Five reasons why a Rudd fiscal stimulus may not work

AUSTRALIA entered the global economic crisis well placed but our fiscal position is deteriorating more rapidly than in comparable economies. This is due to policy decisions since the May budget, which will erode the projected bottom line by $29 billion in 2008-09.

The international comparisons are telling. According to the International Monetary Fund, average fiscal balances in advanced economies are set to deteriorate by 2.1 per cent of gross domestic product. In contrast, Australia's fiscal balance will deteriorate by 3.6 per cent of GDP.

Moreover, expenditure on the RuddBank and disbursements from the Building Australia Fund seem to have been excluded from the updated budget estimates, so the actual deterioration will be even greater, easily exceeding any previous peacetime fiscal expansion in Australia's history.

Kevin Rudd says the enormous change in the fiscal position is justified by the need to stave off recession. But there are five reasons for questioning that claim.

First, it is far from clear activist fiscal policy will be effective.

Australia is a small, open economy with a flexible exchange rate. There is consequently a real possibility that any increase in demand caused by fiscal easing will merely raise interest rates, induce capital inflow from abroad, appreciate the currency and reduce net exports.

With growth in China and Japan slowing significantly, why implement measures that could exacerbate Australia's expected export downturn?

In the Keynesian framework, monetary policy, on the other hand, is actually more effective in an open economy. A monetary policy-induced reduction in interest rates boosts aggregate demand and induces capital outflow, leading to a depreciation of the exchange rate and a reduction inimports.

As a result, even if we take the Keynesian approach seriously, fiscal stimulus may not only be ineffective, but by impeding or slowing further reductions in interest rates may stand in the way of a more effective response. As Treasury concluded in 2002, "higher budget deficits (or lower surpluses) can have a significant effect on interest rates in Australia", with the result that the "automatic stabilisers are likely to be relatively more effective than discretionary changes in policy". The federal Government must explain why those findings no longer apply.

Second, even if discretionary fiscal policy were effective, the proposed package appears to be too much, too soon. Unemployment is projected to remain fairly close to the non-accelerating inflation rate of unemployment (the rate that is sustainable in the long run) in the near term. Given the scale of the proposed spending, there is surely a risk that the Government is

depleting its ammunition and accumulating future costs before the case for doing so is well-established.

Were the economic outlook to worsen, what room for manoeuvre would be left? With the tragedy in Victoria adding to the pressures on public expenditure, wouldn't a more cautious approach, such as that adopted in Canada (which is more exposed to the US downturn than we are), make sense?

Third, even if the package did create jobs, many of these would merely be displaced from more productive activities. As Treasury secretary Ken Henry said in March 2007, when the unemployment rate was the same as it is today, "in an economy operating at, or close to, full employment, any government intervention will shift resources, including jobs, from one activity to another and impose a deadweight loss of efficiency on the economy". He went on to say that "expansionary fiscal policy tends to crowd out private activity" by putting "upward pressure on interest rates", so "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".

Even in an economy that is weakening, the scale of the Rudd fiscal expansion means it must primarily involve job displacement: for every job saved or created, many will be shifted from more productive alternatives.

How great those displacement effects have been to date, how great they are expected to be in future, and with what costs, are matters simply ignored in the Government's announcement.

Fourth, when governments spend money on projects whose costs exceed their benefits, they make us poorer. The future tax burden associated with deficit spending is then all the more painful, as it needs to be paid for from a smaller income base.

But there seems little reason to expect the spending commitments envisaged in the stimulus package to yield net benefits.

There is, for example, ample evidence that the states do as poor a job of allocating maintenance expenditure on existing infrastructure as they do in selecting new infrastructure. But the Government, while proposing to throw cash at infrastructure maintenance, does not appear to be imposing any requirement for a credible cost-benefit test to be met.

The other spending commitments are no better targeted.

Finally, the package lacks a credible strategy for returning to budget balance. All spending must be paid for and the increased taxes associated with budget deficits inevitably distort economic activity and reduce welfare. Moreover, the expectation of future deficits may have immediate, adverse consequences for confidence and output. However, the Government's announcement merely sets a vague commitment to return to surplus through future reductions in spending growth. It does not say how great the cuts in spending will need to be or where those cuts will be made, and it ignores the obvious point that if there is wasteful spending that can be cut tomorrow, it ought to be cut today.

That so many vital questions remain unanswered highlights the inadequacy of the documentation that accompanied the stimulus package, including the absence of any details

on what would happen without the spending, the impacts of individual programs and comparisons with alternative options.

This is in striking contrast to the US, where the Congressional Budget Office last week released an independent, detailed assessment of the new administration's stimulus package, as well as of alternative proposals. That assessment concluded the administration's package would have positive near-term macroeconomic effects, but the increase in public debt would reduce output and welfare in the long run.

In other words, there were trade-offs that politicians and the public had a right to assess in determining the course for the country.

Australians too have every right to be aware of the choices that underpin, and the consequences that are likely to flow from, the Government's package. Parliamentary scrutiny of spending decisions is fundamental to democracy. With so many important questions unanswered, the Senate should insist on doing its job, and on having the time to do it well.

Henry Ergas is chairman of Concept Economics