# Coalition Senators' Dissenting Report

## SPENDING SPREE NOT STIMULUS

### SUMMARY


Having carefully considered the Government's package, and the evidence presented to the Committee, Coalition Senators believe the package:

- will not achieve the objectives the Government claims;
- is too big at this time, leaving little scope for further measures if needed later;
- is poorly thought through and a poor quality use of $42 billion of taxpayers' money;
- lacks ingredients that should be part of packages of this kind – measures to increase employment, productivity, efficiency and competitiveness; and
- commits Australia to record amounts of debt (the Government seeks authority to borrow $200 billion), endangering the nation's long-term economic security.

Coalition Senators are not opposed to a responsible stimulus package.

But nothing Coalition Senators have heard at the Committee's hearings gives them confidence that the package has been subject to the full intellectual rigour and detailed examination that should be required when committing to spending $42 billion of taxpayers' money.

Rather, it appears that the development of the package and its contents have been politically driven not economically driven.


### INTRODUCTION

On Tuesday 3 February 2009, the Government announced a new package of measures totalling $42 billion and including an Updated Economic and Fiscal Outlook (UEFO). The new measures bring the total Government stimulus packages announced to date to $74 billion or 6.4 per cent of GDP (see Table 2).

The legislation effecting the package was introduced on Wednesday 4 February 2009, with the Government insisting that both the House of Representatives and the Senate should pass the legislation unamended by Thursday 5 February 2009. That is, the Government insisted that Parliament approve the expenditure of $42 billion of public money in 48 hours.

Because such a large amount of taxpayers' money is involved, Coalition and minority Senators voted that an Inquiry be held into the package of legislation, so it could be subject to detailed scrutiny.

Despite the need for careful examination, the Government forced a hurried inquiry, with the Report due by Tuesday 10 February 2009. The Government has been unable to articulate a strong reason for the unnecessary haste. It originally claimed that the Centrelink cash bonuses could not be delivered on time unless the package was rammed through the Parliament in 48 hours. Yet in evidence to the Committee, the CEO of Centrelink Mr Finn Pratt said "If the parliament passes this legislation next week, as currently presented, we will be able to implement it for 11 March". (Proof Hansard Friday 6 February 2009, p8). Further, Coalition Senators expressed their concern that the timetable for consideration of this huge financial package has been so hasty that Treasury has been unable to provide answers to many of the Committee's questions on notice.

Coalition Senators note that the unprecedented demand for the passage of a series of large measures without due scrutiny poses a significant risk to the Public Account. Not only is there a risk that the size of the package is too great, but the components of the package might be of poor quality and therefore achieve less impact than some alternative package. The spending of taxpayers' money is not costless; there is an opportunity cost in providing public spending and that includes alternative options foregone such as returning taxes to the people who paid them.

Coalition Senators have reached the conclusion that this package does not conform with best economic theory and evidence, has been insufficiently analysed by the Departments of Treasury and Finance, is too large, and leaves insufficient capacity to respond to future needs.

Coalition Senators are deeply concerned that the Government has failed to consider or model alternative policies and has committed significant public money to a range of programmes that will not achieve the Government's stated objectives.

***To summarise, the package:***

- ***is too large;***
- ***has been introduced too early;***
- ***imposes too much debt on Australian taxpayers; and***
- ***is poorly targetted to achieve its stated objective "to support economic growth and jobs in Australia"*** *(UEFO, page 17).*

Coalition Senators therefore recommend that the Senate vote against the package as a whole.  The Government should then present to the Parliament an appropriate stimulus package that is more modest, better targeted and which contains components that would genuinely improve productivity, assist in genuine job creation, and raise the living standards of the Australian people.

## ECONOMIC CIRCUMSTANCES

### *International*

International economic conditions have weakened, and it is widely accepted that the world is in recession, with the G7 countries in particular suffering significant recessions. According to the forecasts in UEFO, Chinese growth has also dropped significantly, to an estimated 6 ½ per cent in 2009. Forecasts for growth in the euro area are around minus 2 per cent in 2009. It is noteworthy that the majority of countries – including the G7 countries and Brazil, Russian, India and China – have included tax cuts in their stimulus packages. According to *The Economist (*31 January 2009, p71*)*, the average stimulus is estimated at 2.8 per cent. Governments have also taken on substantial public liabilities, in many cases taking equity in private banks.

### *National*

Australia's economic conditions have weakened, but remain significantly stronger than the rest of the world. The UEFO forecasts growth in Australia to be 1 per cent in 2008-09 and ¾ of a per cent in 2009-10. It also forecasts that unemployment will rise to 7 per cent by the June quarter 2010, compared with the present unemployment rate of 4.5 per cent for the month of December 2008.

There are a number of reasons for the relative strength of Australia's economy compared with overseas. A major reason is a long series of economic reforms, commencing with the Hawke/Keating Government's floating of the dollar in 1983 with bipartisan support from the Coalition which then accelerated under the Howard/Costello Government. These macroeconomic and microeconomic reforms included: liberalising trade, opening capital markets, improving the regulation of the corporate and financial sector, enhancing competition, freeing up the labour market and a myriad of other measures to make Australia's economy stronger, more resilient and more dynamic adding to the living standards of Australians.

Australia's financial sector is the envy of the world – the four major Australian banks now being in the top 20 of the highest credit ratings of banks in the world. Our regulation is, as the Deputy Prime Minister said at Davos, "better than world class". According to the Australian Prudential Regulation Authority, Australian banks continue to be in a relatively strong state, a testimony to the success of the prudential regulation regime established by the former Coalition Government.

The legacy inherited by the Rudd Government in November 2007 was one of a very strong economy, with a dynamic and flexible labour market, sound financial regulation, and strong economic growth. The unemployment rate was at a 30 year low, with record high participation rates; public net debt had fallen to minus $41 billion; inflation was in the target range of 2 to 3 per cent; consistent budget surpluses had been achieved and were forecast over the forward estimates; a number of significant investment funds were established to address long-term challenges such as the ageing of Australia's population (including the Future Fund and the Higher Education Endowment Fund); and a long series of sustainable tax cuts have returned the benefits of sound economic management to the Australian taxpayer.

Professor McKibbin in evidence to the Committee (Submission) lent his support to the view that the Australian economy was very strong compared with other countries and said:

> "Up until this point the Australian economy has proven to be a good model for economic reform combined with careful regulation and an appropriate role for Government. This reality should be reinforced whenever possible".

## *Government policy to date*

Many of the Government's policies to date have been misguided, ad hoc, and hasty. For example, the Government's decision to provide an unlimited guarantee for bank deposits created a substantial distortion which negatively affected – and continues to affect – the savings of hundreds of thousands of Australians. Similarly, through much of 2008 the Government overstated the inflation threat and increased inflation expectations leading to higher interest rates. The effects of those increases are still feeding through into economic activity. The Government talked down the economy for political gain, undermining business and consumer confidence. The Government took decisions to increase taxes and other revenue in the May Budget after talking of "painful" budget cuts in the months and weeks beforehand.

Coalition Senators consider that this pattern of policy mistakes and rushed decision making in the attempt to appear "decisive" has weakened the Australian economy, lowered business and consumer confidence, and exposed Australia needlessly to additional risk from the global financial crisis. Coalition Senators consider that the present package continues this pattern of rushed decision making and urge the Government to be more cautious, competent and strategic in its management of the economy.

The importance of business and household confidence was emphasised by Professor McKibbin in evidence to the Committee. He said:

> "Therefore, the first requirement of the Nation Building and Jobs Plan Bills should be to help restore confidence. Ideally this would imply that all sides of politics would reach a consensus on the way forward and would quickly pass legislation through the Parliament. It is unfortunate that this consensus was not reached early through a bipartisan approach" (Submission).

Coalition Senators agree with this statement and regret that the Coalition's repeated offer to work with the Government in a bipartisan manner has been consistently rejected by the Prime Minister.

## THE PACKAGE

The stimulus package comprises 10 components structured into two key themes: building prosperity for the future and supporting jobs now, as shown in the table below.

**TABLE 1: Key components of the $42 billion package**

| | Underlying cash balance impact | | | | |
|---|---|---|---|---|---|
| | 2008-09 | 2009-10 | 2010-11 | 2011-12 | Total |
| **Building prosperity for the future** | | | | | |
| Building the Education Revolution | -987 | -8,624 | -5,109 | 0 | **-14,720** |
| 20,000 Social and Defence Homes | -260 | -4,274 | -1,794 | -312 | **-6,640** |
| Energy Efficient Homes | -39 | -1,540 | -1,544 | -736 | **-3,859** |
| Small Business and General Business Tax Break | 0 | -840 | -1,350 | -515 | **-2,705** |
| Black Spots, Boom Gates and Community Infrastructure | -480 | -410 | 0 | 0 | **-890** |
| **Sub-total** | **-1,766** | **-15,687** | **-9,797** | **-1,563** | **-28,813** |
| **Supporting jobs now** | | | | | |
| Tax Bonus for Working Australians | -6,950 | -1,201 | 0 | 0 | **-8,151** |
| Single-income Family Bonus | -1,273 | -147 | 0 | 0 | **-1,420** |
| Farmer's Hardship Bonus | -20 | 0 | 0 | 0 | **-20** |
| Back to School Bonus | -2,347 | -271 | 0 | 0 | **-2,618** |
| Training and Learning Bonus | -413 | -98 | 0 | 0 | **-511** |
| **Sub-total** | **-11,004** | **-1,717** | **0** | **0** | **-12,721** |
| **Total Stimulus Package** | **-12,770** | **-17,404** | **-9,797** | **-1,563** | **-41,534** |

Source: Updated Economic and Fiscal Outlook, page 17

The Government argues that the components in the *Building prosperity for the future* are aimed at improving productivity, but Coalition Senators consider that spending taxpayers' money on these projects is unlikely to enhance productivity. Programmes that simply spend taxpayers' money on social housing or subsidise activities that are self financing are highly unlikely to improve productivity.

The various grants under *Supporting jobs now* are clearly attractive to recipients. But by focussing on grants rather than tax cuts, the Government has rejected a more effective measure. And by making the grants so large, the Government has reduced the scope for future stimulus measures.

## *Deficits and Debt*

The UEFO shows that the accumulated deficits between 2008-09 and 2011-12 are projected to be $118 billion. Of that, policy decisions taken since the May Budget make up the majority: $67 billion over the forward estimates, including $29 billion in 2008-09. The Government's own figures show that in the absence of its policy decisions, the budget would still be in surplus in 2008-09. The Government has simply run up Commonwealth debt – its amendments to the Commonwealth Inscribed Stock Act seek authority for borrowing up to $200 billion – an unprecedented amount for Australia. This amount – $9500 per man, woman and child – is a burden on Australian taxpayers that will reduce Australia's growth. Treasury was unable in the timeframe to provide an estimate of the interest cost of the debt. However, David Crowe in the *Australian Financial Review* (10 February 2009) estimates that the interest cost on the proposed debt will rise to $7 billion a year.

The net deterioration in the Commonwealth's Budget position between 2007-08 and 2008-09 is projected to be 3.6 per cent of GDP. This is similar to the deterioration under the Whitlam Government, which went from a surplus of 1.9 per cent of GDP in 1973-74 to a deficit of 1.8 per cent of GDP in 1975-76. However, Coalition Senators note that although the current deterioration is roughly similar to that previous episode in terms of percentage of GDP, under the current Government the deterioration is projected to occur over the course of a single year – twice as fast as the deterioration under the Whitlam Government.

Coalition Senators further note that the latest stimulus package follows earlier measures which together now total almost $75 billion. Again, the Government has been unable to articulate the need for a further stimulus package of such a size and composition following these earlier packages which have not been assessed for their efficacy. At 6.4 per cent of GDP (see Table 2), the stimulus measures in Australia are larger than those in the United Kingdom and United States among others – countries that are in considerably worse economic health and therefore require commensurately larger fiscal stimuli.

In evidence tabled by Treasury to the Committee on 5 February 2009, a comparison of fiscal stimulus packages around the world in 2008 and 2009 was provided. This supports the Coalition Senators' view about the relative size of the Australian stimulus. Using only the $10.4 billion and $42 billion packages, Treasury calculates that Australia's stimulus is 4.9 per cent of GDP. This is four times the size of the US stimulus as a proportion of GDP (1.2 per cent) as shown in the Treasury evidence. It also showed that the UK's stimulus was 1.4 per cent of GDP, Germany was 2.6 per cent of GDP, Japan was 2.6 per cent of GDP and France at 1.4 per cent of GDP.

Excessive debt has been a major cause of the global financial crisis. Coalition Senators therefore are bemused that the Government is unconcerned about the prospect of a significant increase in public debt. The lessons of the mid-1990s show that the burden of public debt significantly impaired the economic performance of Australia.

Coalition Senators are concerned by the lack of a clear strategy to return the budget to surplus. The UEFO provides no detail other than allowing tax receipts to increase and holding growth in real spending to 2%. Worryingly, despite numerous queries, officials from the Treasury and the Department of Finance and Deregulation were unable to provide further detail about how these commitments would be met over the period.

Furthermore, Coalition Senators are concerned by the UEFO projections outlining $50 billion in deficits over 2010-2012 despite a projected economic recovery and 3% growth in real GDP. Treasury officials were unable to project when the community might expect the budget to return to surplus.

**TABLE 2: GOVERNMENT STIMULUS PACKAGES ANNOUNCED TO DATE**

| Package | $ million |
|---|---|
| Economic Security Strategy (October 2008) | 10,400 |
| COAG Package | 15,200 |
| Nation Building and Jobs Plan (February 2008) | 41,534 |
| Ruddbank (Government contribution) | 2,000 |
| Local Community Infrastructure | 300 |
| Infrastructure package | 4,700 |

| | |
|---|---|
| **TOTAL** | **74,134** |

[1]

Coalition Senators are concerned that the Government is unable to provide evidence on the success or otherwise of the $10.4 billion package announced on 14 October 2008, yet it is now asking the Senate to approve a further package of four times the size. In evidence to the Committee, Dr Henry said "so we are only going to get by the first week of March a very partial reading of the impact on both household consumption and household saving of the October package" (Proof Hansard 5 February 2009, page 9). Further, in evidence given on Monday 9 February, Richard Evans of the Australian Retailers Association stated "it is too early to determine whether or not the cash has entered the market in any significant way. Indeed it may take six months before we actually the results …". (page 2-3).

When questioned about the small increase in retail sales in December, Mr Evans noted "retailers have been discounting since November to stimulate customers. It was very soft in December" (page 2).

Even more concerning, when asked about how Australians could judge the success of the proposed $42 billion package, Dr Henry conceded that we may never know. He said "… it is going to be difficult for us to be able to provide the Parliament with precise estimates of the actual fiscal impact of the package". (Proof Hansard, Monday 9 February 2009, page 56).

## ECONOMIC PRINCIPLES, THEORY AND EVIDENCE

Many leading academic economists have spoken publicly of their concerns that fiscal stimulus of the sort proposed by the Government is ineffective or, worse, counterproductive. This view reflects a large body of theoretical and empirical work over the last thirty years (the Appendix contains more detailed discussion).

In the United States, three Nobel laureates in economics (James Buchanan, Edward Prescott and Vernon Smith) and a number of other economists including Deepak Lal, John Cochrane and Michael Bordo have signed an open letter to the American President stating that:

> "*… it is a triumph of hope over experience to believe that more government spending will help the U.S. today. To improve the economy, policymakers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a reduction in the burden of government are the best ways of using fiscal policy to boost growth*" (Open letter from 200 economists *New York Times/ Washington Post/Wall Street Journal*, January 2009).

Harvard University economics professors, Robert Barro and Greg Mankiw have provided clear statements of their concerns.

Barro has cautioned against "programs that throw money at people" and "massive public-works programs that do not pass muster" and emphasised the value of income and corporate tax reductions (*Wall Street Journal*, 22 January 2009).

[1] Note the above packages have been expressly identified by the Government. Other policies have been claimed by the Government as being designed to respond to the Global Financial Crisis, for example the "New Car Plan For A Greener Future" ($6.2 billion) which add further to size of the Australia stimulus package

Mankiw has pointed out three home truths as his government rushes to introduce a huge increase in government spending (*New York Times*, 11 January 2009). First, the effect of government spending on the economy is not very large. Second, public spending on poorly chosen projects will not improve economic well-being. Third, evidence suggests that the effects of tax cuts are greater than spending increases, perhaps twice as large.

A number of leading Australian economists have raised similar concerns about fiscal policy in general and the Australian government's approach in particular. Professor Tony Makin of Griffith University has written:

> "*The textbook consensus is that for open economies, fiscal policy is ineffective in stabilising aggregate demand in the short run under floating exchange rates – especially if it means lifting unproductive government spending and running up public debt to fund it*" (*Australian Financial Review*, 15 December 2008).

Australia is an open economy with floating exchange rates and a high degree of international capital mobility. Further, "if the extra government spending fails to generate an economic return sufficient to cover the servicing costs of the foreign borrowing required to fund it, the seeds are sown for a future currency crisis" (*Australian Financial Review*, 4 February 2009). The proposed expenditure on education and social housing, as well as the transfer payments will not generate a return to cover debt servicing costs.

In evidence to this committee, Professor Sinclair Davidson, of RMIT, has argued that spending multipliers are often overstated. He has advised that the government should consider tax cuts such as a GST or pay roll tax holiday and bringing forward the "aspirational" income tax cuts suggested by the Labor Party prior to the election.

Reserve bank board member and professor at the Australian National University, Warwick McKibbin, has stated that the December 2008 stimulus payments did not have much impact and has called for a halving of the GST for a year (reported in *The Age*, 30 January 2009).

The chairman of Concept Economics, Professor Henry Ergas (*Australian*, 9 February 2009) has a number of concerns about the effectiveness of fiscal policy, noting also that the latest stimulus appears to be "too much, too soon", a view shared by the Coalition and discussed further below.

There is no evidence that the government has requested or considered a detailed examination of the theoretical and empirical work on this subject before reaching its policy conclusions. In public it has relied on selective use of opinions expressed by certain individuals at international bodies such as the IMF while eschewing the views of the organisation.

Whilst much of the evidence suggests that tax cuts have a relatively large fiscal multiplier, Coalition Senators note that the Government effectively raised taxes when the planned "aspirational" tax cuts were abandoned in the Mid-Year Fiscal and Economic Outlook. Page 52 of that document states that:

> "In the 2008-09 Budget, the Government made a provision for its aspirational tax goals in 2011-12. The Government said that achieving its aspirational tax goals 'will depend on economic conditions and the need to maintain fiscal responsibility'. Given

> the dramatic deterioration in the global economic outlook and associated increased uncertainty, the provision will no longer be maintained. The Government will reconsider the policy parameters following an improvement in overall economic conditions."

Coalition Senators are puzzled as to why the Government believed back in November 2008 that it was not fiscally responsible to carry out its election commitment of planned tax cuts and quietly abandoned them, but that less than three months later it has now decided that it is fiscally responsible to spend $42 billion and seek authority for borrowing up to $200 billion. No explanation of this has been provided.

## THE GOVERNMENT'S ANALYSIS

Treasury's modelling of the stimulus package is a black box. We have no idea of the structure of the model, the data used or the results for GDP or employment for each of the ten policies in the plan. The figures that have been floated are unsupported by detailed analysis, appear fanciful and are inconsistent. The Government claimed that the $10.4 billion package will create about 75,000 jobs at an average cost of $139,000 per job; infrastructure package of $4.7 billion will create 32,000 jobs at a cost of $147,000 per job; COAG package of $15.1 billion will create 133,000 jobs at a cost of $114,000 per job. Yet, the $41.5 billion package will "support" up to 90,000 jobs over the next two years at an average cost of $461,000 per job or $230,500 per job per year. Coalition Senators note the change in language and Treasury's inability to account for this.

The $41.5 billion package has much lower job "support" than the $10.4 billion package. The result is curious as the second package has large infrastructure spending which Treasury tells us (Dr Gruen's evidence, 5 February 2009, p. 11) has a higher GDP multiplier (closer to 1) than transfer payments (closer to 0.5). No details have been supplied about exactly what are the estimated GDP and employment multipliers for each sector of the economy in the model of the ten components of the package.

It appears that the Nation Building and Jobs Plan was provided by the government to Treasury for modelling, rather than prepared by Treasury. And it appears that Treasury was not asked to model any alternative policies.

The Government has consistently stated that it wanted open, transparent and accountable government with evidence based policy. Yet in the case of the present package, the Government has failed to provide any accountability measures and has not provided any regulation impact statements to establish that the Bills will provide a net benefit to Australians and that the proposed measures are superior to any alternatives. The Government has also failed to provide any key performance indicators to assess the effectiveness and efficiency of the package.

## SIZE OF STIMULUS

The Government has not made available analysis of the size of the stimulus. This appears not to be readily available despite the Prime Minister's statement on the importance of co-ordination across countries.

According to page 71 of *the Economist* (31 January 2009), the weighted average stimulus of the G7 countries plus Brazil, Russian, India and China, was 3.6 per cent of GDP spread over several years. See table for the individual country details.

Australia has a bigger stimulus than these other countries which are in a significantly worse financial and economic state than Australia. (Australia's stimulus is about 6.4 per cent of GDP (and around 4 per cent for the $42 billion package) taking into account the $10.4 billion package, the $15 billion COAG package, the $4.7 billion infrastructure package and this $42 billion second stimulus package). 2

A smaller stimulus today would leave greater room for the future should a further stimulus be required.

Saul Eslake said that a large fiscal stimulus leading to high debt would mean higher taxes in the future. "It may well be that servicing or repaying the debt incurred now will ultimately require higher taxes" (Proof Hansard Monday 9 February 2009, page 37).

Dr Henry said in evidence to the Committee when asked about repaying the debt "it could also be achieved by asset sales" (Proof Hansard Monday 9 February 2009, page 40).

Professor McKibbin in evidence to the Committee argued that Australia's relative economic strength and the likelihood that the global economic slowdown may be sustained suggested that:

> "The current package is too large at this stage of the global economic slowdown. Given the circumstances in Australia, the package should be less than the 2 per cent of GDP average stimulus recommended by the IMF". (Submission)

## TIMING OF STIMULUS

In his address to Treasury staff on 14 March 2007, Dr Henry stated that "for macroeconomic purposes, it is probably reasonably safe to assume that we are already at full employment – or, at least, very close to the NAIRU, the non-accelerating inflation rate of unemployment". When Dr Henry made this statement, the unemployment rate was 4.6 per cent (February 2007, seasonally adjusted).

In evidence to this Committee, Dr Henry has said "we are not in a position of full employment… this is not a situation in which we are having a fiscal expansion with an economy already at full employment" (5 February 2009, p. 30). While Coalition Senators note that unemployment is a lagging indicator, no explanation was provided for the

[2] The Aggregate of stimulus packages announced by Kevin Rudd this financial year is $74.1 billion or 6.4 per cent of GDP when calculated the same way as the Economist table. That is, it is the total amount announced even though spread over several years divided by this year's GDP. Note also, that a larger stimulus by Australia cannot possibly increase world economic growth.

contradiction in his views nor was evidence provided that the unemployment rate is significantly higher than the Australian Bureau of Statistics' figure of 4.5 per cent.

In evidence to this committee, Dr Gruen said that in the Treasury's modelling, "the unemployment rate will return to the model's rate at which inflation is neither rising nor falling sometimes called the NAIRU" (5 February 2009, p. 42).

This is not an abstract point. If NAIRU is between 4.5 and 5 per cent, then there is a practical question of why we are undertaking such a massive fiscal policy intervention now. While the government wishes to pre-empt an increase in unemployment, on Treasury's analysis, it would seem prudent to wait. There are costs of acting precipitately. It will be a large diversion of productive resources into less productive uses for limited immediate benefit should conditions not deteriorate as much as some fear. Alternatively, it will leave the government less able to respond in the future should conditions dramatically worsen.

Professor McKibbon, in evidence to this committee noted that an economic downturn may persist for some time and that the economic and regulatory strengths of the Australian economy allow Australia to have a smaller response than other countries. The Coalition considers that there is, therefore, a very real concern that this stimulus package may be, as Henry Ergas puts it "too much, too early".

## COMPOSITION OF STIMULUS

As discussed above little consideration has been given to alternative policies and no justification has been provided for why the elements of the package have been chosen above alternatives.

### *Tax cuts*

Many leading economists conclude that tax cuts are preferable to spending increases.

*The Economist* (31 January 2009, page 71) table referred to above shows that all of the G7 and BRIC countries have tax cuts in their stimulus packages. The IMF's *World Economic Outlook* (October 2008, page 178) concludes that "revenue-based stimulus measures seem to be more effective in boosting real GDP than expenditure-based measures", especially in advanced economies like Australia's. The six-monthly Outlook is the most important regular statement of IMF policy and this conclusion is contained in a chapter examining in detail the evidence on fiscal policy as a countercyclical tool.

The Government has rejected the possibility of tax cuts which so many other countries consider superior to a handout only package. It has also rejected the considered advice of the IMF in favour of tax cuts over transfer payments (IMF, *World Economic Outlook,* October 2008).

Tax options raised by leading Australian economists include permanent measures such as bringing forward the already announced tax cuts scheduled for 2010 or introducing the aspirational income tax cuts. Temporary measures include a GST rate cut or payment holiday and a payroll tax holiday.

Payroll tax and GST can be changed quickly and implemented as quickly as spending increases, as can the Coalition's suggestion of some federal assistance to partially pay for the superannuation guarantee of small businesses.

Another reason to favour tax cuts as a significant part of the package is because tax cuts can be relied upon to increase the productive capacity in the longer-term and therefore they increase GDP growth. As the Treasurer himself noted in his Second Reading speech on the Tax Laws Amendment (Personal Income Tax Reduction) Bill to the House on 14 February 2008:

> "Economic modelling undertaken by the Treasury indicates the personal income tax reforms alone will lift aggregate labour supply by around 65,000 persons in the medium term. This increase in workers, together with the increase in the effort of existing workers, will make available around 2.5 million additional hours of work to the economy each week. These tax reforms will also enhance the incentives for taxpayers to upgrade their skills and gain higher qualifications by allowing workers to keep more of the wage gains that come with being more highly skilled and productive."

Professor McKibbon also noted in his testimony:

> "The main problem I see is in the cash payments. I would replace the intent of these payments by bringing forward the tax cuts that are already legislated for future years."

Poorly selected spending programmes, by contrast, will work in the opposite direction. Experience suggests that the private allocation of resources generates higher returns on average over the long-run.

## *Quality of projects*

Many economists have raised the concern that public spending on poorly chosen projects will not improve economic well-being.

The announcement of $21.4 billion in public expenditure on schools and public housing provides no serious explanation as to why these projects were chosen instead of the many other alternative public and private projects that could be undertaken.

Of course the Coalition believes in our schools and in housing, but are these the best investments to undertake with over $21 billion of public money and debt?

In evidence (5 February 2009, p. 18) Dr Henry states "a project which would make a substantial enhancement to the future supply capacity of the economy is a project that should be done anyway. And it should be done on top of these measures."

However, Coalition Senators endorse the view taken by many of the world's leading economists that such an approach is unnecessary and undesirable. All projects chosen as part of a stimulus package can and should be worth doing in their own right.

The Coalition finds it remarkable that the Government has been unable to identify worthwhile projects given that it says it has been thinking about Australia's infrastructure needs since it won office over a year ago.

Coalition Senators are also surprised that the Government does not appear to have estimates of the multipliers for individual components. Senator Joyce asked if this meant that spending $42 billion digging holes and filling them in again would result in the same stimulus as the 10 components actually chosen. Dr Gruen replied:

> "I guess the answer to that is that Keynes at some point made the point that the effect on aggregate demand would be the same if you dug holes and filled them in. It is actually a famous example. But to the extent that you can do something which has the same effect on jobs and you end up with something that is actually what society wants, that is clearly preferable to digging holes and filling them in." (Proof Hansard Monday 9 February 2009, page 57).

Coalition Senators are concerned about the shortcomings of the Government's analysis which is unable to distinguish the effectiveness of different programmes either in their short-term stimulus effects or their long-term effects on economic growth.

In regard to long-term effects on economic growth and employment, Treasury has confirmed that "in the long run we are not talking about saving jobs" (Proof Hansard, Thursday 5 February 2009, page 41). This is in contrast to statements from the Government which appear to suggest that the job creation effects of the package are both short and long-term. For example in UEFO (page 17), it states that the *Building prosperity for the future component* of the package will not only boost demand and increase employment over the next couple of years, but will also add "to the productive capacity of the economy in the longer-term".

Coalition Senators also noted that the component to encourage insulation in homes is inconsistent with the Government's own Carbon Pollution Reduction Scheme. The Treasurer's "Energy Efficient Homes Program" released on 3 February 2009 says:

> "Overall, it is estimated that these new measures could result in the abatement of 4.7 million tonnes of carbon dioxide equivalent (Mt CO2-e) per year from the end of the program, and total abatement of 49.4 Mt CO2-e by 2020."

However, the CPRS White Paper involves a reduction target of 5 per cent of emissions by 2020. The installation of insulation would reduce the price of permits to other emitters and not result in any additional carbon emissions reductions beyond the 5 per cent target. By reducing the permit price, the insulation scheme is an effective subsidy to high emitters.

## CONCLUSION

Australia has enjoyed a long period of strong economic growth, falling unemployment due in large measure to a long series of micro and macro-economic reforms. As a result, Australia is better prepared than other countries to withstand the economic downturn.

The Government has panicked and wants to rush through an extremely large fiscal package with inadequate analysis and scrutiny and without considering alternatives. In addition the Government has failed to demonstrate the effectiveness of its previous stimulus measures, especially with regard to its claims that the October 2008 package would create 75,000 jobs – a claim that has now been widely discredited.

**RECOMMENDATION**

Accordingly Coalition Senators recommend that the Senate reject this package and vote against the six Bills.

**Senator Mitch Fifield**
**Deputy Chair**

**Senator Scott Ryan**

**Senator Barnaby Joyce**

**Senator Eric Abetz**

**Senator Helen Coonan**

## APPENDIX

Coalition Senators firmly believe that some basic economic principles should be kept in mind when examining the efficacy of fiscal stimulus packages. A dollar of additional Government spending creates both benefits and costs. Weighing up those costs and benefits should always be done with a great amount of care, in order to obtain maximum "bang" for taxpayers' "buck". This is even more important when such large amounts of money are at stake and the size of the debt to be incurred by the public in this instance is so significant.

The basic economic principle of opportunity cost means that an additional dollar of Government spending must always draw resources away from alternative economic uses in the private sector. As Treasury Secretary Dr Ken Henry noted in his speech of 14 March 2007:

> "Expansionary fiscal policy tends to 'crowd out' private activity: it puts upward pressure on prices which, all things being equal, puts upward pressure on interest rates. Depending upon the size of the interest rate response, the nominal exchange rate might also appreciate, squeezing further resources out of the traded goods and services sectors of the economy. As a rather crude, but nevertheless instructive generalisation, there is no policy intervention available to Government, in these circumstances, that can generate higher national income without first expanding the nation's supply capacity. Policy actions that expand the nation's supply capacity target at least one of the 3Ps — population, participation or productivity – that we have been talking so much about in recent years.
>
> Now you might be thinking that that's all pretty obvious. It is, after all, a tautology. But one of my messages to you today is that if you understand what I have just been talking about, then you are a member of a rather small minority group. The political economy hasn't kept pace with the real economy."

The Department of Finance's *Handbook of Cost Benefit Analysis* makes a similar point at page 43:

> "(a) Employment multipliers
>
> The existence of unemployment sometimes leads analysts to augment the benefits from Government projects due to indirect effects of the project on employment and output. The reason given is that if labour which would otherwise be unemployed is used on a public project, the expenditures of the newly employed workers may raise employment and incomes in other sectors of the economy where labour and other factors of production would otherwise be involuntarily idle, and so on in a chain reaction.
>
> The problem with this approach is that any such multiplier effect could also be achieved by alternative uses of the project resources. Instead of undertaking the project, the Government could reduce taxation or increase expenditure, either of which could be expected to have an expansionary (though not necessarily similar)

> effect on income and employment. It should be remembered that cost-benefit analysis is always concerned with incremental costs and benefits, that is, with effects which would not have occurred in the absence of the project."

And on page 40 the handbook states that:

> "To say that a project will create 100 jobs is not to say that a project will reduce unemployment by 100 people. As a general rule, it is recommended that analysts assume that labour, as with other resources, is fully employed. Moreover, unless the project is specifically targetted towards the goal of reducing unemployment, it can be expected that many of the jobs will be filled by individuals who are currently employed but who are attracted either by the pay or by other attributes of the new positions. The research necessary to justify the use of shadow pricing of labour should include, therefore, the mix of unemployed and continuously employed persons in the additional employees."

Professor Kevin Murphy of the University of Chicago has recently developed these ideas further, proposing a simple analytical framework for assessing the proposed fiscal stimulus package in the United States.[3] He notes that a proper assessment of the benefit of an additional dollar of spending should take account of the extent to which worthwhile projects will be correctly identified and ranked by the Government, the extent to which the dollars that are spent will actually employ idle resources, the opportunity cost of those idle resources, and the efficiency cost of raising the tax revenue to fund the additional spending.

Professor Sinclair Davidson in his evidence to the Committee highlighted these concerns and the evidence from leading international economists. In particular he concludes "discretionary fiscal policy has a poor track record of success". In particular "Keynesian strategies are less likely to work in small open economies". Professor Davidson also reminded the Committee of the important role of independent monetary policy and the automatic stabilisers in fiscal policy.

Coalition Senators are not convinced that the Government has based its decisions on credible theoretical arguments or empirical evidence regarding any of these individual aspects of the fiscal stimulus package.

Coalition Senators were disappointed at the inability of the Government to precisely define what is meant by the concept of the "fiscal multiplier" and the complete lack of convincing empirical evidence regarding the sign and size of fiscal multipliers for Australia in general and for this set of measures in particular, both for the package as a whole and for individual policy proposals. In particular, there appeared to be some confusion as to whether the multiplier measured the change in aggregate demand brought about by a change in fiscal policy, or the change in GDP that is brought about (the latter is the accepted definition).

Coalition Senators were also disappointed that the Government did not consider the effect that talking down the economy would have on businesses and consumers, the reaction of the private sector to deficits and debt, and the role of business and consumer confidence would play in the economic recovery.

[3] See http://gsbmedia.chicagogsb.edu/GSBMediaSite/Viewer/?peid=439a24a984fa449a8833412955afac45

Coalition Senators were not convinced by the vague theoretical arguments putting forth the proposition that fiscal multipliers for spending were higher than for tax cuts, and were not presented with any compelling empirical evidence supporting this claim.

For their part Coalition Senators note that the fiscal policy decisions of the Coalition Government in the 1996-97 Budget – which involved policy decisions to significantly cut outlays in order to reduce the irresponsible budget deficits it had inherited, and to repay the previous Government's $96 billion debt – appear to have had exactly the opposite effect compared to these vague theoretical claims.

Table 3 below shows that in its 1996-97 Budget, the Coalition took policy decisions to reduce outlays by $12.9bn over three years, when the Australian economy was much smaller.

**Table 3: Reconciliation of Underlying Budget Balance Estimates**

| | 1995-96 $m | 1996-97 $m | 1997-98 $m | 1998-99 $m |
|---|---|---|---|---|
| **1995-96 Budget Underlying balance estimates(a)** | **-6747** | **-590** | **2690** | **8042** |
| **(per cent of GDP)** | **-1.4** | **-0.1** | **0.5** | **1.3** |
| **Changes between 1995-96 Budget and federal election** | | | | |
| Effect of policy measures(b) | | | | |
| Outlays *excluding* net advances | 231 | 552 | 614 | 616 |
| Revenue | -180 | -43 | -13 | 50 |
| Effect of parameter and other variations | | | | |
| Outlays *excluding* net advances | 415 | 2058 | 4176 | 4701 |
| Revenue | -1568 | -4371 | -5227 | -6055 |
| **Revised Underlying balance (12 March 1996)(a)(b)** | **-9141** | **-7614** | **-7340** | **-3280** |
| **(per cent of GDP)** | **1.9** | **-1.5** | **-1.3** | **-0.6** |
| **Changes between federal election and 1996-97 Budget** | | | | |
| Effect of parameter and other variations | | | | |
| Outlays *excluding* net advances | -163 | 1235 | 749 | 1061 |
| Revenue | -992 | -709 | -613 | -1073 |
| **1996-97 Budget Underlying balance (no policy change basis)** | **-9970** | **-9558** | **-8702** | **-5414** |
| **(per cent of GDP)** | **-2.1** | **-1.9** | **-1.6** | **-0.9** |
| Effect of policy measures | 347 | -3908 | -7152 | -6371 |
| Outlays *excluding* net advances | 347 | -2929 | -5197 | -4847 |
| Revenue | 0 | 979 | 1955 | 1524 |
| **1996-97 Budget Underlying balance estimate** | **-10317** | **-5649** | **-1548** | **957** |
| **(per cent of GDP)** | **-2.1** | **-1.1** | **-0.3** | **0.2** |

(a) Adjusted for reclassifications.
(b) Estimates of the revised underlying balance as at 12 March 1996 vary slightly from those in the Treasurer's press release of 12 March 1996. This reflects movements in the estimates of decisions taken before the federal election as well as reclassifications.

What was the fiscal multiplier associated with this tightening? The Australian economy grew by 3.9 per cent in the year to June 1997, by 4.5 per cent in the year to June 1998, and by 5.2 per cent in the year to June 1999. Unemployment fell from 8.2 per cent in June 1997 to 6.7 per cent in June 1999.[4] The evidence from this episode seems to suggest that the fiscal multiplier for spending is negative in Australia and does not seem to be consistent with the vague theoretical claims that were presented to the committee.

This kind of empirical evidence is neither unique nor new. Thirty years ago Professors Robert Lucas (Nobel Laureate) and Thomas Sargent wrote that:

> "In the present decade, the United States has undergone its first major depression since the 1930s, to the accompaniment of inflation rates in excess of 10 per cent per annum. These events have been transmitted (by the consent of the governments involved) to other advanced countries and in many cases have been amplified. These events did not arise out of some reactionary reversion to outmoded "classical" principles of tight money and balanced budgets. On the contrary, they were accompanied by massive government budget deficits and high rates of monetary expansion, policies which, although bearing an admitted risk of inflation, promised according to modern Keynesian doctrine rapid real growth and low rates of unemployment.
>
> That these predictions were wildly incorrect and that the doctrine on which they were based is fundamentally flawed are now simple matters of fact, involving no novelties in economic theory. The task now facing contemporary students of the business cycle is to sort through the wreckage, determining which features of that remarkable event called the Keynesian Revolution can be salvaged and put to good use and which others must be discarded". [5]

More recent empirical evidence can also be found. A 2005 empirical study by Professors Andrew Mountford and Harald Uhlig entitled "What are the Effects of Fiscal Policy Shocks?" found that:

- "a surprise deficit-financed tax cut is the best fiscal policy to stimulate the economy
- a deficit-financed government spending shock weakly stimulates the economy
- Government spending shocks crowd out both residential and non-residential investment without causing interest rates to rise." [6]

Professors Christina Romer and David Romer of the University of California at Berkeley find that the fiscal multiplier for a tax cut is 3, a much larger value than most estimates of spending multipliers.[7]

---

[4] GDP growth data is from Table 1, *Australian System of National Accounts, 2007-08*, ABS Cat. No. 5204.0. Unemployment data is seasonally adjusted in is taken from Table 2, *Labour Force, Australia, Spreadsheets*, ABS Cat. No. 6202.0.55.001.

[5] Lucas, R. and Sargent. T. (1979) "After Keynesian Macroeconomics," Federal Reserve Bank of Minneapolis Quarterly Review, Spring. http://www.minneapolisfed.org/research/QR/QR321.pdf

[6] http://sfb649.wiwi.hu-berlin.de/papers/pdf/SFB649DP2005-039.pdf

[7] http://www.econ.berkeley.edu/~cromer/RomerDraft307.pdf