



# Fiscal Consolidation, the Economy and Employment

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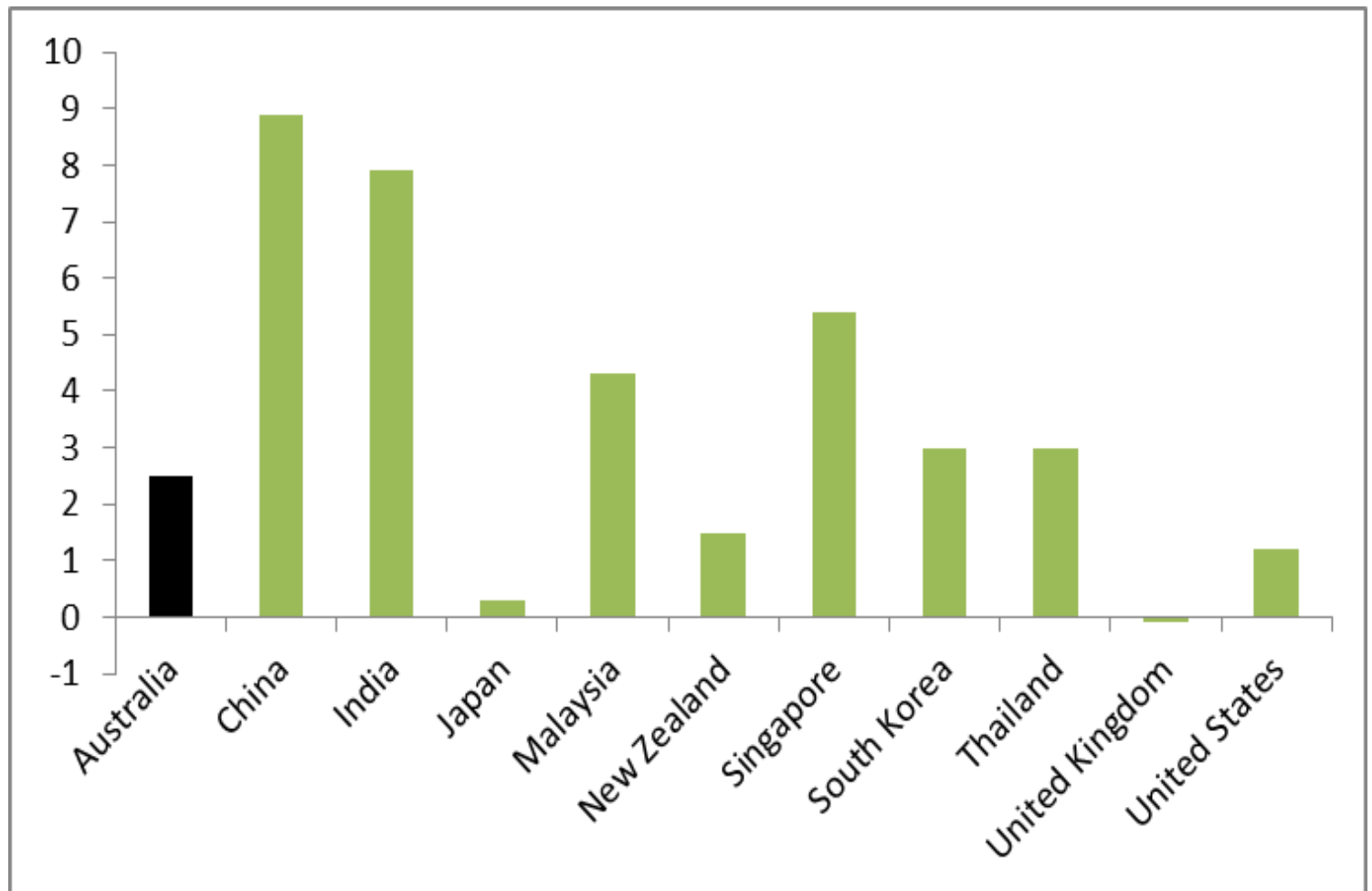


# Key Themes

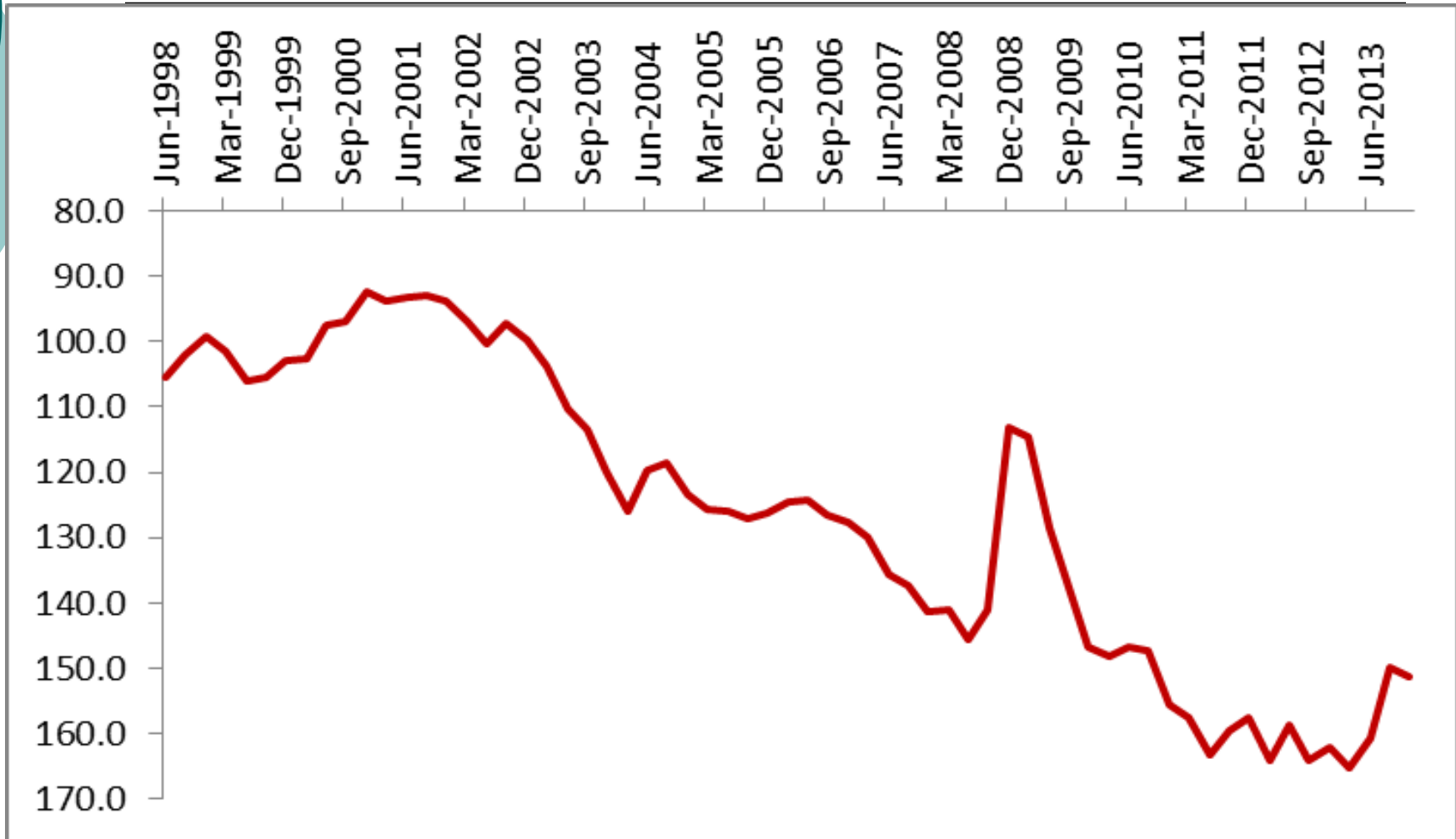
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- Australia's Worsened Competitiveness
- Productivity and Labour Market Flexibility
- Competitiveness and Fiscal Policy

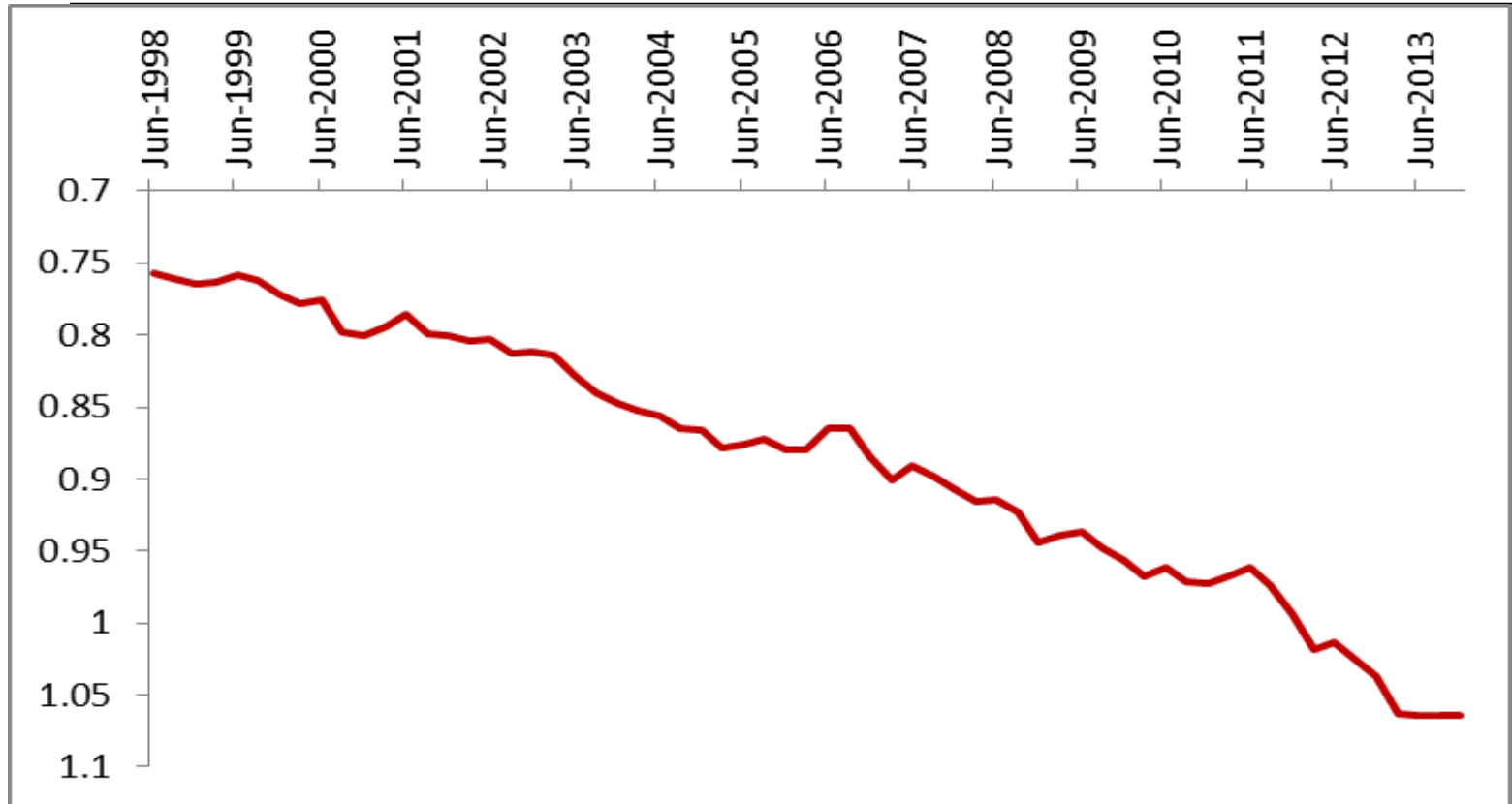
## Economic Growth in Australia's Top 10 Trading Partners (annual average growth 2009-13, %)



# The Slide in Competitiveness (Measure 1)

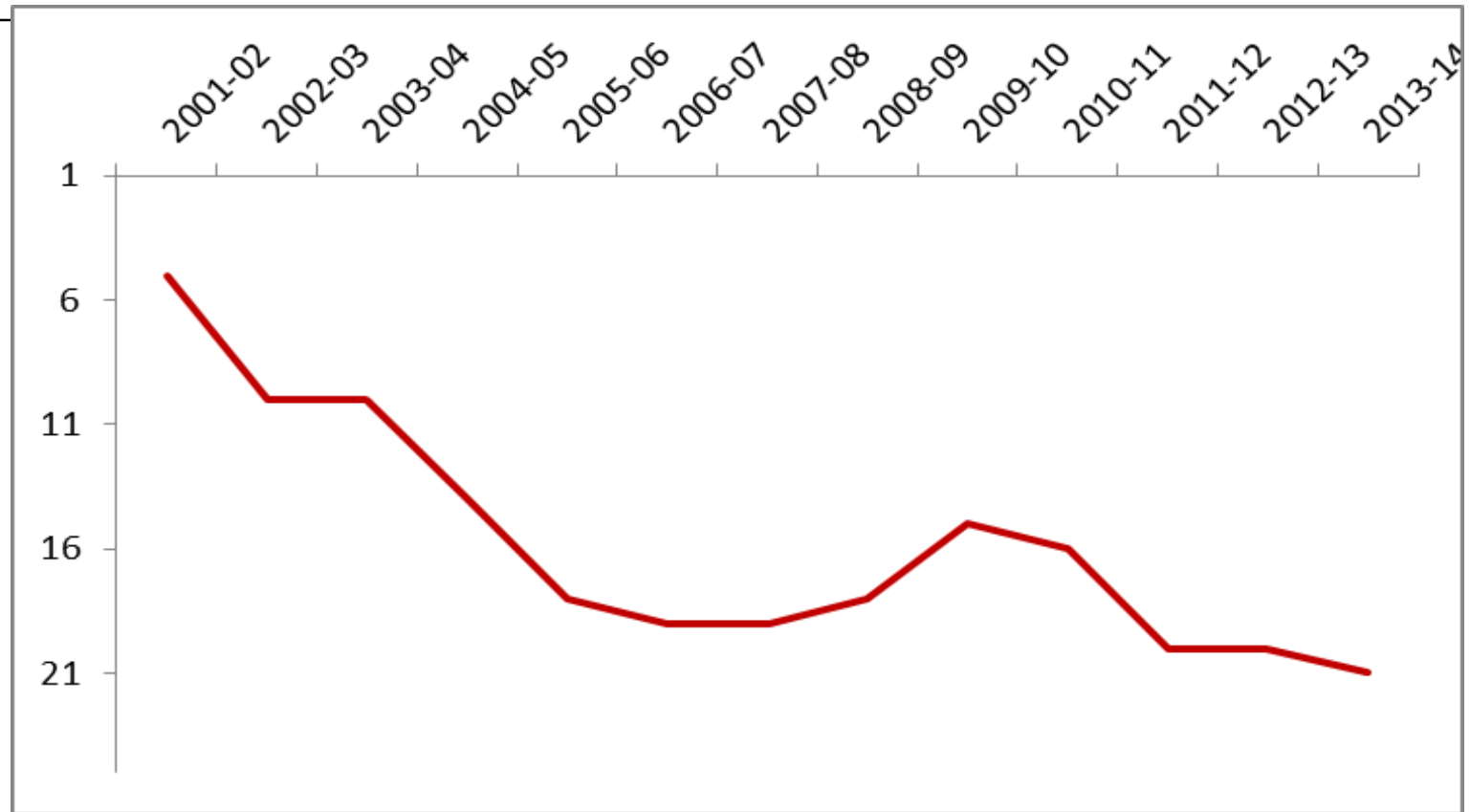


## The Slide in Competitiveness (Measure 2)



Note: The ratio of non-tradables to tradables prices based on official CPI data  
Source: Reserve Bank of Australia, Statistics, CPI Table G2, available at <http://www.rba.gov.au/statistics/index.html>

# The Slide in Competitiveness (Measure 3)



Note: Left axis shows Australia's WEF Competitiveness Ranking

Source: World Economic Forum, Annual World Competitiveness Reports

# WEF Global Competitiveness Index, 2013-14 Rankings

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Country/Economy	Rank (out of 148)
Switzerland	1
Singapore	2
Finland	3
Germany	4
United States	5
Sweden	6
Hong Kong SAR	7
Netherlands	8
Japan	9
United Kingdom	10
Norway	11
Taiwan, China	12
Qatar	13
Canada	14
Denmark	15
Austria	16
Belgium	17
New Zealand	18
United Arab Emirates	19
Saudi Arabia	20
Australia	21
Luxembourg	22
France	23
Malaysia	24
Korea, Rep.	25
Brunei Darussalam	26
Israel	27
Ireland	28
China	29
Puerto Rico	30

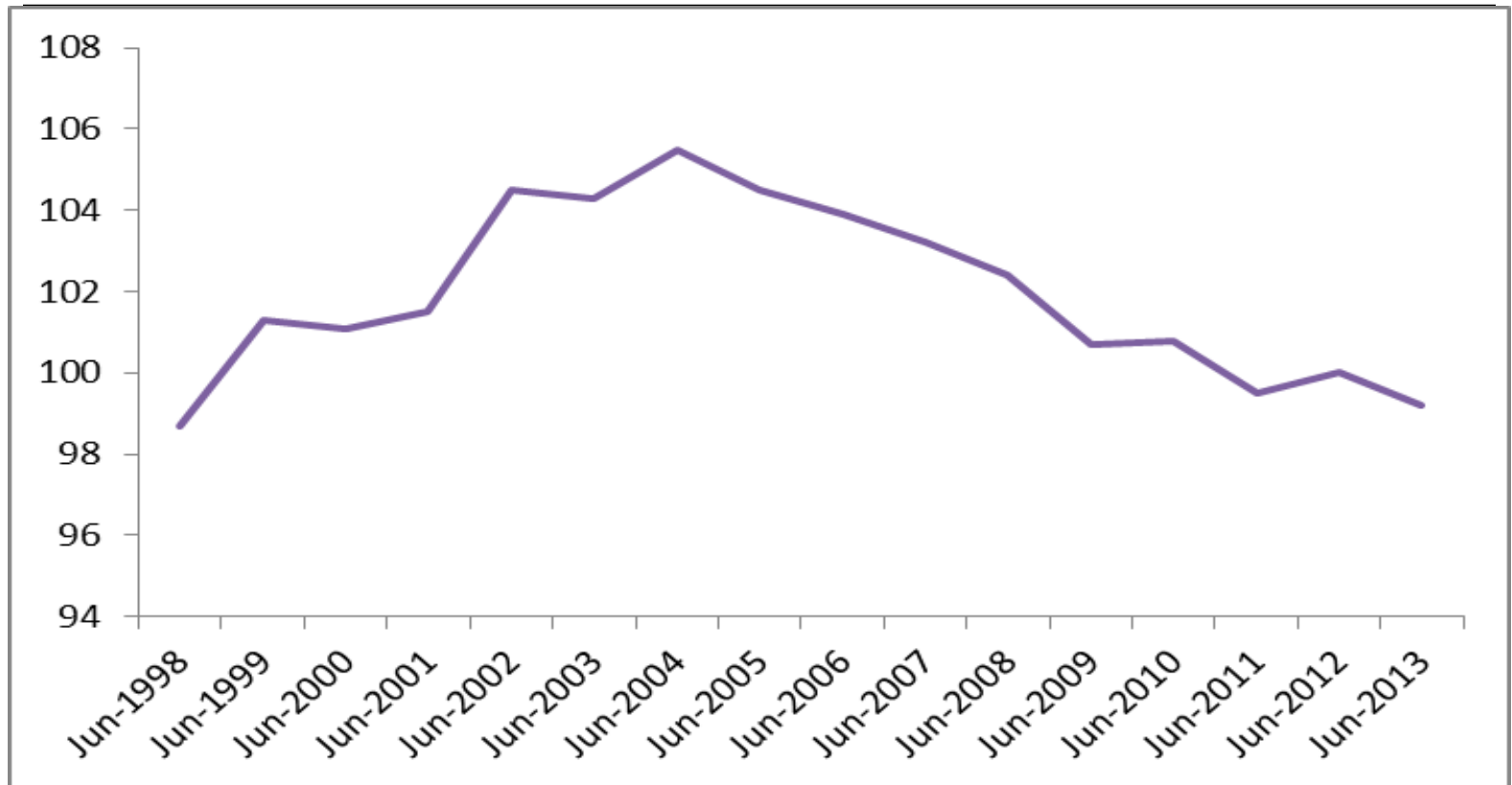
## WEF Global Competitiveness Index, 2013-14 Rankings

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- The standout weak points in Australia's WEF measure are the highly inflexible labour market and excessive government regulation
- Ironically, the labour market has become less flexible when massive structural change in the economy due to the mining boom implies greater flexibility is needed



# The Slide in Multifactor Productivity



Note: Multifactor productivity, quality adjusted hours worked index measure  
Source: Australian Bureau of Statistics, Cat 5204.0, 2012-13, Table 13,  
available at [abs.gov.au](http://abs.gov.au)



# Productivity and Labour Market Flexibility

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- The importance of labour market flexibility to overall productivity performance remains an issue of economic debate
- But standard measures of productivity are not linked to the degree of flexibility in labour markets which is effectively assumed away

# Productivity and Labour Market Flexibility

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- Allowing variation in what economists call the 'elasticity of substitution' between labour and capital yields different results when estimating productivity
- This elasticity measure is the rate at which labour can be substituted for capital and is heavily influenced by labour market flexibility

# Productivity and Labour Market Flexibility

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- The substitution elasticity and labour productivity rose significantly and remained elevated during the economic reform period of the 1980s and 1990s
- Labour productivity increased by more than the conventional productivity measures show between 1998 and 2008 when the labour market was more flexible

# The Revival of Fiscal Activism

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- Before the last US presidential election, 673 US macroeconomists, including Greg Mankiw, John Taylor, Robert Lucas, Robert Mundell, Gary Becker, Robert Barro, Martin Feldstein, as well as former IMF deputy, Anne Krueger, and former World Bank President, Robert Zoellick, criticised the Obama administration's fiscal policy on the grounds it had contributed to ***anaemic economic recovery and high unemployment in the US***
- According to them, ***fiscal "stimulus"*** (note the inverted commas) ***'provided little sustainable lift to the economy'***

# The Revival of Fiscal Activism

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- prior to the North Atlantic banking crisis support for fiscal activism had waned
- hundreds of US academic economists agreed in 2009 that increasing government spending to counter recession was

*"a triumph of hope over experience"*

and that

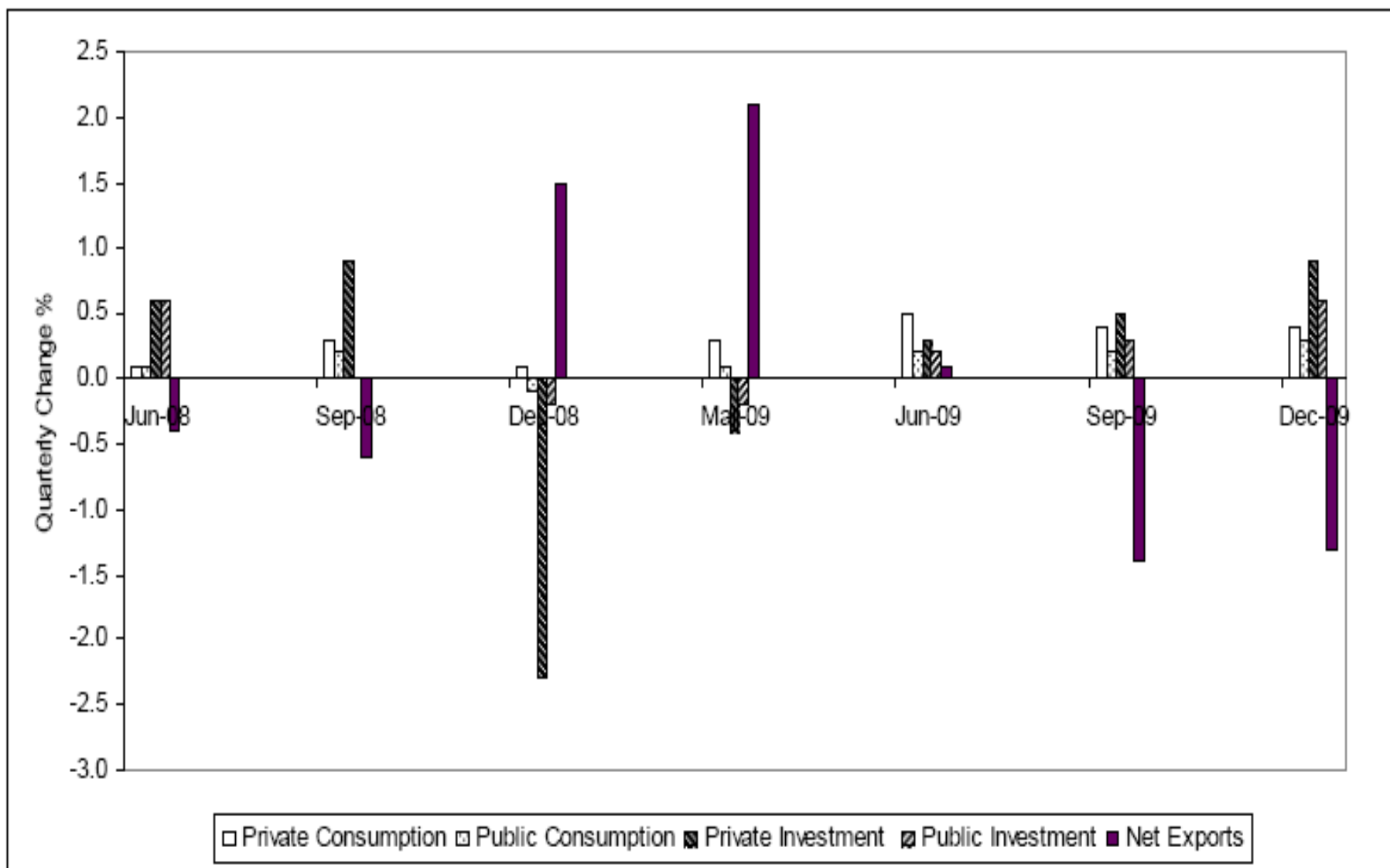
*"More government spending by Hoover and Roosevelt did not pull the US economy out of the Great Depression"*

# The Australian Response

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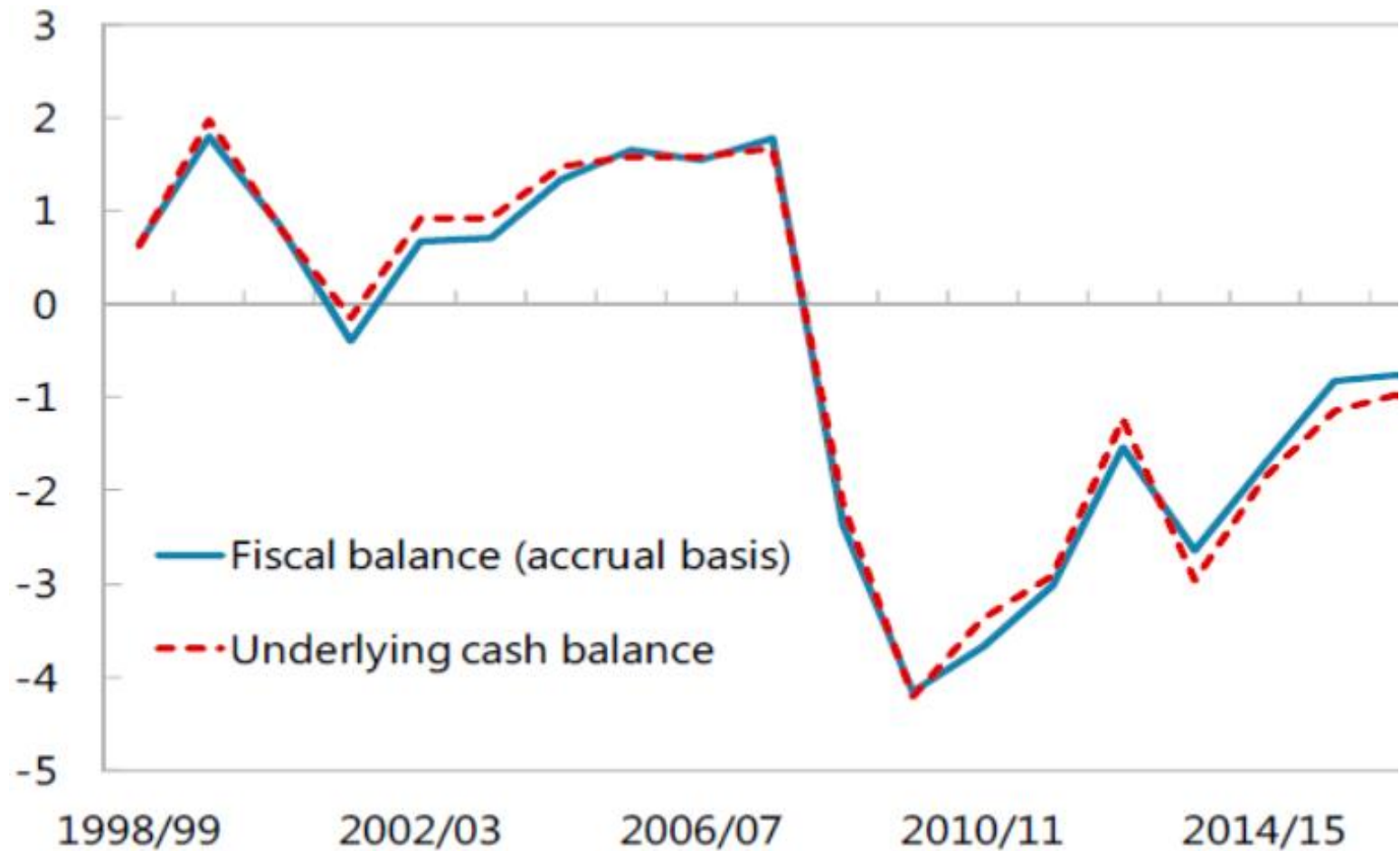
- Australia's fiscal policy in 2008-10 was the most activist ever, reminiscent of the 1970s
- yet, the national accounts show that "recession" was avoided in 2008-09 because net exports rose following a major loosening of monetary policy, capital outflow and a 30% exchange rate depreciation

Figure 1 - Contribution to Change in GDP by Expenditure

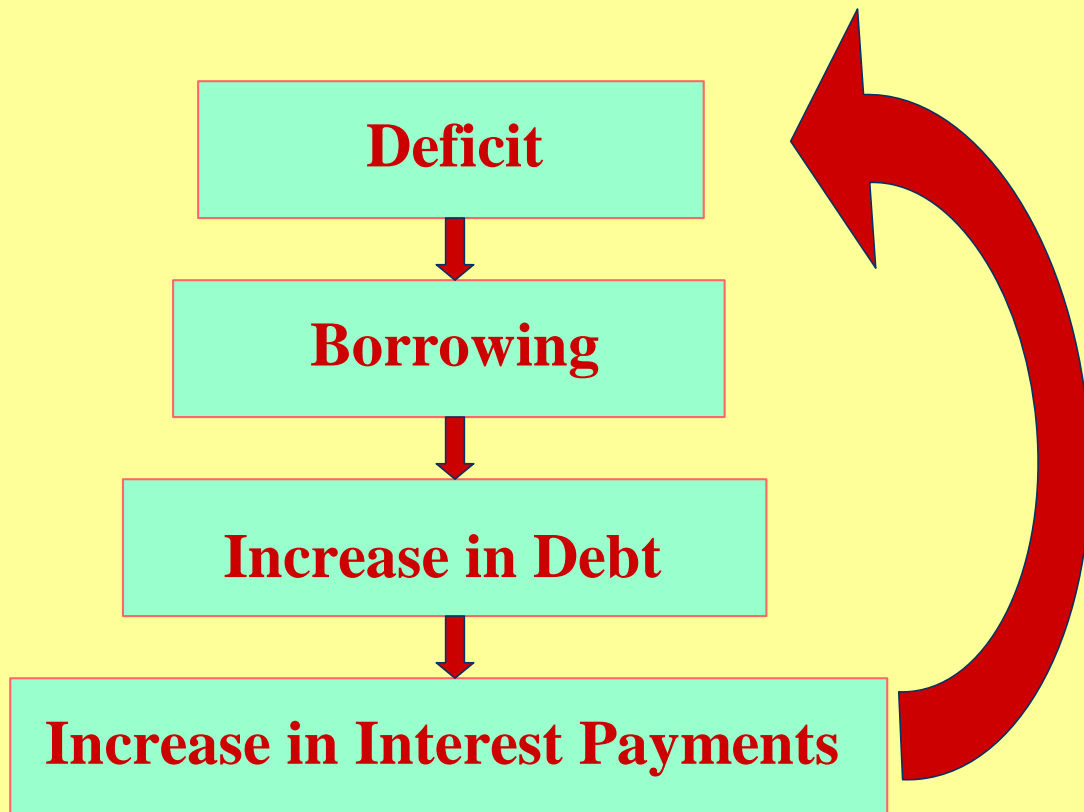




# Federal Government Budget Balance (%GDP)



## Vicious Circle of Deficit & Debt



# Keynesian Fallacies

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- the multiplier critically depends on the Keynesian consumption function, but evidence supports Friedman's permanent income theory of consumption
- in practice, there are lags due to recognition, implementation and action



# Keynesian Fallacies

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- Cutting government spending
  - is bad for confidence
  - worsens economic conditions because it reduces aggregate demand

# Keynesian Fallacies

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- Even if total spending falls, as recorded by the expenditure measure of GDP, this not necessarily bad since government spending artificially inflates the GDP expenditure measure
- No one worries about reduced foliage after pruning the garden

# Keynesian Fallacies

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- yes, 'in the long run we are all dead'
- but, due to the government's budget constraint, the vast majority of the population can in their lifetimes expect higher taxes, higher interest rates, and possibly higher inflation

# The Recent Budget

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- The federal budget could have cut government spending more eg industry assistance
- The \$30 billion 2014-15 deficit will add to Australia's public debt and see another 12 billion or so in public debt interest paid to foreign bondholders, which subtracts from national income



# The Recent Budget

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- The budget another opportunity missed to correct the debt overhang due to the ill-advised Keynesian stimulus program
- The boost to government spending a reason for Australia's recent sub-optimal growth





## The Role of Federal Treasury

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- federal Treasury predicted in the 2009-10 Budget papers that, reflecting the stimulus spending, the economy would be growing at 4.5 per cent in 2012-13
- in reality, GDP growth below 3 per cent this financial year



## The Role of Federal Treasury

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- in the lead up to this budget Treasury argued the economy was too fragile to weather bigger spending cuts on the grounds that lower government spending would weaken aggregate demand



## The Role of Federal Treasury

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- Federal Treasury, the key source of that original ill advice, like latter day Bourbons, have seemingly “learned nothing and forgotten nothing” about Keynesian demand management



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Thank You!