

Testimony to the Standing Committee on Finance and Public Administration on the Inquiry into the National Building and Jobs Plan Bills.

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The comments that I wish to make today about the Nation Building and Jobs Plan Bills, I make in my capacity as a Professor of Economics at the Australian National University and an expert on the global economy and macroeconomic policy. Although I am a member of the Board of the Reserve Bank of Australia, nothing I say should be attributed to the other members of the Board nor the management of the Reserve Bank of Australia. These are my own personal views.

I'm going to divide my comments into several parts. Firstly in commenting on the Bills being considered, we need to have a view on the nature of the shock facing the Australian economy. This is important, because the policy response should be determined by the nature of the shock. Secondly, given we have some view of the nature of the shock, the question is - Is this package of measures of the appropriate size? Thirdly, since different types of fiscal spending and tax changes can have very different consequences, is the composition of the package of policies appropriate for the problem that is being addressed?

The Nature of the Shock Facing Australia

The world economy is currently faced with a severe economic contraction. The source of this contraction is a financial crisis in the United States and United Kingdom triggered by problems in housing markets, particularly in the nature of housing mortgages, but spread by regulatory failures in the financial systems of these countries. These financial problems have occurred and have been compounded by persistent global macroeconomic imbalances between economies. In addition to the national financial crises which spread to the global financial system, there has been a significant loss of financial wealth through share market declines and housing market weakness as well as a loss of confidence by corporations and

households globally. The result of which has been a substantial reduction in global demand.

Due to the strength on the Australian financial system, Australia does not yet have a domestic financial crisis, but it does face a substantial reduction in the demand for Australian exports and a substantial decline in the wealth of Australian citizens. The external demand shock is similar to the problem we faced in the 1997/98 Asian financial crisis, but the current shock is of a larger magnitude. In recent months, there has also been a substantial decline in both producer and consumer confidence. This loss of confidence has been partly caused by a continuous stream of bad news from overseas, falling share markets at home as well as unhelpful domestic commentary on the crisis.

The policy responses for Australia have to be carefully considered and are likely to be different in detail to the responses undertaken in the United States and United Kingdom where domestic financial crisis are also impacting on these economies.

As was the case during the Asian crisis, the decline in external demand has partly been addressed by a substantial depreciation of the Australian currency. This depreciation, although reducing domestic income, does enable domestic production to continue and hence assist in maintaining employment in traded industries. There has also been a substantial relaxation of monetary policy on which I do not intend to comment further. Together with the substantial decline in oil prices, there has yet to be a substantial decline in the after tax income of many working Australians although self funded retirees are bearing the brunt of the income consequences from the reduction in wealth.

The decline in spending and investment is mostly related to the loss of confidence. The response of fiscal policy should be to: 1) assist in restoring confidence in the economy; 2) to maintain demand to the extent possible; 3) and if possible to put in place the long run capacity required when the global economic slowdown has passed. Although the short-term decline in demand from the global crisis is a cloud rapidly approaching, the opportunities to put in place additional long-term capacity is at least a silver lining – an

opportunity that should not be squandered. It must be stressed that although fiscal policy can offset, to some extent, a loss in domestic and foreign demand it is unlikely that it can completely eliminate the impacts of the global financial crisis on the Australian economy because the wealth effects are real. However it has an important role to play in dampening the effects.

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. 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.

The size of the package.

It is difficult to know exactly how large a fiscal stimulus package should be given the unusual nature of the external shock facing the Australian economy. The IMF suggests a fiscal stimulus of 2% of GDP, on average for the world economy. As the Deputy Prime Minister has pointed out in her speech to the World Economic Forum in Davos, Australia is very well placed to withstand the shock which is currently emanating from the world economy. This is a result of a combination of the reforms of the Hawke-Keating governments, as well as the regulatory reforms of the Howard Costello government. In addition a long period of prudent fiscal policy has put Australia in a very advantageous fiscal position to respond to external shock. This suggests that the scale of the Australian response should be less than the world average. Secondly, it is likely if this is a sustained global economic slowdown as many commentators have suggested, Australia will need to have the capacity to implement additional fiscal stimulus over the coming year. My view, therefore is 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% of GDP average stimulus recommended by the IMF.

The composition of the package.

It is critical to note that the composition of fiscal policy is very important. For example, a dollar of government spending has more stimulus in the short run, than direct cash payments to individuals or tax reductions, because a dollar of spending impacts directly on the economy, whereas a dollar of tax cut or cash payment will be partly spent and partly saved by household. To the extent that the payment is saved, this will reduce the short run demand impact. A dollar spent on infrastructure is a short run demand stimulus, as well as providing the required capacity in the economy to respond on the supply side once the economic slowdown has passed. A dollar of investment in education and health also gives a much larger return in terms of economic potential of sustained improvements in the quality of life in the Australian economy. A tax reduction for households stimulates demand in the short run to the extent that that tax reduction is spent. An income tax change not only provides a short run demand stimulus, but also changes the incentives to work, which can produce a positive long run supply response because it changes incentives. A cash payment to the extent that it is not saved only has the potential to temporarily stimulate demand and has no long-run benefits to the economy.

It is important to stress that the problem with the current shock to confidence is that the more people are worried about the state of the economy, the more they are likely to save rather than spend any additional income. It is therefore problematic to have such a large part of the stimulus package, made up of cash payments to people rather than direct spending and rather than investing that money in future capacity building for the overall economy.

Much of the stimulus package, as outlined in the proposed legislation, is well targeted to infrastructure spending, investment incentives, capital projects and investment in education. 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.

An additional policy response that should be considered is to temporarily reduce the GST by 50% to be returned to its original level at a date in the future. This would give a powerful incentive to bring consumption spending from the future to the present year. The GST should then be increased just as the bulk of the infrastructure spending is having its largest impact early in 2010. In addition, further income tax cuts could be adjusted to coincide with the increase in the GST to minimize the demand effects of raising the GST in the future.

The overall response.

My own personal view is that this package would be better focused and of a more suitable size if the transfer payments to individuals was eliminated from the Bills. This additional funding could then be used for further fiscal stimulus if required over the next six to 12 months. The remainder of the package could stay in place and still be a substantial stimulus of the order recommended by the International Monetary Fund adjusted by where Australia sits relative to the average economy in the world.

I would also encourage Australian politicians to continually reinforce the fact, well argued by the Deputy Prime Minister in Davos, that the Australian economy is well positioned to respond to the global economic crisis. As far as the data for Australia is concerned we do not face the severity of the problems being experienced in the United States and United Kingdom. It is true that there are some parts of the Australian economy where people are hurting. Policy interventions should be well targeted to assist these people over time.

In conclusion I support much of the policy changes contained in the bills but I strongly feel the cash transfers should be eliminated and tax changes legislated for future years should be bought forward into the current year for further stimulus at low cost. In order to get the maximum effectiveness from these bills in terms of confidence building, all sides of politics should be united in finding the solutions to the policy challenges that Australia faces over coming years.

Thank you for your attention.