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A Fiscal Vaccine for COVID-19

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CIS Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

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A Fiscal Vaccine for COVID-19

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"Great nations are never impoverished by private, though they sometimes are by publick prodigality and misconduct."

Adam Smith 1776

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Introduction

The COVID-19 health crisis has plagued economies worldwide, with the severity of the economic symptoms varying according to how quickly the virus spread and how strictly government lockdown restrictions were applied. Under these circumstances, central banks and governments countered with fiscal and monetary policies to mitigate the economic impact of the lockdowns on business and private sector employment. Despite these palliative measures, federal Treasury (2020) estimates a 10 per cent fall in Australia's national income and a 10 per cent rise in unemployment in 2020.

Providing ample liquidity through monetary measures involving the central bank and commercial banks is warranted in a crisis situation, as it can easily be withdrawn subsequently. On the other hand, the 'whatever it takes' fiscal policy response to the COVID19 (hereafter CV) crisis paralleled the Rudd government's panic macroeconomic response to the Global Financial Crisis (GFC). Although the causes of the two crises bear no similarity, in both instances there was a rush of budget red ink to policymakers' heads.

The fiscal response to the crisis ensures that the federal and state governments will experience large budget deficits and escalating public debt for the foreseeable future. Federal government debt could for instance conceivably double to over $1 trillion within a few years in the absence of substantial budget repair. Many economic questions arise about Australia's policy response to the virus.

Specifically, have the economic benefits of the government-mandated lockdown outweighed its total costs? Related critical macroeconomic questions are: Was the fiscal injection for the economic side-effects of the lockdown an overdose? How serious will the associated hike in Australia's public debt be, and what risks does it pose? And what budgetary and structural reform policies are needed to address the deficits and debt while assisting economic recovery?

This paper aims to address these questions, focusing mainly on the fiscal elements of Australia's CV response and its economy-wide side-effects. After briefly evaluating the budget response, the paper considers the resurgence of crude Keynesianism before highlighting risks of the fiscal legacy. It then focuses on budget and other reform measures, stressing the need to reduce government spending and the size of government in Australia to ensure fiscal sustainability and stronger economic growth.

2. Evaluating the Economic Policy Response

According to the International Monetary Fund (2020a), Australia's CV response has been one of the largest in the world in terms of direct budgetary support, relative to support in the form of government loans and guarantees favoured by France, Germany, Italy and the United Kingdom.

Key Fiscal Elements

Federal Treasury estimates fiscal support for the economy at $259 billion across the forward estimates, over 13 per cent of annual GDP. Elements of the fiscal support include:

- extra health spending
- cash flow support and investment incentives for businesses
- wage subsidies
- income support to households
- free childcare to around one million families

Additionally, early access to personal superannuation accounts is available, which will add to the federal government's future age pension liabilities.

Subsequent to the first round of fiscal measures, the federal government has announced budgetary support for industry, such as the HomeBuilder scheme.

State and territory government also responded with fiscal measures including:

- extra health spending
- payroll tax relief for businesses and
- relief for households, such as discount utility bills
- cash payments to vulnerable households

Did the Costs Exceed the Benefits?

Given there is obviously a trade-off between saving lives and maintaining employment as well as general economic well-being, whether the economic benefits of the government-mandated lockdown outweighed its economic costs is ultimately an empirical question. The answer to this depends on whether the total present value of the benefit of saving lives through social distancing, valued by number of lives saved, exceeded the total present value of the costs incurred, directly and indirectly.[1]

These include budget outlays on extra health spending, income support, wage subsidies, lost income, lost wealth implying future lost income, mental health including depression, domestic violence, lost human capital from missed schooling, and suicide. Estimating precise monetary values for some of these social cost variables and appropriately aggregating is challenging, to say the least. The number of lives social distancing measures has saved is also highly uncertain, with estimates varying greatly according to different epidemiology modelling approaches.

Then there is the vexed question of how to value lives by age cohort. . While it is conceivable that social distancing could deliver a net economic benefit by preventing very high morbidity, this seems not to have been Australia's 2020 experience to date.

Needed Supply Side Support

A macroeconomic policy response was necessary and what transpired had elements directed at supporting the supply side of the economy and the demand side. The monetary policy response to ease liquidity and assist cash flow provided support for both aggregate supply and demand, as did new investment incentives for firms, and the JobKeeper wage subsidy program for firms that suffered a fall in revenue. Thankfully, this program — now expected to cost $70 billion — will prove less costly than the original $130 billion Treasury estimate.

There have been obvious flaws in the operation of JobKeeper and no doubt more will be learned about the inequities and rorting of the scheme in due course. As implemented, the scheme should have had more stringent eligibility criteria. While the program is overly generous for some employees earning more on $1500 per fortnight not working than otherwise, it is in principle more justifiable than the other crude Keynesian elements of the fiscal response aimed at boosting aggregate demand. Indeed, a more efficiently designed low-cost JobKeeper scheme provides a possible prototype for dealing with future black swan emergencies.

Ill-Advised Demand Side 'Stimulus'

However, other elements of the fiscal response aimed at the demand side were not only extravagant but ill-advised, particularly those aimed at boosting household spending via increased bonus payments to pensioners and other welfare recipients. These replicated the old-style Keynesian cash splash element of the Rudd government's failed fiscal 'stimulus' response to the GFC. Cash handouts to households are also a key element of the United States government's response.

1 This paper abstracts from the question of whether the national lockdown was warranted, compared for instance to the 'herd immunity' approach Sweden adopted.

Why governments chose this fiscal option is puzzling, for several reasons. First, it was at odds with government lockdown restrictions, including 'stay at home' advice and limits on the provision of goods and services to essential services. Pensioners of all groups, for instance, were not supposed to be out spending.

Second, economic theory suggests that as these payments are one-off and hence temporary, they are more likely to be saved than spent, yet at significant cost to government saving. If they are spent, it will add to imports, detracting from Australia's GDP. Effectively a subsidy to retailers, such payments are an inefficient, duplicative and ineffective means of preserving employment, especially since JobKeeper was devised for that explicit purpose.

Similarly, targeted industry support like HomeBuilder on the grounds it creates jobs is akin to trade protection. Just as a tariff on imports is a tax on exports, budgetary assistance for industries with the loudest lobby voice is a future tax on everyone else.

Third, all announced budget outlays will be funded by new government borrowing, mostly from abroad; worsening the federal government's balance sheet and causing further deterioration in the federal government's negative net worth.[2]

Key questions arise about how best to address the macroeconomic side-effects of the costly fiscal policy response. Before doing so, a digression on the fallacies of Keynesian thinking follows to provide necessary background for the remedial fiscal measures proposed subsequently.

3. Resurgent Crude Keynesianism

The CV fiscal response cannot be understood with reference to textbook macroeconomic theory, but its consequences can, as can the implications of future fiscal policy options. Inevitably, interpretations of the macroeconomic role and efficacy of budgetary policy are coloured by views of how it is transmitted in the macroeconomy. At the risk of oversimplification, these perspectives, as well as those about the policy significance of public debt, can be categorised as either Keynesian or non-Keynesian.[3] Keynesianism, however, takes many forms.

Keynesian Schools of Thought

Since the Great Depression, a range of different schools of Keynesian thought have emerged, each variant purporting to convey what Keynes *really* meant. Doctrinal differences between these schools — for instance about the role of money, the significance of inflexible wages and prices, the rationality of financial markets and the importance of capitalism itself — parallel differences between sects of the same religious faith.

The main Keynesian schools to emerge over the years have been the neo-Keynesian, the Post-Keynesian, the New Keynesian and Modern Monetary Theory (MMT), the crudest being the fundamentalist, quasi-Marxist Post-Keynesian and MMT perspectives. At the crudest level, Keynesianism borders on being a creed based on a holy book, Keynes' *General Theory of Employment, Interest and Money*.

For fundamentalists, the message of this book is that economies are best managed by increasing government spending to reduce unemployment, drawing inspiration from the concluding chapter, where Keynes asserted — wrongly as it turned out — that in the post-Depression era "…somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment" (p378) and that "The central controls necessary to ensure full employment will, of course, involve a large extension of the traditional functions of government" (p379).

All these Keynesian schools, to varying degrees, have been at odds with the free market-oriented approaches of the Monetarist, New Classical and Austrian schools that stemmed from Classical Economics originating in Adam Smith's (1776) *The Wealth of Nations*. When Keynesian thinking previously dominated macro-policymaking in the 1970s, Monetarist and New Classical economists convincingly argued that inert fiscal policy was superior to fiscal activism. Milton Friedman (1962) has to this day been the most influential non-Keynesian thinker since the Depression, along with Friedrick Hayek (1995), a contemporary of Keynes.

In the Keynesian tradition, private consumption, investment and government spending, as well as net exports in open economy extensions, determine aggregate demand, national income and employment in the short run. Whereas in the classical and

2 Australian Office of Financial Management data shows foreign holdings of Australian government bonds on issue have varied between 60-80 per cent of the total since the GFC.

3 Some views were not necessarily held by John Maynard Keynes himself who declared late in life that he was not a Keynesian. See Hutchison (1977).

neoclassical tradition, national income is best explained as a supply side phenomenon with reference to saving, capital accumulation, workforce expansion, and productivity.

Modern Monetary Theory

Since the GFC, so-called Modern Monetary Theory (MMT), a deeply fundamentalist Keynesian approach, has surfaced as an alternative way of conducting macroeconomic policy. MMT's main point is that fiscal policy in the form of increased government spending should replace monetary policy as the macroeconomic instrument for steering the economy, and hence employment levels, via aggregate demand management. MMT assumes more government spending and higher public debt are inconsequential; and that if monetisation of public debt is inflationary, government should just raise taxes to control it.

MMT has a bland, yet deceptive, name, for it is in essence a rebranding of discredited old closed economy Keynesian ideas from the 1930s. In other words, corked old wine in a seemingly new bottle. Labelling this approach as something new is therefore misleading. So is referring to it as a monetary approach when it advocates fiscal policy (not monetary policy) as the key to macroeconomic management. As a theory, it is also at odds with reality; especially regarding the inflationary consequences of debt monetisation.

Counter-arguments

The main counter-theories to Keynesianism are:

(i) the loanable funds approach, which implies that extra government spending must be funded; it thereby either crowds out domestic private investment, increases foreign borrowing and the external debt, or leads to a combination of both;

(ii) the textbook open economy model[4] that proposes government spending puts upward pressure on interest rates which induces capital inflow from abroad; that in turn appreciates the currency, worsens international competitiveness, crowding out net exports. This assumes an unchanged monetary policy stance; but in the current context, to the extent the Reserve Bank keeps interest rates low through massive bond purchases, exchange rate appreciation will be dampened;

(iii) Ricardian Equivalence, which implies crowding out of private consumption as households save to meet future tax obligations to repay public debt.[5]

Together, these approaches suggest that increased government spending, particularly public consumption, fails to stimulate national income and employment. In sum, these non-Keynesian perspectives, backed by a body of empirical evidence, tell us extra government spending aimed at bolstering aggregate demand side has offsetting effects elsewhere in the economy that negate its purpose. Lastly, there is:

(iv) the intergenerational inequity argument that it is unfair for future generations to repay public debt incurred by the present generation.[6]

4. Higher Public Debt is a Problem

It was once a tenet of Keynesian economics that public debt was not a problem because 'we owed public debt to ourselves.' This implied governments could run up public debt, without worrying unduly because its citizens and local financial institutions within the economy earned interest on it. This is false because the federal and state governments borrow mainly from abroad to cover their budget deficits. This can worsen Australia's international competitiveness, further drain national income, lower economic growth and risk high inflation. Moreover, the public debt is bequeathed to future generations to repay.

Worsened Competitiveness

Given Australia's external borrower status, federal and state government bonds issued to fund budget deficits in the tens of billions will entice strong capital inflow from abroad. To the extent that strengthens the real exchange rate, it will worsen the economy's international competitiveness, thereby harming net exports by lifting imports and curbing exports. In this way the exchange rate could mimic its behaviour in response to the Rudd government's counterproductive fiscal response to the GFC.

4 Known as the Mundell-Fleming model, this approach is expounded in all reputable intermediate level university textbooks. See Mankiw (2020) for instance.
5 Makin (2018) elaborates on these perspectives.
6 See Buchanan (1958).

The national accounts show additional government spending at the time did not save Australia from recession. Net exports did, due to strong mining exports to China and reduced imports, courtesy of a heavily depreciated exchange rate at the time. The exchange rate subsequently began appreciating to historical highs (over $1.10 against the $US) in part due to belated spending 'stimulus' that induced foreign capital inflow to buy Australian government debt. This severely worsened Australia's competitiveness and soon reversed the contribution to GDP from net exports, as well as euthanasing parts of the manufacturing sector.[7]

Foreign-funded budget deficits lead to higher public debt that precisely doubles as foreign debt. In turn, this directly reduces national income by the amount of public debt interest paid abroad. Higher public debt will therefore exacerbate the already significant drain on national income which, at federal level alone, is currently more than three times the size of Australia's foreign aid budget and exceeds outlays on many other federal government programs.[8]

The Risk to Australia's Credit Rating

Australia is one of 12 economies in the world with a current AAA credit rating; but with federal budget deficits and public debt set to escalate, the nation's creditworthiness is obviously under threat. A creditworthiness downgrade for federal government debt would have the following economy-wide impact.

First, interest rates on government bonds would rise instantly to reflect a higher risk premium, the rise depending on the bond market's reaction. If the Commonwealth loses its AAA rating, the loss would automatically flow on to the states and territories that still have AAA (NSW, VIC and ACT) and perhaps affect others as well. For every basis point of an increased risk premium, public debt interest would rise by another $100 million should the federal government's gross debt near $1 trillion — as is possible within a few years.

Second, the downgrade would influence the entire interest rate spectrum, affecting mortgage and commercial loan rates. Third, it would dent household and business confidence, slowing consumption, construction and business investment. Moreover, if world interest rates rise this will further add to the public debt interest burden and enlarge the national income drain. Once lost, Australia's AAA rating will take at least a decade of fiscal repair to restore, if history is any guide.

Lower Growth

Both the size of government, to be discussed further below, and public debt have long term consequences and are sure to retard future growth. As governments around the world continue to soak up funds to cover budget deficits and for refinancing maturing debt previously incurred, the availability of funds for private investment shrinks. This implies future global growth will be lower because economies' productive capital stocks will be lower.

Numerous empirical studies suggest a 10 per cent increase of public debt is associated with a 0.2 per cent decrease of economic growth. While seemingly small on an annual basis, it means a significant national income loss over the longer term due to compounding.

Higher Inflation

Lastly, history shows that there is a very big risk of higher inflation taking hold globally — perhaps with a lag of a few years — if central banks continue buying huge volumes of public debt, expanding domestic money supplies in the process. It has been known since Roman times that excessive money supply growth fuels inflation and can at worst lead to hyperinflation, as has been well documented in the voluminous academic literature.[9] High inflation in the 1970s prompted the original Monetarist attack on Keynesianism, which could not explain it.

Inflation on a scale not experienced since then must rate as likely in light of the monetisation of public debt that has already occurred, especially if there is a severing of international supply chains — including from China — that have kept production costs in advanced economies down. Low-cost production inputs, along with other cheap merchandise imports from China and other emerging economies, have contributed to low world inflation in recent decades. This low inflation, in Australia's case persistently below the official 2 to 3 per cent target range, has arguably been too low; so to the extent it rises initially may be welcome. However, preventing a rise in inflation above the target range could become a major challenge for monetary policy.

When inflation is high it tends to be more variable, which introduces additional uncertainty for business, and complicates long-term planning decisions. These include the inconvenience and real cost to business of having to mark prices up very frequently (the so-called 'menu cost' of inflation). If unanticipated, high inflation also causes arbitrary redistribution of wealth

7 Makin (2016) provides more detailed analysis.
8 See Makin and Pearce (2016) for related discussion.
9 Cagan (1956) is a classic empirical study of historical money generated hyperinflations.

between borrowers and lenders in the economy. Hence in the 1970s, the saying that 'inflation was theft' was popular as it conveyed the notion that inflation robbed those with accumulated savings.

There would also be extra inefficiencies because the price system would not clearly signal which relative prices are changing when all prices are rising. As a result, resources can be misallocated reducing overall productivity and economic growth. This occurred around the world after the Keynesian fiscal excesses of the 1970s, resulting in prolonged stagflation — which in turn exacerbated unemployment.

5. Australia's Already Oversized Government

Australia's pre-CV fiscal position was not as strong as it should have been, because successive federal governments had failed to rewind the growth in government expenditure sufficiently in the wake of the GFC. This contrasted with fiscal consolidation efforts in many other advanced economies and with the consolidation undertaken under the Hawke-Keating and Howard-Costello governments in the 1980s and 1990s following earlier budget blowouts.

Apart from difficulties passing fiscal repair legislation in the Senate, the lack of commitment to cutting outlays was also abetted by official advice, including from federal Treasury. This was reflected in the IMF's annual Article IV surveys of the economy (see IMF 2020a), where Australia was cautioned against undertaking fiscal repair too quickly, lest this retard growth. The federal government should simply have ignored such wrongheaded Keynesian advice. For much of its history the IMF was explicitly non-Keynesian — influenced by a line of Chicago economists — but has sharply changed direction post GFC.

Spending by all levels of government in Australia is 37 per cent of GDP, lower than sclerotic European economies like France, Greece and Italy with public spending shares over 45 per cent, but considerably higher than in more dynamic advanced economies in our region. For instance, in Singapore, South Korea and Hong Kong it is only around 20 per cent of GDP.

Australia's economic history shows that whenever the size of government increases, it is not significantly wound back, the notable exception being during the Hawke-Keating years. Yet, contrary to Keynesian doctrine, empirical evidence suggests that when public spending is scaled back, this buoys the economy.

The Optimal Size of Government

Economic theory suggests there is an optimal level of government spending.[10] If government spending is too low, the supply of 'public goods' (national defence, legal institutions guaranteeing property rights, the rule of law, basic education and healthcare, the correction of other forms of genuine market failure, public infrastructure spending, as well as income redistribution to assist the deserving poor) is less than it needs to be to maximise economic growth. Hence, under these circumstances, government spending can be sub-optimal.

However, beyond a certain level of spending as a share of national income, the size of government starts to negatively affect economic growth due to increased inefficiencies, work and investment disincentives due to the higher income taxes needed, crowding out of private investment and net exports, and increased uncertainty affecting business and household confidence. When government expenditure exceeds a certain percentage of GDP, diminishing returns set in. This suggests a trade-off between government size and economic growth beyond some optimal level.

Finally, as proposed in the public choice literature, a higher government share implies a larger bureaucracy pursuing its own interest rather than the public interest. For instance, in Niskanen's (1991) budget maximising model, officials forever seek to expand public spending to maximise their own power and influence. This reduces the efficiency of resource use in the economy, with significant negative effects on productivity, ensuring economic growth is persistently lower than it should be.

In line with the above principles, the share of government spending in Australia consistent with

10 The remainder of this section draws on Makin, Pearce and Ratnasiri (2019).

maximising economic growth should be 31 per cent of national income — significantly below the current 37 per cent level. Moreover, other empirical research on the optimal size of government in advanced economies suggests a one per cent increase in the size of government reduces long-term economic growth by 10 basis points. This implies a 5 per cent cut in government spending across all levels of government would deliver a 0.5 per cent of extra growth per annum. That would cumulatively generate tens of billions of dollars' worth of extra national income for Australia.

Reduced Government Spending Pays Dividends

Only via primary budget surpluses can public debt be paid down to prevent a vicious cycle of deficits and debt and preserve an economy's credit worthiness in the short term, and in the long term reduce the burden of public debt for future generations. The spending side of the budget — literally significantly more than half of the budget story — has been largely ignored for a decade or more on the unproven Keynesian grounds that spending cuts reduce national income.

Yet from a macroeconomic perspective, fiscal repair generates additional national saving, improves credit availability, and puts downward pressure on the interest rates business face, as well as on the exchange rate which boosts international competitiveness.

Business confidence has been persistently below par during the post-GFC period of budget deficits and rising public debt, due to the uncertainty that fiscal deficits (and how they will be eliminated) have created. Weak business confidence also implies lower private investment and diminished capital gains, which in turn has meant reduced tax revenue.

Is Infrastructure Spending Any Different?

Infrastructure influences an economy's aggregate demand and supply sides by increasing demand through investment, while simultaneously adding to the capital stock. Crude Keynesian theory suggests that *any* form of government spending always boosts economic activity, irrespective of its intrinsic economic worth, while any cut in government spending reduces it.

While deficit-financed spending on infrastructure can augment the economy's productive capacity if it passes rigorous cost-benefit tests, it can also slow national income if it manifests as debt-funded spending on public works; such as 'roads and bridges to nowhere', as Japan's experience shows. Encouraging public-private partnerships is a way of minimising that risk.

Candidate Items for Spending Cuts

Public finance theory tells us there are two basic rationales for public expenditure. Firstly, to correct for genuine market failure, which includes providing so-called 'public goods'; and secondly, to redistribute income.

A comprehensive external root and branch review of existing public spending programs of all levels of government along the lines of the Henry Tax Review could be instigated immediately as a blueprint for public expenditure reform. It could assess whether existing programs meet at least the first of these principles. Addressing the second principle is most likely infeasible, given there will never be political consensus on what income and wealth distribution is 'fair'.

Such a review would uncover a multiplicity of candidate items for expenditure reduction. In the meantime, some obvious ones are:

- the duplication in health and education across levels of government
- industry assistance spending across all sectors at all levels of government, federal, State and local
- means testing the aged pension for the family home
- public sector employee growth nation wide

Conclusion

Keynes famously justified ignoring the future negative consequences of his advocacy of fiscal activism by quipping that "in the long run we are all dead." In contrast, the CV lockdown and related fiscal largesse was justified on the grounds that, without it, in the short run too many of us would be dead. However, the economic policy response raises important questions about its form, cost and legacy.

The fiscal response, in particular, leaves an economically threatening legacy of high budget deficits and public debt that was overly weighted to direct budgetary support relative to government loans compared to other advanced economies. Unlike emergency monetary responses to increase liquidity and loosen credit availability, panic government spending binges — particularly of the cash splash and welfare support kind — cannot be readily withdrawn once announced, and have lasting negative macroeconomic consequences.

The idea that copious government spending necessarily mitigates the macroeconomic impact of a crisis is a Keynesian fallacy. Suddenly injecting government spending is not akin to injecting liquidity and bank credit via emergency monetary easing, because government spending has to be funded from elsewhere; in Australia's case, mostly from abroad. Walter Bagehot's (1873) classic dictum that central banks lend freely during crisis episodes still rings true for monetary policy.

But so does David Hume's (1777) even earlier dictum for fiscal policy. Because elected representatives make populist knee-jerk decisions and spend excessively under crisis conditions, he said, "The practice of contracting debt will therefore almost infallibly be abused in every government.". Announcing bonus cash payments and bolstering welfare payments under crisis conditions with public debt already escalating rapidly due to revenue loss is not unlike a household deciding to spend more each week at pricey restaurants while under pressure to meet the mortgage payments.

The size of government pre-CV in Australia was already above its optimal level. Hence, cutting government spending should take precedence over raising taxes as the priority fiscal repair option. Reduced public spending — particularly on industry assistance and the overlap in spending at federal state levels — should therefore be central to the recovery program. This should be accompanied by tax reform (including to internationally competitive company tax rates) as well as business deregulation and industrial relations reform.

Another budget option for reducing the level of public debt is greater privatisation of federal government assets, including its sizeable land and property holdings. Though once-only sales proceeds could be used to pay down public debt, this option would not provide a lasting solution to the structural budget deficit problem.

Australian governments should therefore focus on reversing the increased size of government over the past decade by reducing spending, while also reducing business regulation and company tax, as well as undertaking industrial relations reform to boost the supply side.

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Related Works

Robert Carling, *State Finances after the Pandemic* (CIS Policy Paper 29, May 2020)

Blaise Joseph and Glenn Fahey, *Pain without gain: Why school closures are bad policy* (CIS Policy Paper 28, May 2020)

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