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**DAVIDSON, Professor Sinclair, RMIT University and Institute of Public Affairs**

*Evidence was taken via teleconference—*

**CHAIR**—We will resume proceedings. Welcome, Professor Sinclair Davidson. Would you like to make an opening statement?

**Prof. Davidson**—Thank you, and I apologise for the change in plan.

**CHAIR**—I understand that, and we apologise to you for the inconvenience.

**Prof. Davidson**—You should have before you a 29-page document which sets out a submission. It contains a number of different bits and pieces and studies, which I have undertaken in the last while with my colleague, Ashton de Silva, also of RMIT University, to have a look at the impact that the stimulus package is actually having on the economy. Before I talk through the document, if I could just remind the Senate what I said in February of this year when I was speaking to the inquiry into the stimulus package before it was undertaken—certainly the second stimulus package—I made a number of points. The first point I made was that there was a lot of spending and little actual stimulus and the second point was that this was very poor quality expenditure of taxpayer funding and that fiscal policy has a very poor track record. I think nothing has happened since February to cause me to revise my opinion, and as a matter of fact if we think that the majority of OECD economies have all undertaken massive stimulus packages and, with the exception of Australia, have tended to go into recession, I think we can add this incident to the continued poor track record of fiscal policy timing the economy.

The other point that I made was that this particular stimulus package, or certainly the \$42 billion stimulus package, consisted of a great deal of government spending a dollar, any dollar, on any project. Of course we realise that there are going to be teething problems in any particular project but I think the almost daily revelations of extraordinary waste, which the *Australian* has been very good at highlighting, simply goes far beyond teething problems. We have actually seen a very poorly implemented policy of a substantial amount of taxpayer money that has basically, to a large extent I believe, been wasted.

Then to the current inquiry, I have to say that the argument that the stimulus package has worked on face value appears to be extraordinarily powerful. Australia is the only OECD economy that we have data for that has not officially entered into recession. If you have a look in my submission at figure 1 on page 5, we actually see a graph of the size of the stimulus packages that have been unveiled across several economies and then the GDP growth to the June quarter of this particular year.

There we see that there is a single economy that has done particularly well, and that is the Australian economy, with positive growth. All the other economies have got large negative growth. If we look at that diagram, we see that there are about seven economies that have stimulus packages in excess of three per cent of their 2008 GDP. So, if people want to argue that the Australian stimulus package has prevented the Australian economy from going into recession, they would also need to explain why those other economies with similar sized

stimulus packages to ours have not gone into recession. So I think we need to look beyond the stimulus package and to look at other things that could possibly have contributed to the Australian growth which we have seen over the last year or so.

I want to jump over whether this is the greatest crisis since the Great Depression—it certainly is not the greatest crisis since the Great Depression in Australia's sake—and have a look at some of the other arguments that have been made to suggest that the stimulus package has been successful. The argument that we heard a lot of quite early on was that retail sales in Australia had held up very nicely and this was due to the government's first stimulus package in December of last year where they spent \$10 billion, of which about \$8 billion went in cash handouts. Of the second stimulus package, about \$12 billion went in cash handouts. So, all up, we have had about \$20 billion in cash handouts. A lot of people argued that the benefit of a cash stimulus was that the money would be quickly spent and we would see the numbers coming through in retail sales.

Unfortunately, the ABS stopped publishing their trend data in November last year. But if we have a look at the figures, we see that the retail sales figures do appear to be quite high. An analysis undertaken by Tony Meer of Deutsche Bank—and reported at Peter Martin's blog and then in the *Age*—tends to suggest that retail sales were far in excess of what we might otherwise have thought. But Ashton and I have undertaken an analysis of the retail sales, and our argument is that, simply by extending the ABS trend data—which they stopped doing in November last year—and putting in another very commonly used trend figure, retail sales trends are not unusual at the moment and retail sales are at about trend. So the argument that retail sales are unusually high and this is due to the government's stimulus package cannot be sustained on that particular type of analysis.

But the other thing that we did—which is a far more powerful test, I suggest to you—is that we undertook a forecasting exercise and we imagined that we were back in May 2008. If you recall, in May 2008, everybody was suggesting that the Australian economy was doing very well. The Reserve Bank were raising rates, they had a tightening policy and people were talking about decoupling and all that sort of stuff. So everybody in May 2008 suggested that the economy was going very, very well. So, if we had stood in May 2008 and tried to forecast retail sales out into the future, what would we have found? If you look at our figure 6 on page 12, you will see the results of that particular exercise. The black line represents actual retail sales, the dotted green line represents our forecast and the red lines represent the upper and lower 95 percentile figures. You will see that, by and large, the actual retail sales is within a 95 per cent confidence band of what we would have expected in May last year—which again suggests to us that retail sales are not that unusually different from what they might otherwise have been if we could forecast this from almost over a year ago.

The other alternate argument is that the government so finely calibrated its stimulus package that it returned sales to what they otherwise might have been. That is an argument but, given the exchange between Senator Joyce and Dr Gruen on 22 October in the *Hansard*, I suggest that is not the case. Senator Joyce asked if there had been any formal modelling undertaken of the stimulus package and Dr Gruen indicated that there had been no modelling. So, to the extent that the stimulus package has actually returned sales to where they would have been, that would be a pure luck argument, and certainly Ashton and I do not believe that to be the case at all.

We have also had a look at unemployment. The argument has been made that if it were not for the stimulus package, unemployment would have gone through the roof. There seems to be a powerful argument for this case. In May of this year the government was forecasting an 8.5 per cent unemployment rate by the end of the financial year and at the moment we are 'only' at 5.8 per cent, which is a level last seen in October 2003, so it would appear that we have done a lot better. But, if we have a look at the overall OECD report, unemployment has not actually risen very much across the entire OECD. There are a couple of standout economies—the United States, Canada and Spain, for example, have all had massive increases in unemployment—but, if you look at figure 7 on page 14 of my submission, you will find that in most of the OECD unemployment has obviously increased, and that is not a sign of success; nonetheless, it has not increased that much. But unemployment has increased quite a lot in Australia compared to other OECD economies, so it is a bit hard to point to the unemployment figure as being an indicator of success.

The other thing that we have done is plotted the size of the stimulus package against the increase in the unemployment rate, and we see that Australia has a very large stimulus package but a very underforecast increase in the unemployment rate. If you look at figure 8 of our analysis, you will see that it would seem that there is a lot more to the performance of the Australian economy than the stimulus package. In recent weeks a variable called 'hours worked' has been considered. If you look at figure 9, which has been shown around the traps quite substantially, you will see that hours worked do seem to have peaked in the middle of 2008 and fallen quite substantially over the last two-year period. Ashton and I plotted that entire time series from July 1985 through to August of this year and put a very simple linear time trend through that number. We found that over the last few years the hours worked has been above trend and over the last year or so has simply reverted back to trend. There is nothing unusual in that to suggest that unemployment would have gone through the roof, that hours worked would have massively exploded or anything along those lines, so again it does not appear that the stimulus package—certainly when we look at unemployment and retail sales—has worked as was advertised.

At the time when the spending packages were announced there was a bit of a debate over whether the packages would be saved or spent. This is quite important because at the time the policy advocates were saying that, if you gave a lot of money to liquidity-constrained individuals, they would very quickly spend the money and this would get money moving through the economy—and the goal of the policy was for money to be spent very quickly. A number of US studies have been done—and there is also now an Australian study by Professor Leigh, who I understand you spoke to this morning—and in these particular studies it looks as if a fair amount of the money was actually spent—it was normally about 40 per cent or so—but that the vast bulk of the money tended to be saved in one form or another. In his study, Professor Leigh found that about 40½ per cent of the money was spent and about 59½ per cent of the money was actually saved. This is in line with US studies, and we know that the stimulus packages in the United States have failed, so we would anticipate that the Australian study would indicate that we had failed as well and that the money was not in fact spent; it was mostly saved. If you have a look at the Australian Bureau of Statistics data at figure 11 on page 20 of my submission, you will see that household final consumption expenditure has tended to trend upwards in a nice smooth line and household disposable income shows a bit of a kink in it where the stimulus package money was received. But there is no corresponding kink in the consumption figure, so basically the money has not really been spent; it has mostly tended to be

saved, which is what we would have expected to have happened if we had some sort of real income hypothesis going along. That is much the same result as you find in the United States.

Finally, on the studies we have done: we have got access to the Oxford economic forecasting model, and we are the only Australian university to have access to this forecasting model. What we have done is to audit the budget assumptions. There was a lot of talk around about May when the budget came down that the government was forecasting too high a GDP rate and was forecasting too quick a decrease in the unemployment rate. So we have relaxed the very unrealistically high assumptions that we believe that the Treasury and the government have made in their modelling and had a look to see what happens to federal debt if we relax those two assumptions. On figure 12 on page 21, we show a historical figure which indicates the net debt of the Commonwealth since 1970 and up until the present, and then forecast out three or four years. We also have the underlying budget cash balance.

If you have a look at the net debt position, you see that net debt very quickly spikes up on a number of occasions but it tends to come down quite slowly. The Commonwealth went into a positive net debt position in the mid-1970s and only returned back to a negative net debt position in the mid-2000s. So for all that period the Commonwealth actually had a positive net debt position.

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. Again, if we have a look at the budget figures, we see when the budget balance goes into deficit we see a slow recovery from deficit positions. We do not actually see very quick recovery. The historical evidence, we need to suggest, is that the economy recovers slowly from deficit and debt is actually quite difficult to eradicate in total.

I will jump over some of the gory details, but if we have a look at figure 13 on page 23, the government is forecasting that the economy will start growing at 4½ per cent very soon. What we have done there is to actually tabulate annual growth rates in GDP, and we show those instances where the economy has actually grown at more than 4½ per cent or at 4½ per cent, and what we find in recent history is that this is actually quite a rare occurrence. Even if you believe that there is such a thing as the mining boom or the China boom, or whatever you want to call it—which Ashton and I do not believe—even during the so-called unsustainable boom period of the 2000s, the economy was not growing at 4½ per cent. So it is very unlikely that it could do so again.

The government are also forecasting a massive decline in unemployment over the next budget period. In figure 14 we show historical data as to how slowly unemployment declines from peaks. We have all heard the term ‘jobless recovery’ and that term actually exists for good reason. The economy recovers far exceeding the decline in the rate of unemployment. We have actually calculated more plausible decreases in the unemployment rate and, over the government’s forecast period, they suggest that unemployment will be down to 6.5 per cent. We say, ‘If your history is any guide, it would actually be only 7.4 per cent. Luckily, unemployment has not reached that level just yet. Nonetheless, we are auditing the budget papers and we throw the government’s numbers into the Oxford economics model and we solve the equations. If you look on page 28, figure 16, you will see that over the period to 2012-13, we believe that there

will be nearly \$40 billion more net debt than the government has actually indicated in their budget papers, using the far more realistic approaches to how fast the economy would grow and how quickly unemployment would decline—which are contained in the budget papers, which are the most up-to-date official forecasts we have of the economy right now. This indicates that net debt per capita, or debt per capita, would not be about \$8,500, which the budget papers suggest but would be over \$10,000 per Australian. On the current budget settings, the government would actually incur a great deal more debt than they have indicated in the budget papers.

This then brings us to two very important issues. One is the argument that this is the greatest crisis since the Great Depression. That is extraordinarily misleading, especially in the case of Australia. Unemployment during the Great Depression in Australia for trade union members rose to about 29 per cent. Unemployment in Australia today is 5.8 per cent. To be sure, 5.8 per cent is unacceptably high, but it is nowhere near the 29 per cent figure that we experienced in the 1930s. Similarly, the Australian economy fell, GDP fell, for several years from the late 1920s all the way through to the early 1930s, whereas, over the current crisis, we have had one quarter of negative growth—again, nowhere near the kind of economic turbulence which we might have expected. And it is almost the case in the United States that it is not the greatest crisis that they have faced since the Great Depression—that is only true if you exclude the economic downturn in the late 1940s. So it is a fine piece of rhetoric but it is simply not at all economically accurate.

Finally, why has the Australian economy performed well compared to many of the other economies? The first thing to bear in mind is that the subprime crisis and the financial crisis have affected Australia from the outside. Our financial institutions are basically very sound. We have had a deregulated labour market for a while. Over the last 20 years labour markets have been steadily deregulating. We have had a deregulated financial market. So the exchange rates took a hit. The stock exchange took a hit. People reorganised their labour market conditions. The Reserve Bank of Australia lowered interest rates by 4¼ per cent very quickly. So our economic institutions of civil society, the market mechanisms, the government mechanisms, all of these mechanisms, actually worked very well to cushion the Australian economy, and they worked in precisely the way they are supposed to have worked.

So we have done well because we have had 25 years of hard-earned, hard-fought-for economic reforms, and that has cushioned us from the external shock to the economy. This is what economic reform is supposed to deliver. And I want to really emphasise that we have not done well through good luck. We have not done well through China. We have not done well through the mining boom. We have done well through our own efforts to improve our economy and to liberalise our economic conditions. So why we are doing well has nothing to do with factors external to the economy. It is certainly not the government's stimulus package and it is not good luck that we have done well.

**CHAIR**—Thank you very much. We will now open the meeting up to questions to you from the senators, beginning with Senator Brown who made this reference.

**Senator BOB BROWN**—Thank you, Professor. You said at the outset that the massive stimulus package has been common to OECD nations and yet they have all, except Australia, gone into recession.

**Prof. Davidson**—Yes.

**Senator BOB BROWN**—Isn't it the other way around—that they were all headed into recession and therefore they had a massive stimulus package?

**Prof. Davidson**—The stimulus package was actually designed to prevent the recession from occurring. So, yes, they realised there was economic trouble and they instituted these massive stimulus packages, and the stimulus packages have failed to prevent recession.

**Senator BOB BROWN**—And you can titrate that to say that, without the stimulus package, the recession would have been the same—it would not have been any worse; the economies would have been affected in the same way?

**Prof. Davidson**—I would probably titrate it to say that, over time, if it were not for those stimulus packages those economies would perform better in the long run.

**Senator BOB BROWN**—Yes, but we are looking at the impact in the short run here as well.

**Prof. Davidson**—In the short run I would certainly say that those stimulus packages have done nothing to prevent those economies from going into recession. That was the policy objective and, if so, that policy objective has failed.

**Senator BOB BROWN**—In Australia's case, the performance of the Chinese economy has done nothing as well, you say?

**Prof. Davidson**—No, I would not say that the performance of the Chinese economy has done nothing. I would say that, if we had not had entrepreneurial foresight, if we had not had people who had put in, who had prospected, who had put in mines, who had ventured their capital in order to sell stuff to the Chinese, we would not have prospered at all. So it is not through luck that we have prospered by selling to the Chinese. You cannot fatten the pig on market day. You actually have to prepare, work, invest and take risks.

**Senator BOB BROWN**—But you have to have a market as well, don't you?

**Prof. Davidson**—Yes.

**Senator BOB BROWN**—You point out that it is not the greatest crisis—there was a deeper one in the early 1940s—since the Great Depression. I just want to hear this again. You say that the stimulus packages around the world have not had an impact on lessening that crisis?

**Prof. Davidson**—Yes. We need to be clear: the world economy is facing a crisis. The stimulus packages have done nothing to eliminate those crises.

**Senator BOB BROWN**—Thank you, Professor.

**CHAIR**—Professor, I would like to ask you a question about the Chinese issue. Surely the fact that, whether we like it or not or whether it was due to entrepreneurship in the past or not, the Chinese economy picked up and they began to buy large amounts of iron ore again, and coal,

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I presume, must have made a contribution to our balance of payments in terms of trade and cushioned Australia somewhat through the difficulties the world was experiencing and which we were as well.

**Prof. Davidson**—Having our trading partners perform well is always good for the Australian economy. But I think to make the argument that the Australian economy is now one of the world's wealthiest economies and that our economy is doing well simply because one of our trading partners is doing well is not entirely convincing. The Japanese are, I think, still bigger trading partners for us than the Chinese. The Americans are still bigger trading partners than the Chinese. I think to 'blame' or to attribute everything that has happened to the Chinese economy is simply not giving sufficient credit to the entrepreneurial behaviour of Australians and, of course, to the economic reform that Australian governments have undertaken over the last generation.

**CHAIR**—We do respect the entrepreneurial spirit of Australians and we do respect the reforms that were put in place; nevertheless, I would have thought that—regardless of the fact that the Chinese have a large trade largely in manufactured goods with the United States, I think, and with other places—the fact that they have continued to buy our minerals did provide some balance and assistance to the Australian economy.

I see that the IPA is of the view that tax cuts might have been a more effective way of dealing with the crisis, such as it was. Would you explain that point of view to the committee?

**Prof. Davidson**—First of all, I want to say that the IPA has no formal views on any issue.

**CHAIR**—My apologies—Alex Robson, then. I notice in one of your documents you refer to that.

**Prof. Davidson**—Yes. At the February Senate inquiry into the implementation of the stimulus package I made two arguments. The first was that, if the government wished to actually stimulate the economy, and to prevent unemployment from rising and all those good things, they would buy out the payroll tax of the state governments. My view was that state governments are very financially fragile because the Commonwealth has taken all the best taxes for itself and that the state governments, which provide the bulk of services to the Australian people, would actually be quite hard hit by the crisis. So buying out the payroll tax would have the effect of giving money to the state governments and at the same time taking out a disincentive to employment for employers.

Combined with that, I made the argument that there should be a GST tax holiday, whereby corporations could continue to either administer the GST and keep the 10 per cent, which would flow straight down to their bottom line, or, conversely, lower their prices by 10 per cent. I suggested that could even be targeted at people who do not actually get the payroll tax cut.

The empirical evidence suggests that tax cuts have a bigger impact on the economy than do government spending initiatives. Economic theory suggests, of course, that government spending would have a bigger impact than tax cuts. But, as we now know, economic theory does not always work as well as economic experience. The empirical evidence suggests that tax cuts

would have been far more valuable from a stimulus perspective than would have other spending. My suggestion at the time was that this be aimed at the payroll tax and at the GST.

**CHAIR**—Thank you. We all agree that payroll tax is very pernicious, but your colleague Alex Robson put forward a proposition about income taxes.

**Prof. Davidson**—Yes, last week he put forward the proposition that instead of the government borrowing and spending the money, if they had had a tax cut of—I think he worked it out to be about \$96 billion that the government has spent one way or the other, and that that money would be better given as a tax cut. At the margin, a tax cut would be better than a spending initiative. Bear in mind, however, that those tax cuts would be just as unfunded as would the spending, but nonetheless it would allow individuals to spend the money in better ways than those in which the government would spend the money.

**Senator HURLEY**—It does seem to me that you have started with a proposition that business and the market will manage things better than the government, and have organised your statistics to prove that. For example, where you were talking about the aggregate monthly hours and how they are simply returning to trend, you say that that proves that government spending has had no effect on unemployment, and yet you go on later in the paper to say that unemployment should go up to 7.4 per cent, so we have not yet finished with this. Whether the government is right or whether you are right on unemployment, we have not yet finished with an assessment of how monthly hours worked goes back to trend or not.

**Prof. Davidson**—First of all, it is not just my opinion that markets work better than governments. It is bitter experience of the 20th century. We know full well that governments fail—

**Senator HURLEY**—I do not want to get into this theoretical argument.

**Prof. Davidson**—Yes, I understand. My statistics all come from the Australian Bureau of Statistics. Those hours worked are their numbers, and all I have done is apply the time trend. The 7.4 per cent that you refer to is when I am actually auditing the government's budget papers. If you have a look in the submission, I make the argument that we are not providing our own forecast of the economy. On page 20 it says:

In this section it is important to note that we are not providing a macroeconomic forecast of the Australian economy, we are auditing the underlying assumptions in the Budget Papers.

So what we have done—

**Senator HURLEY**—So do you or don't you agree that unemployment may not have finished trending one way or the other?

**Prof. Davidson**—It may or may not have. It all really depends on the government's fair choices legislation because when you re-regulate the labour market, we expect unemployment to increase. I would have thought any increases in unemployment are simply the government's delivering on an election promise from the last election.

**Senator HURLEY**—That just confirms my view that you are starting from an ideological viewpoint and looking for ways to put statistics in a way that confirms that.

**Prof. Davidson**—You are entitled to your opinion, Senator, but I am just an economist and I am telling you what would happen if government follows particular strategies.

**Senator HURLEY**—Right. You were talking about how the past 25 years of hard won economic reform have put us in the position where we are, rather than the government's stimulus package. I would say that a part of that economic reform in the last 25 years has included, apart from the Howard government years, a steep increase in productivity in Australia.

**Prof. Davidson**—Yes, I have would totally—

**Senator HURLEY**—I would also say that a lot of what is included, clearly not the cash part of the stimulus but the infrastructure parts, will contribute to that productivity in the future and therefore set us up again.

**Prof. Davidson**—No, I totally disagree with the argument there. Certainly the school halls seem to be the most extraordinary waste of money that we have ever seen in our lifetimes. The *Australian* reported that \$850,000, I recall from memory, was being spent on a single-pupil school and nobody thought to think why would we even think about giving this kind of money to a single-pupil school let alone actually give such an amount of money to a single-pupil school. And in today's *Australian* we read that they are spending \$2.45 million on a school hall for a school that already has a hall, which will give it an extra 30 square metres of space, but nonetheless most of the kids will still have to stand outside. I cannot believe for one second that this is productivity enhancing expenditure.

**Senator HURLEY**—If you had been at Senate question time, you would have heard many of the articles in the *Australian* comprehensively taken apart and proved to be wrong. But even if we accept that, the examples in the *Australian* have been a small part of what is being spent in the stimulus. I do not really think you can—

**Prof. Davidson**—You may well be right, it may be a small part, but it is the tip of the iceberg.

**Senator HURLEY**—I do not think, Professor Davidson, that you could argue that the infrastructure spending on education and transport and health that the government has done will not contribute to productivity in some way.

**Prof. Davidson**—I would be very surprised if a primary school hall where kids have already got one, discounted back to the present at any reasonable discount rate, would add to the productivity.

**Senator HURLEY**—If that is the best argument you can raise about the total infrastructure spending, Professor Davidson, I will hand over to someone else.

**CHAIR**—Before I hand over to Senator Ryan, I just want to say that in my remarks I said that the American trade with China was largely in manufactured goods. Of course that trade has collapsed because the Americans and Europeans are not buying.

**Prof. Davidson**—If I can just add to that: value added for mining in Australia is less than 10 per cent of GDP. It is not a big number.

**CHAIR**—It is very nice to have it, though.

**Prof. Davidson**—It is better than nothing.

**Senator RYAN**—You mentioned in your answers to a couple of previous questions the issue of the increase in government debt, and I just wanted to explore that for an issue. We heard this morning from Dr Kates and Professor Leigh that one of the things that should be taken into account is the cost to the economy, deadweight or otherwise, of the increased taxation necessary to pay for either the servicing of the debt or the repayment of the debt given that all of this has been funded by borrowed money. Do you have a view on whether or not that should have been considered in the development of this package?

**Prof. Davidson**—Yes, it very much should have been. Professor Kevin Murphy of Chicago university has set out a very nice model. He says in order for a stimulus package to work, you have to consider the benefits of the stimulus spending compared to the deadweight losses of the taxation and the inefficiency of government spending. As I indicated before, and with my exchange with Senator Hurley, the government spending has been extraordinarily inefficient and the deadweight costs of additional taxation can be quite high. People estimate between 20 and 80 per cent for a deadweight cost, so it can be very high. And you would anticipate that that would be included into any cost-benefit analysis undertaken of the spending.

**Senator RYAN**—And so it is therefore a fair conclusion to draw that due to the increased burden of taxation that will be necessary in the future, compared to what would have been the case without this package, that there will be a medium- or long-term cost to the economy—

**Prof. Davidson**—Yes, absolutely.

**Senator RYAN**—as a direct result of the borrowing used to fund this package?

**Prof. Davidson**—The costs will occur in a number of ways. First of all, increased mortgage rates on all Australians. Even the OECD have come out and said for the Australian level of net debt, even if we just believe the government's numbers, that should add about a quarter of a per cent to our borrowing costs in future. Then of course there is the fact that government debt crowds out personal investment and private investment. So we would see a distortion in the economy away from the future and towards the present, which would mean that we will probably be underconsuming in the present and underinvesting into the future. All of this is due, in large part, to the effect of government debt. Government debt has a very, very deleterious impact on the economy.

**Senator RYAN**—That brings me to the point: comparing the way Australia has dealt with this particular global challenge with the so-called Asian crisis of the late 1990s and the US recession of the early part of this decade, would you consider the fact that Australia's budgetary position was in a strengthening phase—our debt position was falling at that time—along with other factors, was instrumental in Australia weathering those particular downturns without suffering a notable economic downturn itself?

**Prof. Davidson**—I think, for the present, that the fact that Australia went into the current crisis with no debt and with a strong budget surplus has been an important part of weathering the storm. As to the weathering of the storm in 1998—at that time we had a budget deficit and we had a lot of government debt—the impact in Australia was quite well cushioned by the exchange rate and the fact that the monetary authority did not increase interest rates like the New Zealand monetary authority did. It was the consequence of reforms taken by the Hawke government that was instrumental in the East-Asian crisis. In the early part of this century, to a large extent, it was because we were perceived to be an old economy; we were not a dotcom economy. The monetary authorities lowered interest rates very quickly but then, very importantly, raised interest rates again once it was clear that the crisis had passed. So it was Australia's reform processes working, and we have seen that again this time.

**Senator RYAN**—Do you consider that the approach underpinning this package and the package itself represents a seismic or otherwise significant shift in the way Australia has managed its economic policy since those reforms you mentioned of the early- and mid-1980s, where there was a focus on reducing government debt, trying to get to a budget surplus or a smaller deficit and increasing the business profit share of the economy?

**Prof. Davidson**—Yes. It is my opinion that the underlying logic of this current stimulus package is certainly a backward step, not only for Australia but for many other economies around the world. Professor Buchanan, who was a Nobel Prize winner in 1986, has made the argument that democracies have an inherent bias towards debt and deficit, and I had hoped that Australia had moved beyond that. Nonetheless, 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.

**Senator RYAN**—Regarding your audit of the government's budget assumptions and estimates, which I think was a topic back in the earlier hearings into the stimulus in February, the issue of the projected 4.5 per cent growth, or the very rapid return to above-trend growth, was discussed. That is substantially above our historic average of growth, isn't it?

**Prof. Davidson**—Yes. That is above our historic average and it is certainly not something that we have experienced much of since the 1960s. There have been four episodes since the Hawke government came along. It is not at all plausible to believe that we would maintain rates of growth above 4½ per cent, especially when our trading partners are in deep recession and are going to recover slowly.

**Senator RYAN**—Would it be fair to say that, given the debates of the middle of this decade, where growth numbers beginning with three were considered to be inflationary and leading to skills shortages, which some of us considered to be a good thing because there was low unemployment, that a sustained growth rate of 4.5 per cent would pose serious inflationary threats?

**Prof. Davidson**—It would depend on other policies that government were actually operating. It might do but I would have thought that the Reserve Bank would quite strongly keep a lid on inflationary expectations. It might do but I cannot be totally sure. It would depend on what else was happening in the economy.

**Senator RYAN**—We heard earlier today that this package has a potential inflationary aspect to it. Do you have a view on that statement?

**Prof. Davidson**—I would have thought, given the qualitative easing which may have occurred and given the fact that the Reserve Bank may have compromised the quality of its balance sheet, that there may well be inflation down the track. I think the ball is very much in the Reserve Bank's court. If it will accommodate the amount of spending which the government has undertaken and is continuing to undertake then inflation can arise out of all of this. My hope is that it will not, but of course getting rid of that inflation in the system would imply higher interest rates.

**Senator RYAN**—Do you see there being a risk from interest rates rising at the same time as aspects of this stimulus package are being rolled out—for example, over the next 24 or 36 months—where there seem to be expectations in the market and otherwise that interest rates will start to tighten in the second half of this year? This stimulus package will keep stimulating, allegedly, over the next 18 to 24 months.

**Prof. Davidson**—There is always a problem when you have monetary policy and fiscal policy out of whack with each other. You get horrendous inconsistencies that do need to be managed very carefully. I would have thought that, if the economy is doing well, the stimulus package would need to be wound back.

**Senator RYAN**—What are some of the consequences of interest rates and monetary policy being tightened if a stimulus package is not wound back?

**Prof. Davidson**—I would have thought we will start seeing various distortions in the economy. Employment would be attracted to those areas of the economy where the stimulus package is operating—construction, education, health and these sorts of things, where at the moment there is no unemployment—and would be allocated away from those areas of the economy where inflation would be hitting hard. As the stimulus package unwinds, of course, all those people who have now trained up in these areas would be left with superfluous human capital and would be unable to move back. It would lead to overinvestment in some sectors of the economy and underinvestment in other sectors of the economy.

The way to think about this is to pour a jar of honey onto the table. You will see a mound of honey will develop where it is poured onto the table. When you switch off the pouring of the honey, that mound falls down. Those are resources being spread out throughout the economy. So the economy can actually be quite sticky and difficult to operate. It certainly cannot be easily manipulated, as the stimulus package seems to imply.

**Senator COONAN**—Following on from something you said to Senator Ryan, does it follow from your analysis that, if the rate of unemployment is not due to the success of the stimulus package, similarly winding it back would not send unemployment through the roof—if you could wind it back?

**Prof. Davidson**—No, I do not think that unemployment would go through the roof if the stimulus package were wound back. I do not know that it can be wound back. There are all sorts

of issues about changing laws that have been passed. But I am not convinced that unemployment would shoot through the roof if the stimulus package were wound back.

**Senator COONAN**—I am just going to put a figure to you. If, for example, you could wind back \$20 billion that has not yet been expended, would that find your support?

**Prof. Davidson**—I think less government spending would always find my support.

**Senator CAMERON**—Professor Davidson, you are an academic economist. Is that correct?

**Prof. Davidson**—That is correct.

**Senator CAMERON**—You have never worked in industry?

**Prof. Davidson**—No, that is not correct.

**Senator CAMERON**—I am just asking the question.

**Prof. Davidson**—I have worked.

**Senator CAMERON**—As an economist?

**Prof. Davidson**—No.

**Senator CAMERON**—So all your economic analysis is based on an academic point of view and not what happens out there in real life in the economy?

**Prof. Davidson**—I do not understand your point.

**Senator CAMERON**—You have never actually advised a company or the Treasury; you have simply been an academic economist.

**Prof. Davidson**—Yes. That is one way of looking at it.

**Senator CAMERON**—In terms of this issue you raised earlier about modelling and the stimulus package, did you raise any concerns when the previous Prime Minister, John Howard, decided to invest \$10.4 billion in the Murray-Darling Basin without going to cabinet or Treasury?

**Prof. Davidson**—I do not know the former Prime Minister.

**Senator CAMERON**—John Howard.

**Prof. Davidson**—No. I have never met him. Why would I raise a concern with him?

**Senator CAMERON**—I am not saying personally with him; I am saying in terms of the political and economic outcomes of a decision like that.

**Prof. Davidson**—No, I did not, because I have no interest in water economics.

**Senator CAMERON**—So you have no interest in water economics.

**Prof. Davidson**—No, and I did not have the Oxford Economics model available to me at that time.

**Senator CAMERON**—So a \$10.4 billion investment in the economy did not attract any of your attention at that time, even when that investment did not go to cabinet or to the Treasury.

**Prof. Davidson**—Similarly I have not complained about the \$43 billion National Broadband Network, because I do not actually know anything about broadband either. So it is really a case of saying things where I can make a contribution beyond, ‘Gee, that’s a lot of money.’

**Senator CAMERON**—Let us see what contribution you have made here.

**CHAIR**—Commendable.

**Senator CAMERON**—Sorry?

**CHAIR**—I just made a comment.

**Senator CAMERON**—What was that? To me?

**CHAIR**—No, to the witness. I said ‘commendable’.

**Senator CAMERON**—Let us see where that commendable contribution leads us. Professor Davidson, why are you at complete odds with the IMF, the World Bank, the OECD and the treasuries of major advanced economies? Why have you got it so different from the bulk of economic thinking—and some of those economists would not be labelled Keynesians by any stretch of the imagination.

**Prof. Davidson**—The difference between my view and that of the IMF, the OECD and the World Bank and what have you is that last February I said the stimulus packages were a terrible idea and were not going to work, and they have not actually worked. Those economists all said, ‘Spend billions of taxpayers’ dollars on stimulating the economy to prevent recessions,’ and they have failed. They now have to say something.

**Senator CAMERON**—So the IMF are just saying something, and all of their analysis is wrong. Is that what you are putting to this inquiry?

**Prof. Davidson**—No, I am suggesting to you that I do not agree with the analysis of those multinational organisations. The very important thing to remember about the OECD, the IMF, the World Bank and what have you is that those organisations are not Australian taxpayers. They are not going to be paying for the consequences of all this reckless spending, unlike my good self, who is an Australian taxpayer. So I have a far more vested interest in making sure that my advice is right, as opposed to them.

**Senator CAMERON**—But Ben Bernanke and other senior economists are indicating that all of the debt is manageable. Particularly, the IMF has indicated that Australia's debt is eminently manageable.

**Prof. Davidson**—Australia's debt relative to, say, the United States or Japan's level of debt is manageable. It is not a question of whether or not we can manage to pay off money that has been wisely invested. It is whether or not we want to pay off money that has been irresponsibly invested. We need to think about what value we are getting for our dollar that has been spent. I put it to you that we have not got good value for that money.

**Senator CAMERON**—What about some of the infrastructure projects that form part of the package?

**Prof. Davidson**—Name them.

**Senator CAMERON**—The Ipswich Motorway.

**Prof. Davidson**—The government's job is to build roads anyway. I would have thought that is a state government responsibility.

**Senator CAMERON**—Are you seriously putting to this inquiry that the federal government should play no role in investing in the nation's road infrastructure?

**Prof. Davidson**—I am putting it to you that if you wanted to build roads that you would give the money to the states and allow the state governments to make decisions as to what roads they wish to build.

**Senator CAMERON**—That is an interesting point of view!

**Prof. Davidson**—We have a constitution that actually has states that make decisions about these things. You do represent the states, don't you?

**Senator CAMERON**—I am here to ask the questions, not you.

**Prof. Davidson**—Actually, I am a taxpayer. I will ask questions too.

**Senator CAMERON**—You will not ask me any questions. I will be asking the questions, thanks very much. We are investing about \$884 million in the Ipswich Motorway. I do not know if you have ever travelled on the Ipswich Motorway between Brisbane and Ipswich and been caught in a traffic jam there. If that is improved, isn't that an improvement to the long-term productivity of the country?

**Prof. Davidson**—It may well be. It raises the question, though, of why we do not have a toll road.

**Senator CAMERON**—Are you saying we should have a user-pays system?

**Prof. Davidson**—I am saying, have they actually compared a toll road to a government financed extension?

**Senator CAMERON**—So we should have a toll road in Ipswich. Should we also have a toll road on the Pacific Highway, where the government is investing \$618 million on improvements?

**Prof. Davidson**—Having a tollway is one of the options which should be considered.

**Senator CAMERON**—What about the Pacific Highway?

**Prof. Davidson**—I drove down the Pacific Highway just yesterday. It seemed a fine stretch of road to me.

**Senator CAMERON**—It depends what time you were on it and what you were doing.

**Prof. Davidson**—It was at rush hour actually. The road changes from four lanes to two lanes very quickly and slows the traffic down. I am well aware of these problems, but you need to consider what the best option is for infrastructure spending. You simply say, ‘Well we are going to expand a road.’ For what purpose? Why? When? What alternatives were considered? What did the local government think of putting in money? There are a whole range of issues. You cannot simply say: ‘We have got a bucket of money and we are going to toss it at the economy. This is good because we are tossing it at something called infrastructure.’

**Senator CAMERON**—Professor Sinclair Davidson, you are not simply an economist, you are a big-time political player through the IPA. I have had a look at some of your comments over a long period of time in the IPA and they are not simply economic points of view, they are strong partisan political points of view. You come here with a strong partisan political history, don’t you?

**CHAIR**—You must not impugn the witness, Senator Cameron.

**Prof. Davidson**—Senator, I find the suggestion you have made most appalling. I am an economist and I am a person who has opinions. I am a taxpayer. I am entitled to have opinions. To suggest that I am somehow a partisan is very strange. I am a free-market economist.

**Senator CAMERON**—And you are a partisan against any government intervention in the economy.

**Prof. Davidson**—Most government intervention in the economy is not for the good.

**Senator CAMERON**—In your writings for the IPA, have you ever written anything positive about the government since it has been elected?

**Prof. Davidson**—Do you mean the current government?

**Senator CAMERON**—Yes.

**Prof. Davidson**—Not that I can recall.

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**Senator CAMERON**—So the government has done nothing positive since it has been elected to power?

**Prof. Davidson**—I would not say that is true at all. The government has appointed Mr Beazley to the ambassadorship in the United States. I thought that was magnificent.

**Senator CAMERON**—Is that an economic issue?

**Prof. Davidson**—I do not know. You asked me whether the government had made a positive contribution.

**Senator CAMERON**—I thought you were here to talk about economics.

**Prof. Davidson**—You asked me, Senator, and I answered your question. You need to be more specific.

**Senator CAMERON**—Do you believe the government has made any positive economic decisions since it has come to power?

**Prof. Davidson**—Yes. The government delivered on the tax cuts that were promised by the Howard government.

**Senator CAMERON**—Is there anything else?

**Prof. Davidson**—The government scrapped the Fuelwatch scheme.

**Senator CAMERON**—Is there anything else?

**Prof. Davidson**—The government scrapped the GroceryWatch scheme.

**Senator CAMERON**—So these are big economic issues for you. You do not care about a \$10.4 billion investment that did not go to cabinet but you can talk about Fuelwatch and GroceryWatch. Is that where you are at?

**CHAIR**—Senator Cameron, that is not a fair question.

**Senator CAMERON**—Of course it is a fair question. He raised the issue.

**CHAIR**—He has dealt with the issues. He has already told you that he is not interested in water. Be fair to this witness, Senator Cameron.

**Senator CAMERON**—The witness raised these issues. I have been absolutely fair to the witness. The witness is biased, but that is a problem for the witness.

**CHAIR**—He has a point of view and you do too, Senator Cameron.

**Senator CAMERON**—It is a biased point of view.

**CHAIR**—He might regard you as extremely biased.

**Senator CAMERON**—Where does Australia rank internationally in terms of government debt?

**Prof. Davidson**—Quite low.

**Senator CAMERON**—Do you believe we should go into more debt to underpin 210,000 jobs?

**Prof. Davidson**—I reject the premise that going into debt is going to protect 210,000 jobs.

**Senator CAMERON**—That is the Treasury projection in the budget papers.

**Prof. Davidson**—Yes, I have already audited the Treasury projections—

**Senator CAMERON**—So the Treasury has got it wrong. The IMF has got it wrong. The OECD has got it wrong. Every progressive economist around the world that supports governments intervening in this global financial crisis have got it wrong—except the IPA and Professor Sinclair Davidson. Is that the case?

**Prof. Davidson**—No, that is not true at all actually. You would find that there were a large number of economists that signed a petition for the Cato Institute in the United States, including five Nobel Prize Winners, criticising their stimulus package. So I think the argument that I am alone in the world in criticising stimulus packages is simply false.

**Senator CAMERON**—So the Governor of the Reserve Bank has got it wrong—are you saying that?

**Prof. Davidson**—No, the Reserve Bank did a fine job in lowering interest rates from 7¼ per cent to three per cent.

**Senator CAMERON**—That is not what I am asking you. When the governor says that the stimulus package should not be pulled back too quickly, has he got it wrong?

**Prof. Davidson**—The governor is a government employee.

**Senator CAMERON**—I am asking you whether he has got it wrong.

**Prof. Davidson**—Yes, I disagree with him on that point.

**Senator CAMERON**—So the governor has got it wrong. What about the Secretary of the Treasury—has he got it wrong as well?

**Prof. Davidson**—I disagree with him as well, yes.

**Senator CAMERON**—What about the ACCI business—have they got it wrong when they say, ‘Keep the stimulus package in place. It has helped create jobs.’ Have business got it wrong?

**Prof. Davidson**—Business are getting money from the government for nothing.

**Senator CAMERON**—That is not what I am asking you. I am asking you whether they have got it wrong.

**Prof. Davidson**—I suggest that they are acting in their own best interests.

**Senator CAMERON**—So have they got it wrong?

**Prof. Davidson**—They are acting in their own best interests.

**Senator CAMERON**—Have they got it wrong? I am simply asking you the question.

**Prof. Davidson**—No, they are acting in their own best interest.

**Senator CAMERON**—No, they have not got it wrong. So when they say that it is good to have the economic stimulus package in place, they are correct, are they?

**Prof. Davidson**—In the same way as Mr Connor Simpson from Freshwater in Queensland got it right because he was going to spend his stimulus money on Cover Girls. Business are taking money from the government for nothing—and good on them—but nonetheless, that does not make it good economic policy.

**Senator CAMERON**—So is it your position that the government should have done nothing—

**Prof. Davidson**—No, the government should have bailed out—

**Senator CAMERON**—Would you let me finish my question?

**Prof. Davidson**—Yes, carry on.

**Senator CAMERON**—Don’t be so excited. It does not do an economist good to get excited.

*Members of the committee interjecting*

**Senator CAMERON**—No, I do not get excited. In terms of the stimulus package, if you are wrong and you are an isolated opinion and the Treasury is right, the IMF is right and the OECD is right that we are protecting jobs, and the Treasury got it right in that it is 210,000 jobs, isn’t it better for us to continue with that package to ensure that there are no jobs lost and we do not have dislocation for individuals, dislocation for families and dislocation for communities? Isn’t this the correct thing to do?

**Prof. Davidson**—If all of those people are right and I am wrong, then we have already seen the impact of the stimulus package.

**Senator CAMERON**—Which has been good.

**Prof. Davidson**—Allegedly.

**Senator CAMERON**—The figures from the OECD—their analysis—the figures from Treasury, the figures from business, all say that the package is working well and should not go away.

**Prof. Davidson**—The figures from the OECD suggest that it is only working in Australia. They need to then explain why it has not worked in the other 29 economies.

**Senator CAMERON**—Let's have a look at one of these the economies. Let us have a look at the United States. You argued that labour market flexibility was one of the factors.

**Prof. Davidson**—Yes, one of the many factors.

**Senator CAMERON**—An important factor?

**Prof. Davidson**—Yes.

**Senator CAMERON**—What about the labour market flexibility in the United States?

**Prof. Davidson**—There is a big difference between the United States and Australia in this instance. The crisis actually originated in the United States; the crisis did not originate in Australia.

**Senator CAMERON**—But we are in a global economy. China relies on the US for its exports and China relies on us for its imports of coal and iron ore. It is a cycle that we are locked into and you cannot simply say that it is a US problem, because it is a global problem, isn't it?

**Prof. Davidson**—No, the subprime crisis very specifically originated in the United States.

**Senator CAMERON**—But that crisis created problems around the world, didn't it?

**Prof. Davidson**—To lesser degrees and, in the case of Australia, our labour market flexibility was a good outcome for us. That does not mean that if we had a home-grown crisis that it would have been, but in response to an external shock, it has been.

**CHAIR**—Senator Cameron, we will have to stop now. We have gone a long way over.

**Prof. Davidson**—Thank you, I have enjoyed our conversation.

**CHAIR**—Thank you, Professor.