# Macroeconomic Policy for Australia in the 1990s

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**Abstract**

*The size of the deficit has little if any significance as an indicator of short-run macroeconomic policy. Government expenditure should be determined by longer term aspirations. Taxation (and other revenue measures) must be used, along with monetary policy, for short-term economic management, but whether revenue should be at a level that results in a deficit or not depends on many things including the composition of government expenditure and the state of the economy. At present, our economy requires a brake on total consumption expenditure and this may require a rise in taxation levels despite the high current level of unemployment. A high rate of capital accumulation is essential to change the structure of production and to increase output and productivity, but the brake on consumption must be eventually relaxed. Without an expectation of healthy consumption growth there will not be an ongoing high rate of accumulation in the private sector.*

What is appropriate macroeconomic policy for a small open economy on the Pacific Rim which has an enduring and indeed horrendous balance of payments problem, reflecting the need to restructure its

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industries, an extremely serious unemployment problem, including a frightening level of long–term unemployment,[1] and major pockets of unacceptable levels of poverty in what basically is still an affluent and relatively harmonious society?

Over the last twenty years or so, we have had a bellyfull of "deficit size" fetishism, as though the economic health of a nation could be measured entirely (or even at all) by the *difference* between government expenditure (G) and government revenue (T), regardless of the *sizes* of G and T themselves, or of the state of the economy when it is measured. So let us get away from this obsession once and for all and reinstate our common sense. I would argue that, by and large, what G should be, at Commonwealth, State and local levels, should be determined by *longer–term* aspirations reflecting both the overall philosophies of the democratically elected government in power and, as a corollary of this, well thought out and integrated plans for the provision of social and industrial infrastructure, as well as inducements to and help for, the private sector.

However, as government expenditure impinges on the *immediate* overall activity of the economy too, the implication is that *most* of the adjustment of the government sector needed to fit in with the activity that the private sector is providing must be through T, complemented by appropriate monetary policy. The latter will have to be associated mostly with selective credit rationing–for if Australia continues to have a floating exchange rate, the structure of interest rates will primarily be determined by the overseas trading, and lending and borrowing positions. (Incidentally, as I am writing about appropriate monetary policys may I refer readers to the passages in the Second Donald Horne Address where I urged the Reserve Bank of Australia to give a lead in encouraging the trading banks to make longer–term assessments of their customers' viability – and, if these are favourable, enable them to see through any short–term difficulties (Harcourt, 1992, pp.11–12). I would now say that the Reserve Bank should insist and *ensure* that they are able to do this.)

This way of looking at G and T brings to the fore some elementary and old–fashioned lessons which nevertheless are often forgotten: to remember that G itself may be divided into (at least) three categories–current expenditure, capital expenditure, and transfer payments. The first two have immediate and direct impacts on employment

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creation. Their longer–term effects differ markedly and so they should be sharply differentiated from one another. The third category only has indirect effects on activity here and now, and in the future. As it entails transfer between citizens, it is only the *net* effect on spending of such transfers that are relevant for activity and employment. (The equity aspects are, of course, most relevant but are outside the rubric of this essay. I also abstract here from the effects of transfer payments between us and overseas where the effects are much more substantial and direct, both immediately and in the future.)

Making a sharp distinction between current and capital expenditure should lead to a rethink about the nature and significance of government deficits and surpluses. Since much of government capital expenditure consists of the provision of needed social and industrial infrastructure, the returns to which only come in the medium to distant future and the immediate impacts of which on employment are markedly different (housing, health, education, transport are obvious examples), it really is foolish economics to expect *total* G always to be covered by total T, regardless of where the economy is in the various stages of the trade cycle, or where it is at in its planned development over the medium to longer term. In an ordinary business which is both viable and growing, we would never expect its *entire* outlays, current *and* capital, always or, indeed, ever to be covered by its *current* receipts. Periodic profits are in fact struck before interest payments on long–term borrowed funds are taken into account and certainly after periodic amortisation reckonings. (Measuring profits gross of interest payments reflects the fact that viability is in some respects independent of the pattern of finance of (at least) capital expenditures.) Why cannot we use this procedure as an analogy for the government sector and examine how *current* revenues measure up against *current* outlays? We should include in the latter, imputed interest on the capital associated with the provision of infrastructure (here we depart from private practice) and estimates of the social rate of amortisation of the capital projects.

It still may be that in some circumstances we would wish T greatly to exceed this associated estimate of G, depending upon how the private sector was faring (and on how the government wished it to fare); but at least we would get away from the foolishness of a crude total G, total T comparison, and from crying "disaster" if there is a

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shortfall, even when T is adjusted to its "full employment" level. There is, of course, nothing novel or original in these suggestions. They were made, for example, by Keynes in the 1930s and 1940s[2] and recently reiterated in 1992 in a U.S.context by Robert Heilbroner (1992).

The Australian scene is complicated by our Federal set up, with the possibility that State governments may be of a different political complexion to that of the Federal government. As in any democracy, compromise and give and take will be needed. At least minimum agreement could be obtained on, first, accounting procedures, and, secondly, implementation of those expenditures for which the Commonwealth government is responsible but which in practice are implemented at State levels through State Institutions.

If budgets are not balanced over the cycle, i.e. total G on average is greater than T, it will be necessary to keep a close eye on the debt to income ratio implied. For if a deficit (on average) were also to imply a *rising* debt to income ratio, we would be building an *eventual* source of instability into the structure of our economy. If, however, the ratio were to remain constant over time, not least because increasing the debt in the first place indirectly helped to raise income over time at a satisfactory pace, then there does not seem to be any overwhelming reason to worry about G exceeding T. In general public debt is not a problem in Australia. By OECD standards the ratio of public debt to GDP is low.

The vast amount of restructuring required almost certainly requires a brake on *total* consumption expenditure. While there is considerable room for redistribution within this total towards the less well-off, nevertheless the bulk of *extra* production in Australia at the moment ought to go into capital accumulation. This *may* require a rise in total T, even though, at the moment, there is heavy unemployment which needs steadily to be reduced. As in the U.K., the long-term needs of the economy and the state of the balance of payments imply that we need a "High Street" led recovery (as the Brits say) like we need a hole in the head. I realise that constraints on consumption require a further period of real sacrifice by the bulk of the workforce for, unlike the Brits, Australia does not have the equivalent of a cushion of North Sea Oil to allow 8–10 years of a fool's paradise to reign. Enterprise bargaining is going to complicate this task even more, for it will tend to make more unequal the pre-tax

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distribution of income. We shall need therefore some carefully crafted revisions of rates of taxation in order to bear down on total consumption expenditure. Moreover, the instability built into the Australian consumption function by the vast extension of credit facilities for all will make the task even harder. But as our erstwhile millionaire PM was prone to say, "life was not meant to be easy" and it should not be beyond the wit of the Treasury to provide its minister with a *number* of ingenious schemes from which the latter may choose, in order to attain the government's desired ends.

Nor would I suggest brakes on consumption *for ever*. In a mixed economy the ultimate stimulus to accumulation in large measure must be an expectation of a healthy rate of growth of the consumption demands of its citizens. Only then may we be sure that the "animal spirits" of the decision-makers in the private sector remain vigorous and dynamic.

I have mentioned our horrendous unemployment problem and the overseas balance constraint. I deplore the departure from a commitment to full employment – a departure, moreover, that had the blessing of a number of prominent Australian economists who, in retrospect, ought to be thoroughly ashamed of themselves[3]. However, I do think it is worthwhile remembering that Keynes and his closest colleagues thought that the statistical orders of magnitude of unemployment which would be associated with the *disappearance* of *involuntary* unemployment due to deficiency of aggregate demand, were around 6–8% of the workforce. (By the 1960s, though, there had been a sea change in attitudes on orders of magnitude by Keynes's disciples. Richard Kahn, for example, thought that Frank Paish was a semi-Fascist for wanting unemployment in the U.K. to be over 2.5 per cent when it was currently at 1.75 per cent of the work force.) There is a moral here: not that we should rest content with these higher orders of magnitude but that, when they do exist, in order to reduce unemployment to more socially acceptable levels, we should rely more on microeconomic policies (which should be occurring anyway) rather than continuing generally to increase G or encourage private spending. The policies would include retraining, relocation (of both capital *and* labour), and rehousing. Coupled with this understanding is the need to rethink the new moves in the Accord. For one of the essential aims of the Accord was to influence the overall increase of moneywages and therefore the overall cost level,

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an essential prerequisite for Australia to reach and *then sustain* levels of unemployment which we could reasonably regard as consistent with full employment and continuing growth.

In the move to enterprise bargaining and with the demand for more flexible labour markets, I fear we are in danger of losing sight of the benefits of some long–established Australian institutions for the overall working of the economy, and also of forgetting the funda–mental lessons bequeathed to us by two of our greatest Australian political economists, the late Eric Russell and the late Wilfred Salter. The economic analysis underlying the demand for more flexible and competitive labour markets does tend to treat the demand for and supply of labour as though they were akin to the demand for and supply of peanuts. In particular, it assumes that the demand and the supply curves of particular sorts of labour and even of labour in general, may be regarded as independent of one another. But modern theory and applied research alike suggest that this is a very dubious assumption indeed. For the productivitiy of labour may often depend upon the wage (and other conditions of work) of the labour force concerned. In so far, therefore, as the demand for labour depends upon its anticipated productivity, there is a whole family of demand curves, each member of which corresponds to a specific wage level. Moreover, the concept of a supply curve of labour is undermined for the *quality* of the supply of labour services will vary with the wage postulated to be paid; so that what is measured on the horizontal axis can no longer be regarded as different quantities of a *homogeneous* flow. At best, therefore, we are faced with the possiblities of multiple equilibria and it is not obvious which of them in fact will be established. Or, even more daunting, which ought to be? Indeed, the analysis, strictly speaking, becomes incoherent and so is certainly not a satisfactory guide for policy. Nor is this all. Let me rehearse the main policy conclusions of Salter's 1960 classic *Productivity and Technical Change*:

> "Salter draws three important and topical policy implications... The first is that government economic policy should be directed towards creating a flexible economy which enables an easy transference of resources from declining, high cost and price industries to expanding, low cost and price ones. The second is that wages policy should be national in scope rather than related to the circumstances of particular industries. Relating earnings to the 'capacity to pay' of particular

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> industries tends to bolster declining industries and hamper expanding, progressive ones. It delays the introduction of new techniques and has a harmful effect on overall economic growth. Third, a high rate of gross investment is necessary to allow the structure of production to change quickly and, given the structure of demand, to increase the output and productivity of those industries where technical advances are most rapid."[4]

Russell (allied with Salter until the latter's tragically early death in 1964) fought a lonely but ultimately successful battle to have established the principle that money–wage levels should be adjusted through the Arbitration Commission so as to reflect changes in prices *and* effective productivity. Not only is this consistent with equity, with the traditional Australian sense of fair play, it is also the appropriate macroeconomic policy to follow. Most importantly, it allows, *cet. par.* the accumulation processes, which Salter analysed so incisively, to have their maximum impact on the growth in productivity, both in individual industries, and overall. The early years of the Accord enshrined this excellent principle. As I said in the Horne Address (1992, p.8), it was not the wage–earners but the Australian capitalists who failed to play their part, to wit, to 'Accumulate, accumulate, that is Moses and the prophets' (and also, so as to keep John Hewson and his constituency happy, the profits as well). Another aspect of restructuring associated more with microeconomic policy and the role of government should be the provision of government help via information services and back up generally to exporters (and entrepreneurs involved in import replacement) to help them find and then secure niche markets. This is an obvious lesson which Australia could learn from those NICs which gave business people their heads but backed them up in the national interest as well. A by–product of being successful in this regard may be a reversal of the trend whereby the "brightest and the best" were attracted to services and finance sectors by the grossly distorted signals which were given out in the 1980s (see Harcourt, 1992, p.12). Another lesson from the NICs is that we should leave tariff levels where they are, at least in the medium term.

We need also to think of measures which will eliminate harmful speculation in finance and property markets so that prices and rewards there may more fully and fruitfully reflect useful economic activity. In this way present and past savings will be gathered

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together in a more socially useful way. On the side of real investment the government should take the lead in designing investment incentives which persuade business people to invest in those areas which, overall, the government has decided most need to be developed. Provided these areas are defined broadly enough, the chances of corruption will be lessened, yet neither the government nor its public servants will be able to dodge the responsibility for giving leadership in what should be a partnership between the public and private sectors.

Australia must not accept unemployment close to 10 per cent as an appropriate "natural" rate of unemployment (a non–existent concept anyway, if ever there was one, within the analytical approach taken in this article). A greater rate of capital accumulation and appropriate macroeconomic policies, as spelled out in this article, can enable a substantial reduction in unemployment over the next five years without a blowout in the foreign debt or a rapid resurgence of inflation.

## Notes

1. In May 1993 366,000 had been unemployed for more than one year.
2. Donald Moggridge tells me that Keynes was the author of Chapter XXIX, "The Reform of the National Accounts", in the Report of the Liberal Industrial Inquiry, *Britain's Industrial Future* (The "Yellow Book"), Ernest Benn Limited, 1928, where this matter is discussed in detail. The most clear–cut argument by Keynes on this matter is in his Memorandum, "National Debt Inquiry: The Concept of a Capital Budget", *Collected Works*, XXVII, 1980, 406–13. I am indebted to Bradley Bateman for this reference. Robert Skidelsky has drawn my attention to n2 on p.348 of *Collected Works*, IX, 1933, 1972 – "The Means to Prosperity". There, Keynes wrote: "I strongly support...the suggestion...that the next budget should be divided into two parts, one of which shall include those items of expenditure which it would be proper to treat as loan expenditure in present circumstances".
3. I vaguely remember being summoned by a well–known Professor of Economics some time in the 1970s to a highly secret meeting of about 10 or so Australian Professors of Economics at the University of Melbourne. There we were urged to "educate" the public to accept higher levels of unemployment than had been the feature of the post–war world. I remember that only I and one other person present were scandalised by the request; in retrospect I bitterly regret not "spilling the beans" about

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it all at the time. Now that I am, I can't remember exactly when it occurred or who was there!

4. Immodestly, this is taken from the review article I wrote of Salter's book, which was published in the *Economic Record* of September 1962 and reprinted in *The Social Science Imperialists* (Routledge and Kegan Paul) in 1982.

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