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Is Frydenberg's post-Covid economic optimism justified?

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Josh Frydenberg was pleased with last week's midyear economic review issued by Treasury. He preened himself, opining that the Covid spendathon had kept the economy ticking over and that the future was a deluge of new jobs, higher incomes, and what he described as one of the world's 'strongest recoveries'.

He declared, 'Our economic plan is working!'

Glossed over was some of the enduring economic damage which government policies have left in their wake. The bottom line is that we've seen a permanent uplift in government spending. At a level of 28.7 per cent of GDP this year, it barely falls in future years. That 28.7 per cent share is four percentage points above the level of spending pre-Covid and equivalent to the share the much-maligned Whitlam government bequeathed the nation. Moreover, avoiding funding the spendathon with taxation meant a deficit of 5-6 per cent of

GDP and continuing, albeit lesser, deficits extending as far into the future as anyone can see. Those deficits have to be paid for in taxes which reduce future income levels.

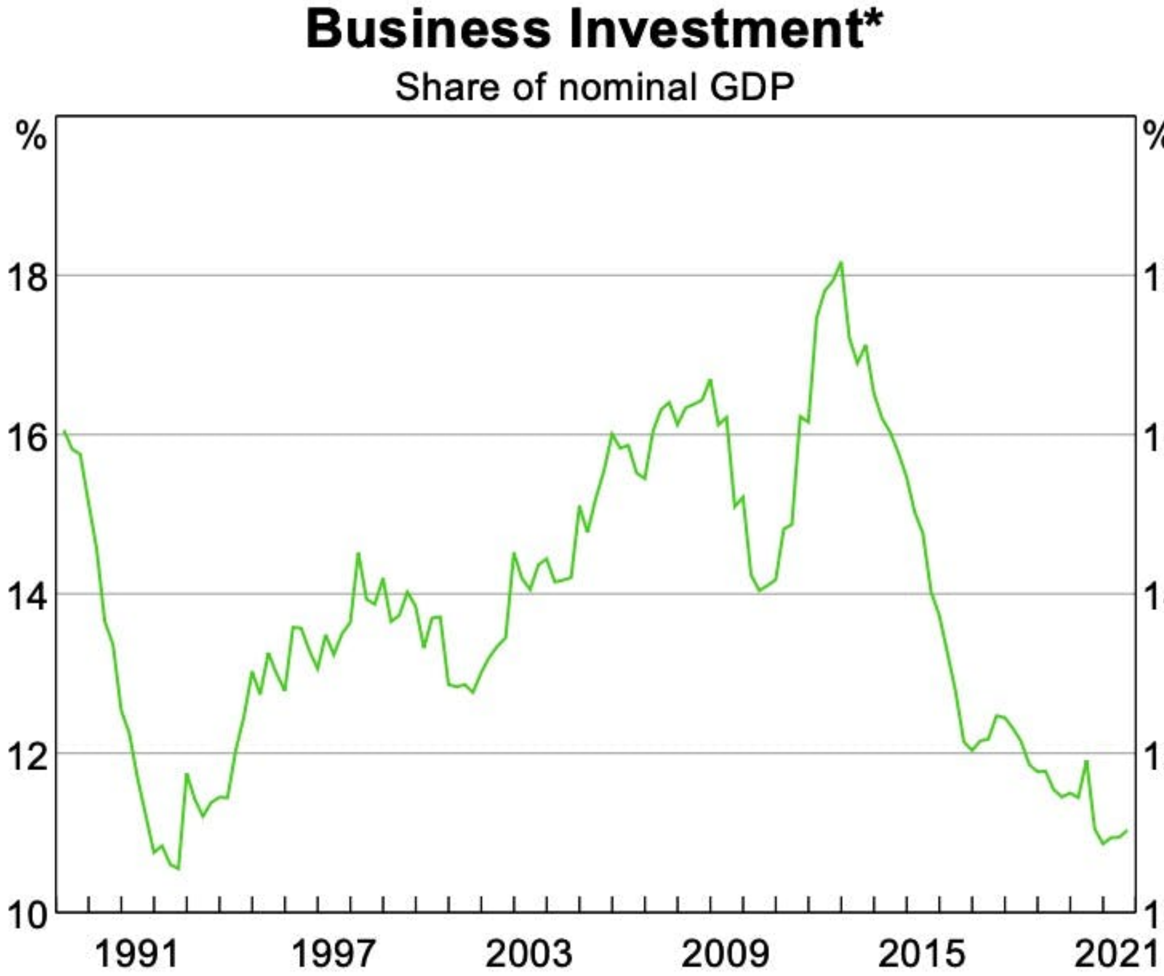
Nor is Australia's projected growth rate enviable. On the figures that the Treasury economists predict, 2-3 per cent a year, it is less than the world average. Projected increases in Australia's national income are insufficient to allow real income growth, especially with a locked-in increase in welfare payments. Should interest rates increase to 'normal' levels, a huge additional claim on spending will take place. Even Treasury's forecasts see average real wages in 2024-25 below those of 2020-21.

And though Treasury can usually get the picture right a year ahead, its analytical framework is incapable of accurately forecasting the medium and long-term future. That's because it is driven by modelling relationships that fail to distinguish between the different components of gross domestic product. Importantly, they fail to see a difference in spending that generates growth and spending that merely consumes income.

The key to growth in every economy is increased capital intensity, increased skills and, in economies like Australia, increased capability of extracting resources. Spending to accomplish this needs to be in a market-oriented framework – as the Soviet Bloc demonstrated, there is little point in reallocating spending on consumption to investment if the investment is poorly directed and managed.

Hence the dangers in increased government presence within the economy. Beyond a point that has long since been passed, increased government spending will reduce the bases on which sustained economic output rests. It will do so both by reducing the share of productive income-enhancing expenditures and by regulatory measures that further diminish the efficiency of that investment.

In the mid-year economic review there are some nods in recognition of this 'supply side' as the key to economic growth. The review is encouraged by its forecast increase in business investment of 7-8 per cent in the coming years. But, as its accompanying chart shows, the increase comes from a very low base.



Moreover, the potency of the investment in generating higher income levels is assumed to be unaffected by regulatory changes. Such is the emphasis of government and the private sector on reducing emissions of carbon dioxide, that the previous relationships of investment and the productivity enhancements stemming from it are severely weakened.

Importantly, in Australia's case, a great deal of the investment by both public and private sectors is wasted, if not harmful. About 8 per cent of Australian investment is in energy, but nowadays this is overwhelmingly in assets – wind, solar and associated network spending that are inferior to, and even undermine, the capabilities of the superior technologies – coal and gas – that they displace.

And while this regulatory distortion is most apparent in the energy area, it is a form of tax that permeates most forms of investment expenditure including in agriculture, commercial buildings and the planning rules governing mining.

So, the economic boosterism from the Treasurer is seriously misplaced. Existing policies offer us only economic stagnation.

But things could be worse!

The Opposition would go even further than the Coalition in stripping the economy of energy-efficient electricity. It would advance the program of replacing fossil fuels with renewables and roll out a massive, costly expansion of energy networks to accommodate this. It would also subsidise electric vehicles. Even more damagingly, Labor would convert the ‘safeguard mechanism’ covering major businesses from the mere ‘paper burden’ imposition on businesses that the Coalition says is its purpose into a new regulatory tool to reduce firms’ CO_2 emissions.

Perhaps we get the government that we deserve.