Remarks to the Senate Finance and Public Administration Committee

Inquiry into the Nation Building and Jobs Plan

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Presentation to the Inquiry into the Nation Building and Jobs Plan Bills

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Given the short period of time that I have to speak to the Senate, I begin by presenting my conclusions on the package and then discuss the reasons behind my views and also present some alternative policy prescriptions that, in my opinion, would better serve the objectives of the proposed package.

Recommendations

In summary, it is my view that the Senate should reject the fiscal stimulus package in its current format.

- The package contains a lot of spending and little actual stimulus.
- The proposed spending is poor quality expenditure of Federal funding.
- Discretionary fiscal policy has a poor track record of success.
- While the government needs to respond to the current economic downturn in a timely manner, there is no urgent need to rush the package. Rather, a better quality package should be designed and implemented.

What should be done?

- Government policy should establish conditions whereby living standards can improve.
- Fiscal policy should be prudent and conservative. That implies balanced budgets, and low taxes.
- Public debt should be used sparingly, if at all.
- Government should target Ken Henry's 3Ps when making policy. Participation, Productivity and Population.
- Government should also consider Glenn Stevens' advice – a good project last year is probably still a good project, whereas a bad project last year remains a bad project now. 'Shovel ready' is not now, nor has it ever been, an appropriate criteria for public spending.

To the extent that the federal government wishes to pursue an activist fiscal policy it should target tax cuts. In particular, the federal government should consider payroll tax relief and a GST holiday. In both instances the federal government would have to

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compensate the States and Territories. (Alternatively, the federal government could reinstate the aspirational tax cuts promised at the last election.)

- The federal government should buy out the payroll tax liability that firms bear.
    - This reduces an existing tax on employment.
    - This reduces disincentives to reemploy workers when the economy recovers.
    - This temporarily stabilises the finances of State and Territory governments during the crisis. It is they who are primarily responsible for education and health expenditure.
    - This policy is not as expensive as it may first sound:
        - Individuals who keep their jobs continue to pay income tax.
        - Individuals who keep their jobs do not receive unemployment benefits.
    - It is important to remember that the payroll tax is regressive – this policy would benefit low-income earners more than high income earners.
- The GST holiday would consist of leaving the GST rate unchanged at 10 percent, but not requiring firms to pay the GST revenue to the ATO for a period of, say, one quarter.
    - This has the effect of temporarily increasing the profitability of firms but not distorting prices (in the long run the GST amount would be competed away, but this would reduce the tax wedge between consumers and firms leading to increased activity).
    - It also leaves the GST rate unchanged and does not necessitate further rate rises in the future.
    - This would allow some firms to lower their prices by the GST rate, if they chose.
    - This policy could be adopted in conjunction with the payroll tax cut, or as a substitute for those firms not liable for payroll tax.

Objections to the Proposed Policy

1. Spending Multipliers are Low.

Fiscal stimulus can be defined as the situation where government borrows money and then spends it, with the expectation that the debt will be repaid out of future tax receipts.

Whether or not fiscal policy can be used to stimulate the economy revolves around the size of so-called multipliers. The multiplier is the ratio of GDP generated by the stimulus to the expenditure of the stimulus. Multipliers can be thought of as being 'bang for buck'.

Professor Gregory Mankiw of Harvard University, former Chairman of the Council of Economic Advisors to President George W. Bush and leading economics textbook writer has compared the size of the multiplier for spending increases relative to the size of the multiplier for tax cuts in the United States. Writing in the New York Times he summarised the empirical evidence for spending versus tax cuts, and finds that tax cuts have a far greater bang for buck.[1]

It is important to note that there is a discrepancy between theory and empirical evidence. In theory, the impact of spending should be greater than tax cuts. In practice, however, careful economic studies find that tax cuts have bigger bang for buck. In fact, the tax cut multiplier is twice the size of the spending multiplier.

- Professor Valerie A. Ramey, at the University of California, San Diego estimates that each dollar of government spending increases GDP by $1.4.[2]
- Christina D. Romer – now Chairman of the Council of Economic Advisors to President Barrack Obama – and David H. Romer, at the University of California, Berkeley, estimates that a dollar of tax cuts raises GDP by $3.[3]

Professor Mankiw – a new-Keynesian economist and author of one of the leading economics textbooks – summarises his argument as follows:[4]

> Do not be intellectually bound by the textbook Keynesian model. Be prepared to recognize that the world is vastly more complicated than the one we describe in [Economics 101]. In particular, empirical studies that do not impose the restrictions of Keynesian theory suggest that you might get more bang for the buck with tax cuts than spending hikes.

[1] http://tinyurl.com/cj5zdl
[2] http://econ.ucsd.edu/~vramey/research/IdentifyingGovt.pdf
[3] http://www.econ.berkeley.edu/~cromer/RomerDraft307.pdf
[4] http://gregmankiw.blogspot.com/2008/12/spending-and-tax-multipliers.html

The Federal Government proposes a lot of spending and no tax cuts in its Fiscal Stimulus package. Based on empirical work, as opposed to theoretical expectations, the stimulus effects will be low. Furthermore, based on the arguments by Michael Knox, in last Thursday's *Australian Financial Review*, 'Rudd pays top dollar to buy time', the multiplier in the Fiscal Stimulus package will be even lower than usual.[5]

Professor John H. Cochrane, of the University of Chicago, has summarised the argument for stimulus spending as follows:[6]

> The classic argument for fiscal stimulus presumes that the central cause of our current economic problems is this: We, the people and our government, are not doing nearly enough borrowing and spending on consumer goods. The government must step in force us all to borrow and spend more. This diagnosis is tragically comic once said aloud.

It is easy to 'Australianise' this comment, 'Australians have not been borrowing and spending enough on alcohol, pokies and tobacco and there are not nearly enough plasma televisions around. The government should borrow and spend more to ensure that more consumer spending occurs'. I invite Senators to read that statement out loud and wonder whether it sounds plausible or responsible. The fundamental problem with a lot of spending stimulus packages is that it consists of government spending a dollar, any dollar, on any project.

Professor Robert Barro of Harvard University has undertaken some empirical studies of the long run effects of government consumption and investment on economic growth. Barro (1991) finds that the ratio of real government consumption expenditures to real GDP had a negative association with investment and economic growth, and that there is no statistically significant evidence of a positive relationship between public investment and economic growth.

Barro and Sala-i-Martin (2003) find a similar negative relationship between non-defence, non-capital educational government consumption and real per capita GDP growth.

Barro, R. (1991) "Economic Growth in a Cross Section of Countries," Quarterly Journal of Economics, 106(2): 402-443.

Barro, R. and Sala-i-Martin, X. (2003) Economic Growth, Second Edition, Cambridge, MA: MIT Press.

[5] Michael Knox, 'Rudd pays top dollar to buy time', *Australian Financial Review*, Thursday 5 February 2009, pg. 63.
[6] http://faculty.chicagobooth.edu/john.cochrane/research/Papers/fiscal2.htm

In an article in the *Australian Financial Review* ("IMF favours spending over tax cuts as fuel for Growth", Monday 9 February 2008, pg. 4), the IMF is reported as having indicated that 'Spending measures are likely to be more effective' than tax cuts 'particularly if they are not targeted to credit-constrained consumers'. Comments like this seem to indicate that spending multipliers are likely to be higher than tax multipliers. This view contradicts the evidence I have referred to above. To investigate this anomaly, I tracked down the IMF documentation and also the sources the IMF refers to as evidence for their argument.

1. The publication that the *Australian Financial Review* refers to reports that multipliers were used in the IMF analysis but do not report individual country multipliers. Here the spending multipliers are greater than the tax multipliers.[7]

2. The IMF document in turn refers to two other IMF publications.[8,9] Neither of these publications provides numerical estimates for either spending or tax multipliers, but they do refer to an unpublished 2004 paper by Professor Roberto Perotti (updated in 2006).[10]

3. The Perotti paper does estimate government consumption and government investment multipliers for 5 OECD economies including Australia. It does not calculate tax multipliers. The important point to note, however, is that the Australian multipliers tend to be low relative to the other 4 economies (Canada, Germany, UK and US).

4. The IMF analysis therefore is not based on empirical evidence, but rather on theoretical grounds.

2. What does work?

Andrew Mountford, of the University of London, and Harald Uhlig, of the University of Chicago, have just had a working paper published by the prestigious National Bureau of Economic Research (NBER) that analyses three types of policy scenario:

1. a deficit financed spending increase,
2. a balanced budget spending increase, and
3. a deficit financed tax cut.

In their analysis they find that deficit financed tax cuts have the greatest stimulatory effect – although they emphasise that they do not necessarily endorse these types of cuts. They also find that tax multipliers are much higher than spending multipliers.

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[7] http://www.imf.org/external/np/g20/pdf/020509.pdf
[8] http://www.imf.org/external/pubs/ft/weo/2008/02/index.htm
[9] http://www.imf.org/external/pubs/ft/spn/2008/spn0801.pdf
[10] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=637190

In particular they find the deficit spending multipliers are higher than tax multipliers in the first quarter only. Over time the tax multiplier has a maximum value of 5.33 while the maximum value of the spending multiplier is 0.65. Further, they find that the spending multipliers are insignificant after two years.[11]

3. When Stimuli do Work.

Professor Kevin M. Murphy, of the University of Chicago, has set out a simple analysis of when a stimulus will add value.[12] Stimuli are likely to work when the economic value of the output from the stimulus is greater than the costs of the inputs and deadweight losses.

- The economic returns of federal investment in school halls etc. are likely to be low.
    - This makes very little, if any, contribution to productivity, participation or population.
    - This is primarily expenditure that should occur at the local level. This expenditure rewards State and Territory governments for past neglect of school infrastructure needs and re-enforces perverse incentives.
    - It is possible that a properly designed scheme could see federal funding that augments local community and State funding, but this should not be primarily funded at federal level.
- The economic returns of home insulation are likely to be low.
    - Are there really under-utilised resources in the home insulation sector?
    - Are the skills developed in this sector generic or specific? What will happen to workers after all homes have been insulated?
    - How will this policy interact with the Climate Change Policy?
        - To the extent that this policy is useful and valuable, an open question, it is better that it be considered as part of the Climate Change policy.
- The economic returns to a $950 hand-out based on having been a taxpayer in 2007-08 are likely to be low.
    - This is a retrospective tax refund that cannot lead people to change their behaviour – i.e. it has no incentive effects.
    - Consequently, this money has no impact on productivity, participation or population.

[11] http://www.nber.org/papers/w14551
[12] http://faculty.chicagobooth.edu/brian.barry/igm/Evaluating_the_fiscal_stimulus.pdf

Rather than undertake low value adding investment and expenditure, the government – if it really wants to invest in infrastructure – should consider assets that will contribute to greater economic growth as the economy recovers and consequently become (partially) self-financing.

- While the economic benefits of the Fiscal Package are low, the costs are likely to be high.
    - The project choices are rushed and more likely to be less efficient.
    - The objective to spend more money faster is likely to lead to poor project choice.
    - Public sector spending tends to be less efficient than private spending anyway.
- The Fiscal Stimulus is funded by public debt.
    - Public debt is associated with intergenerational burdens.
    - Public debt has a history of rising very rapidly to high levels.
    - Public debt is associated with irresponsible fiscal behaviour.
    - Public debt implies that future taxes will be higher than they otherwise would have been.

4. Other Objections.

- The government is not doing nothing!
    - The RBA, an operationally independent arm of government, has lowered rates by 4 percent over six months.
    - The 'automatic stabilisers' are operating to put money into the economy already.
- Spending versus saving is a false dichotomy.
- Keynesian strategies are less likely to work in small, open economies.
- Economists tend to over-estimate the benefits of fiscal policy.

5. Further Inquiry

It also needs to be pointed out that Australia has just experienced a catastrophic failure in economic policy making. While the root causes of the current economic crises are non-Australian, nonetheless both the Treasury and the Reserve Bank of Australia failed to anticipate the impact of the crisis which commenced in mid-2007. The government has already spent $10.4 billion in a previous stimulus package and now proposes to spend an additional $42 billion. An inquiry into how and why the official economic government agencies failed to warn or forecast the local impact of the crisis needs to be undertaken.