant multipliers are the ones for a fixed exchange rate because the whole world is providing fiscal stimulus.[14]

3.15 The size of the multiplier will vary across the cycle:

> If you are in a fully employed economy, our presumption would be that the multiplier would be close to zero—to the extent that, if you are in a fully employed economy and the government engages in expansionary fiscal policy then a range of offsetting things will happen which will completely crowd that out. Whether it is the private sector responses that you are talking about or the anticipation that the Reserve Bank will tighten monetary policy in order to offset it, leading to the exchange rate rising, there are a range of ways in which that will be offset. In a fully employed economy, I would agree with you that the best estimate would be a fiscal multiplier of zero. In a situation such as that Dr Henry talked about earlier, in which private sector demand is retreating and public sector demand is acting to take its place, the strong balance of evidence is that such spending

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11 *Proof Committee Hansard*, 9 October 2009, pp 4-5.

12 Ethan Ilzetzi, Enrique Mendoza and Carlos Vegh, 'How big are fiscal multipliers?' *CEPR Policy Insight*, no 39, October 2009, p 1. Similarly the OECD conclude there are 'lower multipliers for more open economies'; *Economic Outlook Interim Report 2009*.

13 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5. While Australia is not a 'closed' economy in the sense of having heavy tariff restrictions, its physical insularity means that it is likely to always engage in less international trade than do European countries with adjoining partners.

14 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5.

has a positive multiplier, and I think that is accepted by the IMF, the OECD and by most interested observers…[15]

Ricardian equivalance

3.16 One academic argument against the efficacy of fiscal policy is based on 'Ricardian equivalance'. This idea, popularised by Robert Barro, draws on a conjecture dating back to the pioneering British economist David Ricardo two centuries ago.[16] Dr David Gruen of Treasury described the argument to the Committee as follows:

> The idea is that consumers who are in a position to smooth their consumption through time will realise that the extra government spending now implies extra government debt which will need to be paid back at some time in the future and they respond by reducing their consumption now…It certainly works in theory; the question is how relevant it is to the real world…my reading of the evidence is that it is more convincing for economists than it is for the real world.[17]

3.17 Interestingly, even David Ricardo himself did not believe in Ricardian equivalence.[18] It remains the view of most economists that only a small proportion of the population's spending decisions would be based on Ricardian equivalance:

> ...there is not much empirical support for this motivation for savings.[19]

3.18 Dr Gruen referred the Committee to his own research on this topic:

> Many years ago I went out and asked people how much they knew about the level of Australian government debt. I then asked academic economists how much they thought people would know, and it turned out that the academic economists massively overestimated the amount of knowledge of the people I had asked.[20]

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15 Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p 20.

16 Robert Barro, 'Are government bonds net wealth?', *Journal of Political Economy*, November 1974, pp 1095-1117; David Ricardo, *The Principles of Political Economy and Taxation*, 1817, Chapter XVII.

17 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 19.

18 Ricardo makes the theoretical point but warns that in practice people do not behave this way. See the Ricardo reference above and Andrew Abel, 'Ricardian equivalence theorem', *New Palgrave Dictionary of Economics*, 1987, p 175.

19 Max Corden, 'The theory of the fiscal stimulus: how will a debt-financed stimulus affect the future', *Melbourne Institute working papers*, no 15/09, June 2009, p 9.

20 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 19. The research is described in David Gruen, 'What people know and what economists think they know: Surveys on Ricardian equivalence', *Australian Economic Papers*, June 1991, pp 1-9.

'Crowding out'

3.19 Critics of the Keynesian approach argue that even in a recession, government spending displaces private spending:

> Public debt has the effect of crowding out private investment and increasing interest rates. So we would have expected Australia to be paying slightly higher interest rates than it would be if it were not for that net debt. Certainly I think a very low, negative net debt position is prudent fiscal policy, and a balanced budget.[21]

3.20 Economists generally agree that crowding out can be a problem. Witnesses disagreed about the extent it would apply in Australia.

Open economy crowding out

3.21 Professor Makin argued that the Keynesian arguments are less applicable, and crowding out concerns starker, in an open economy. His interpretation is that:

> …the budget deficit will add to the foreign borrowing. Other things remaining the same, this is going to increase interest rates. It must increase interest rates…there would be a higher risk premium on Australian borrowing, and the consequence of that will be two losses to the Australian economy. The first loss will be: the higher interest rates will crowd out private investment. That private investment means we will have a lower capital stock than we would have otherwise had, and into the future we will have a lower growth path. The second cost is the sheer payment of interest abroad, which will be significant. It is a significant part of Australia's external position.[22]
>
> The Nobel Prize winner Robert Mundell demonstrated that quite some time ago—that if you expand fiscal policy you push up interest rates. This induces capital inflow, the exchange rate appreciates, and this worsens competitiveness and worsens the trade account.[23]

3.22 The Reserve Bank Governor's interpretation was that to the extent that the stimulus package made the economy stronger, this would lead to a higher exchange rate:

> …economies which are stronger rather than weaker typically have a firmer currency relative to what they would have if they were weak. One reason for that is that in such economies return on capital tends to be positive and higher rather than lower, which means that foreign funds find it attractive to come there. Of course, one dimension of that is that such countries, not always but typically, have a higher interest rate structure across the board

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21 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 44.

22 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 77.

23 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 77.

> than a country that is comatose. We have low but still positive interest rates, whereas Japan has them at zero as do a number of countries now.[24]

3.23 A similar view was expressed by some business representatives:

> We think that the stimulus package has improved domestic confidence in the Australian economy, the level of investment and the level of activity, beyond what would otherwise have been the case. We think that that level of confidence and activity has given foreign investors greater confidence in the Australian economy and that has contributed to the higher dollar by making us a more attractive place for investment.[25]

3.24 There could be (partly) offsetting effects whereby the stimulus package puts downward pressure on the exchange rate as some of the extra spending leads to higher imports:

> Any increase in imports must then lead to depreciation of the exchange rate…any reduction in demand for domestic goods caused by a leakage into imports will be offset by an increase in demand for domestic goods caused by a rise in exports.[26]

3.25 In total, witnesses did not highlight any impact of the stimulus measures on the exchange rate, particularly as most of Australia's trading partners also implemented stimulus packages themselves. Treasury commented:

> We have also seen significant movements in the exchange rate, most of which we would judge to be unrelated to domestic policy settings.[27]
>
> The substantial movements in the exchange rate over the past 12 months are likely to reflect not only shifts in underlying demand for Australia's commodity exports and subsequent terms of trade impacts, but also shifts in both risk aversion among investors and sentiment regarding Australia's relative economic prospects. While the initial fall in the exchange rate has been a positive for growth, the relatively short duration of the exchange rate trough, the volatility and the subsequent sharp reversal mean that the contribution to growth over the past year is likely to have been modest. In practice, it usually takes some time for trade flows to respond to exchange rate changes.[28]

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24 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 19.

25 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, pp 64-5.

26 Max Corden, 'The theory of the fiscal stimulus: how will a debt-financed stimulus affect the future', *Melbourne Institute working papers*, no 15/09, June 2009, p 4.

27 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 2.

28 *Treasury briefing paper*, p 9.

The hallmarks of a well-designed fiscal stimulus

3.26 There are three criteria which seek to take into account some of the arguments against fiscal stimulus measures outlined above to ensure fiscal stimulus packages are successful.[29]

3.27 The stimulus needs to be ***timely***, with the stimulus being applied while the economy is in a downturn and is operating beneath productive capacity. If a stimulus occurs too late, there is increased danger that the government spending will occur on top of recovering private demand. As well as being too late to have any positive effect during the downturn, this would also increase the risk that the excess demand would fuel inflation and higher interest rates to the detriment of the economy's recovery. This argument is often used to prove the superiority of monetary policy as being more responsive and not subject to political delay or an implementation lag.

3.28 A second criterion is that the stimulus be well***-targeted***. The stimulus needs to be directed in ways that maximise the multiplier effect of the government expenditure.

3.29 The experience shown by the fiscal stimulus packages have tended to be of low value and much of the investment by the Government has been of poor quality that does not provide an economic benefit. Many of the projects were poorly conceived and have provided very little to the wider community – that could be perhaps viewed as "make-work" projects, which are very expensive and provide little benefit.

3.30 Over longer time periods, direct government spending also has a high multiplier effect. Indeed, every dollar of direct government spending flows through to the economy directly. However, direct government expenditure can take some time to be approved by parliament and then further time to get underway. For instance, the lead time on infrastructure projects such as highway construction can take months to years, potentially coming too late to be useful. As a result, direct government expenditure in the form of infrastructure projects will generally have an implementation lag.

> Standard textbook analysis will tell you that fiscal stimulus in an open economy with a floating exchange rate is ineffective, except if it is productive. That is to say fiscal stimulus in the form of a consumption-enhancing expenditure is ineffective.[30]

3.31 The third criterion is that stimulus measures should be ***temporary***. This is because the longer stimulus measures are applied, the greater effect they have on the long-term national budget. The effects of higher national debt are discussed above.

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29 The three criteria are attributed to Larry Summers (currently the director of the US National Economic Council, a professor at Harvard University at 28 and later its president and formerly US Treasury Secretary) by Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, p 5.

30 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 88.

3.32 The stimulus package, as announced by the Government, is planned to continue to roll out until 2012. This is clearly not a temporary fiscal stimulus.

3.33 Despite this, the Governor of the Reserve Bank believed the stimulus packages well met the temporary and timely criteria, although acknowledged the questions about the effectiveness of the targeting.

> I think it is pretty hard not to conclude that it was quite timely. It was very fast. The bulk of it is temporary. Notwithstanding the discussion earlier about 2011 effects, the big impacts are in 2009, which is presumably the year in which the economy would need the most support. On the targeting, that is probably where people are going to differ about just what should be targeted.[31]

Interaction between fiscal and monetary policy

3.34 While three per cent was the lowest the Reserve Bank's official cash rate has ever been, and similar interest rates had not been this low since the 1950s, nonetheless it would have been possible for the Reserve Bank to take them down to (near) zero as has been done in some overseas countries. This would have been consistent with a less expansive fiscal policy, as discussed by Professor Tony Makin.[32]

3.35 However most economists believe that taking interest rates this low would not have been a desirable setting for monetary policy:

> Yes, monetary policy becomes less effective the closer you get to zero.[33]

> I think it is immeasurably to Australia’s advantage that, however we have arrived where we are, we do not find ourselves with the overnight rate at zero,[34]

> …cutting interest rates to very low levels is something that you do if there is no alternative, but that there are attendant dangers in having extremely low interest rates, certainly for any extended period of time…After all, one of the arguments presented about what led to this global mess was an extended period of ultra-low interest rates in the US.[35]

3.36 The Governor of the Reserve Bank elaborated on this trade-off:

> In principle, at the level of logic, of course I guess they [the Government] could take a sequence of decisions which slow down the demand in the economy which would otherwise be occurring and that would presumably have some impact on the outlook, including for inflation, and therefore we

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31 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 22.

32 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 89.

33 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 26.

34 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 22.

35 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, p 5.

would be on a different course from the one we would otherwise be on. So in principle that is possible. I still think though that one should also ask the prior question of whether that is a better set of outcomes. Is it the best outcome to have a huge budget surplus and very low interest rates? There is often a presumption that that is good. I am not sure I share that presumption because there are things that go wrong with very low interest rates and there are possibly reasonable things that the governments can do with the money. I am a bit reluctant to accept that presumption.[36]

3.37 It is hard to quantify the trade-off between monetary and fiscal policy settings:

> There is an interesting question out there as to what expenditure is fiscally equivalent to a one percentage point cut in interest rates. I wanted to have that number to present to you today but…My quick skim of the literature suggests it is not there.[37]

3.38 The Committee acknowledges the lack of desirability of reducing the official cash rate to zero. However, the Committee does consider that scope existed to lower it further, without leading to a huge budget surplus.

3.39 One view is that monetary policy is more nimble and can 'fine tune' around fiscal policy:

> We are sufficiently uncertain as to what the path out of the downturn will be that I think it makes sense just to let fiscal policy roll and let monetary policy, which takes effect much faster, do the finetuning.[38]

> The consensus that emerged in the 1980s…was that there were considerable limitations in using fiscal policy to finetune the economy…monetary policy is probably better able to play that role. But certainly I never interpreted that consensus as implying that, when an economy is hit with an unprecedented negative shock, one should expect that monetary policy could play all of the role.[39]

3.40 It can be argued that the present crisis was unusually well-suited to allowing consideration of how best to employ both monetary and fiscal policy:

> One of the things that made this crisis so unusual and unprecedented—certainly from Australia's perspective—was that we got such a strong and unequivocal signal from the rest of the world in the middle of September that something truly catastrophic was happening in the global capital markets. We were very confident—and that confidence grew over a period of just a couple of weeks—that an enormous negative shock was coming our way. The shock had arrived in the sense that it had already had an impact on share markets and the exchange rate, as you explained, and it was very clear that that was going to lead to a very substantial negative shock to

36 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 24.

37 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 32.

38 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 23.

39 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p 4.

> the real economy…That is an extremely unusual situation and it radically changes the calculus of whether discretionary fiscal policy is a good idea or not.[40]

3.41 An alternative view is that monetary policy is always far more effective than fiscal policy:

> Unquestionably monetary policy is more effective. Monetary policy in an open economy works largely through the exchange rate, and we saw that. We saw that the relaxation of monetary policy by 425 basis points over a short period of time was a reason for the exchange rate depreciation…[41]

3.42 There is general agreement that it is undesirable for monetary and fiscal policy to be at odds. However evidence was received arguing both that this was the case in Australia and not. The Committee considers that Australia is facing a distinct likelihood that these two arms of policy will be working against each other. Indeed, the recent twenty five basis point increase in the official cash rate is specifically intended to slow the economy being sped up by the Government's fiscal policy.

Alternative stimulus approaches

Tax cuts as an alternative

3.43 Many economists argue that tax cuts would be a more effective means of stimulating the economy than one-off payments or government spending:

> Had they gone down the road of, say, finding ways to reduce taxes…which would have a direct effect on business profitability and on cash flow then the reaction within the business community would have been a lot stronger. Not only would employment have been protected in the way that the stimulus was intended but it would be much more general... using the payroll tax system might have been the optimum.[42]

> a [income] tax cut would be better than a spending initiative…it would allow individuals to spend the money in better ways than those in which the government would spend the money. [43]

3.44 Other economists prefer spending to tax cuts as a short-term stimulus:

> My read of that [summary of economic literature] is that the multipliers are highest for infrastructure, next highest for consumer handouts and lowest

40 Dr David Gruen, Treasury, *Proof Committee Hansard*, 9 October 2009, pp 13-14.

41 Professor Tony Makin, *Proof Committee Hansard*, 21 September 2009, p 88.

42 Dr Steve Kates, *Proof Committee Hansard*, 21 September 2009, pp 6 and 9.

43 Professor Sinclair Davidson, *Proof Committee Hansard*, 21 September 2009, p 48.

> for business tax breaks. The impact of business tax breaks on the economy seems to be fairly low.[44]
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> Some have argued that these should have been permanent tax cuts. The difficulty with that is that it does put you into a fiscal position which is pretty hard to unravel unless you are willing to make some hard choices on the expenditure side.[45]

3.45 Treasury considered the cash payments to be superior to a tax cut on the grounds that they were faster to implement and would have a one-off effect on the budgetary fiscal balance. Permanent or semi-permanent tax cuts would have built in a long-term decrease in tax revenues and negative effect on the fiscal balance.[46]

3.46 Behavioural economic theory suggests that cash payments administered in a lump sum were more likely to be spent when compared to the smaller, regular amount that would result from tax cuts.[47]

3.47 However, the work of Milton Friedman and his permanent income hypothesis states that the choices made by consumers regarding their consumption patterns are determined not by current income but by their longer-term income expectations. In essence, transitory, short-term changes in income have little effect on consumer spending behaviour.[48]

Other alternatives

3.48 There are other alternative approaches to preserving employment in a downturn, such as more direct labour market programmes. Views differed about their effectiveness:

> …a lot of the stimulus might be better spent through direct job creation, particularly through community organisations and local councils—again, I think, an effective way of not just spending money but spending it in regions that can absorb it and also in a way that can create jobs where they are needed most.[49]
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> My read of the literature on active labour market programs is that wage subsidies are more effective than direct job creation schemes. But we do not have a great deal of high-quality evidence on how best to create jobs in the

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44 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 28. This is consistent with Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, pp 15-17 and the OECD's *Economic Outlook Interim Report 2009.*

45 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 37.

46 *Nation Building Report*, p 47.

47 *Nation Building Report*, p 49.

48 Milton Friedman (1957), *A Theory of the Consumption Function*, Princeton University Press, chapter 2, 'The Permanent Income Hypothesis', pp 20-37.

49 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 62.

> Australian context. It would be nice to have some really rigorous studies and randomised trials that compared wage subsidies, direct job creation and training, which are the three main things we think about doing in a downturn.[50]

Preparation for future recessions

3.49 Some witnesses commented that the quality of spending in the stimulus packages would be better if thought had been given to possible projects before the recession hit:

> In a perfect world, you would have a long list of infrastructure things that you would get out, dust off and turn on when the need comes. I have been through a few cycles now and I have not seen that happen quite so easily yet, because it is not feasible to do that.[51]

> The main lesson is that it is actually hard to spend a lot of money quickly. I think that, given that Australia can and will have other recessions in the future, we would be well served by beginning to prepare for recessions before they occur. By that I mean that, if people find it a challenge to spend a lot of money very quickly, there is no reason we cannot have a list of important but not urgent projects that are ready to go at any point in time. There is no reason that local councils and other organisations could not be encouraged to prepare lists of exactly such shovel-ready projects…[52]

3.50 The problem with this idea is that while economic theory operates in a perfect world, the real world is not like this and it appears that a number of the projects have been selected on the grounds of being more in the vein of political spending rather than income-generating infrastructure.

3.51 This idea could be aligned with another recent proposal to deal with lags in implementing fiscal policy. A paper cited by witnesses to this inquiry refers to a proposal that the legislature agree to a fiscal stimulus package that would take effect only if a specific triggering event occurred. The trigger suggested was a three-month fall in employment. As well as allowing negotiations to occur *before* the stimulus was needed, a further benefit could be that:

> …this approach could boost household and business confidence by making clear that fiscal stimulus would be used against a serious economic slowdown.[53]

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50 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p 39.

51 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p 21.

52 Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p 62.

53 Douglas Elmendorf and Jason Furman, 'If, when, how: a primer on fiscal stimulus' Brookings Institution, January 2008, p 11. The original proposal is attributed to Martin Feldstein, a Harvard professor, long-time president of the National Bureau of Economic Research and former chair of the US Council of Economic Advisers.