

DETERMINING THE FISCAL POLICY
TIME-FRAME: THE DOMINANCE OF
EXOGENOUS CIRCUMSTANCES

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TABLES AND CHARTS

TABLE OF CONTENTS		Page
Tables and Charts		3
Abstract		4
1. Introduction		5
2. The Objectives To Which Policy May Effectively Be Directed		9
3. The Economic Circumstances And Outlook		18
4. The Varying Impacts And Lags Of The Policy Instruments		21
5. Conclusion: The Political Environment In Which Macro-Economic Policy Is Formulated		34
Bibliography		39
PPP Discussion Papers		44
Table 1: Average Annual Percentage Growth in Real GDP Per Capita, OECD, 1968 to 1990		7
Table 2: Average Annual Percentage Increase in the CPI, OECD, 1968 to 1990		7
Table 3: Average Unemployment Rate (as a Percentage of the Labour Force), OECD, 1968 to 1990		8
Chart 1: Australian Exports by Commodity, as a Percentage of GDP, 1950 to 1990		10
Chart 2: Inflation and Unemployment - Phillips Curves, Australia and the EEC, 1970 to 1988		12
Chart 3: Balance On Current Account and Trade Balance, as a Percentage of GDP, Australia, 1949 to 1990		15
Chart 4: Net Financing Requirement and Current Account Deficit, as a Percentage of GDP, Australia, 1968 to 1991		16
Chart 5: Asset Price Inflation, Australia, 1969 To 1991		17
Chart 6: Movements In the Terms Of Trade and Real GDP, Australia, 1968 To 1991		21
Chart 7: Estimates of the Structural Movements in the Commonwealth Budget, 1980 to 1992		28
Chart 8: Lending and Credit, Australia, 1950 to 1990		29
Chart 9: Interest Rates and Yield, Australia, 1969 to 1991		31
Chart 10: Employment Growth and Real Unit Labour Costs, Australia, 1981 to 1991		33

ABSTRACT

Fiscal policy is one of the fundamental tools of political management, and of macro-economic policy. This paper largely confines itself to the second of these functions. It investigates the question of whether there are any circumstances which justify using fiscal policy in a counter-cyclical stabilisation role. The economic issues relevant to this question are assessed, on the basis of the literature and empirical evidence, under three headings:

1. the objectives to which policy may effectively be directed;
2. the economic circumstances and outlook; and
3. the varying impacts and lags of the principal policy instruments.

This analysis recognises the close inter-relationships between fiscal policy and the other principal macro-economic policy instruments (monetary policy and wages policy). The evidence suggests that there is a counter-cyclical role for fiscal policy in circumstances where there is a significant Keynesian slump in aggregate demand. Such circumstances demand active fiscal response, that is, allowing the automatic stabilisers to perform their "duty" will not be a sufficient enough injection to effective demand to arrest the slump.

In periods of growth, and/or in the presence of a high current account deficit that is indicative of structural imbalance within the domestic economy, however, there are strong grounds for assigning wages policy to the employment (and growth) objective/s. This allows policy-makers the choice of switching fiscal policy to the structural issues such as the balance of payments: a particularly important option for Australia with its relatively high vulnerability to exogenous economic shocks.

1: INTRODUCTION

Fiscal policy is one of the fundamental tools of political and economic management. This paper addresses its economic-budgetary role. The question addressed in this paper can be stated simply ²as follows: are there any circumstances which justify using fiscal policy in a counter-cyclical stabilisation fashion?

I will argue in this paper that there are circumstances which justify such use of the fiscal instrument in a counter-cyclical role. Setting fiscal policy in a medium-term context, within the context of a persistently high current account deficit (which is indicative of significant structural imbalance in the domestic economy), should not be so rigid as to prevent consideration of the fiscal instrument in response to a dramatic decline in output and employment. The message of Keynes is still relevant today.

Several arguments have been put forward in the past fifteen years or so that favour the medium-term approach for fiscal policy. These debates reflect a return to more classical notions of the fundamental economic paradigms. They also parallel the rise of the Rational Expectations school of economics.

Another strand of thought attacks the Keynesian paradigm in practice - on the basis of its alleged over-reliance on the capacity of policy-makers to monitor the economic cycle accurately and to analyse it correctly, and then to respond with the appropriate action at the right time, regardless of the political circumstances. This challenge comes partly from the so-called economic rationalists ⁽¹⁾ (e.g., Lucas, 1976; and Kydland and Prescott, 1977); and - to a somewhat lesser extent - from the public choice school of political studies outside "mainstream" economics (e.g., Breton, 1974; Brennan and Buchanan, 1980 and 1985) ⁽²⁾.

²

(1) "Economic rationalist" in this paper refers to the more narrow sense of being those aligned to the rational expectations schools of economics, rather than the broader sense used by Pusey (1991) and others to denote any bureaucrat who relies exclusively on economic paradigms and methodologies.

(2) There is a third set of arguments which I wish briefly to address here. These views challenge the capacity of economics *per se*, not just the Keynesian paradigm, to provide predictable "scientific" data for decision-making. It is not a new argument, but rather one which may be traced back to the ancient Greeks. In Plato's *Meno* (387bc), Socrates shows Meno, by means of the geometric experiment, the dangers of relying solely on mathematics for answering practical questions. Aristotle, in the *Nicomachean Ethics* (@330bc, para. 1143), argues that decision-makers need to possess "nous" - that is prudence, or practical wisdom. Those who follow Aristotle assert that any policy-maker who confidently

Given the relationship between fiscal policy and the other principal policy instruments, the primary economic factors for assessing the role of fiscal policy can be grouped as follows:

- 1: the objectives to which policy may effectively be directed;
- 2: the economic circumstances and outlook; and
- 3: the varying impacts and lags of the principal policy instruments.

I will discuss each separately, before drawing some preliminary conclusions on the basis of these economic factors. The final section will then assess these conclusions in the context of the political environment in which economic policy is formulated. Before doing so, however, it is necessary to outline the current policy and statistical "state of play".

The difficulties of the 1970s and early 1980s led to the underlying principles of Keynesian macro-economics being seriously challenged (3). The oil "shocks", and their aftermath, provided an opportunity for more classical views of the economy to re-emerge. These views initially favoured the monetarist prognosis, then shifted by the mid-1980s to the longer term structural view.

Fiscal policy in Australia, as well as in many other OECD countries, has been formulated on a medium-term basis since around 1987 (Chouraqi, Clinton, and Montador, 1987, p. 5; Commonwealth Treasury, 1991, pp. 2.5-2.33). In this period, monetary policy has been the principal counter-cyclical instrument. However, it too is being directed more towards the medium-term, its principal objective now being the reduction of inflation and inflationary expectations.

Wages policy - effected through the Accord - is now seen as the primary tool for raising the level of employment in Australia, a task previously assigned to fiscal policy. The Accord has constrained real unit labour costs and reduced the relative cost of labour (Chapman and Gruen, 1990, p. 33;

relies on quantitative techniques as the sole reference points for decisions is following a quite risky course of action (see, for example, Rhoads, 1985, pp. 170-173 and 195-196). The critique is a call to "look out the window" occasionally, and use quantitative information as a guide, or aid, to policy action.

- (3) In particular, the idea that governments could "fine tune" the economy was attacked. Milton Friedman, of course, had been pushing this line of attack against Keynesian economics for a long time prior to the 1980s. See Friedman (1948).

Chapman, Dowrick, and Junankar, 1991, p.50; Cook, 1991, p. 3).

Nevertheless, due to its structural nature, the Accord has only a medium-term impact on employment levels. The Accord's capacity to restrain the growth of unemployment in a recession is limited in comparison with fiscal policy.

TABLE 1: AVERAGE ANNUAL PERCENTAGE GROWTH IN REAL GROSS DOMESTIC PRODUCT/NATIONAL PRODUCT PER CAPITA, OECD, 1968 TO 1990

	1968-73	1974-79	1980-85	1986-90
UNITED STATES	2.0	1.6	1.2	1.8
JAPAN	7.1	2.5	3.1	4.2
GERMANY	4.0	2.6	1.2	2.7
FRANCE	4.5	2.3	1.1	2.7
ITALY	3.0	3.2	1.8	2.8
UNITED KINGDOM	3.9	1.5	1.2	2.7
CANADA	4.1	3.1	1.6	2.1
G7 COUNTRIES	3.4	2.2	1.7	2.7
SMALL EUROPEAN COUNTRIES	4.5	1.4	0.8	2.2
AUSTRALIA	3.5	1.4	1.7	1.6
NEW ZEALAND	3.4	-0.3	1.9	-0.4
OECD	3.5	2.0	1.5	2.5

Note: The category "Small European countries" comprises Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey.

Source: OECD, 1991, *OECD Economic Outlook 49*, Paris, OECD; OECD, 1991, *Historical Statistics 1960-1989*, Paris, OECD.

TABLE 2: AVERAGE ANNUAL INCREASE IN CONSUMER PRICES, OECD, 1968 TO 1990

	1968-73	1974-79	1980-85	1986-90
UNITED STATES	5.0	8.5	6.8	3.9
JAPAN	7.1	9.9	3.6	1.2
GERMANY	4.6	4.7	4.2	1.3
FRANCE	6.1	10.7	10.3	3.0
ITALY	5.8	16.1	15.0	5.6
UNITED KINGDOM	7.5	15.6	9.0	5.0
CANADA	4.6	9.2	7.9	4.4
G7 COUNTRIES	5.6	9.7	7.2	3.4
SMALL EUROPEAN COUNTRIES	5.7	9.9	6.9	4.2
AUSTRALIA	5.6	12.1	8.6	7.7
NEW ZEALAND	7.4	13.8	13.0	9.4
OECD	5.9	10.5	8.3	4.5

Note: For this table, the category "Small European countries" excludes Iceland and Turkey.

Source: OECD, 1991, *OECD Economic Outlook 49*, Paris, OECD; OECD, 1991, *Historical Statistics 1960-1989*, Paris, OECD.

TABLE 3: AVERAGE UNEMPLOYMENT RATE (AS A PERCENTAGE OF THE LABOUR FORCE), OECD, 1968 TO 1990

	1968-73	1974-79	1980-85	1986-90
UNITED STATES	4.6	6.8	8.1	5.9
JAPAN	1.2	1.9	2.4	2.5
GERMANY	0.8	2.8	5.3	5.9
FRANCE	2.8	4.7	8.4	9.9
ITALY	5.7	6.7	9.3	11.7
UNITED KINGDOM	2.4	4.2	10.0	8.4
CANADA	5.4	7.2	9.9	8.3
G7 COUNTRIES	3.2	4.9	7.0	6.3
SMALL EUROPEAN COUNTRIES	4.5	4.9	9.7	9.6
AUSTRALIA	2.0	5.1	7.6	7.2
NEW ZEALAND	0.3	0.8	3.9	5.7
OECD	3.4	4.9	7.6	7.0

Source: OECD, 1991, *OECD Economic Outlook 49*, Paris, OECD; OECD, 1991, *Historical Statistics 1960-1989*, Paris, OECD.

Tables 1-3 above flesh out, in cross-national aggregate form, the economic environment in which these changes in policy attitudes have taken place. The time periods in these tables have been selected to reflect four distinct periods: pre-the oil shocks, the first and second oil shocks and their aftermaths, and the post-oil shock period. The data does not extend to the present downturn. The statistics show that the second half of the 1980s was a period of resurgence, after the difficulties of the late 1970s and early 1980s. Real output growth per capita increased, and inflation had been substantially curtailed. Unemployment, however, had not improved to the same extent. Only in North America and the United Kingdom had unemployment significantly declined in the second half of the 1980s. Italy is an interesting case. It maintained second place on the growth list behind Japan, despite persistently high relative levels of inflation and unemployment.

Australia's recovery since the oil shocks has been relatively weak. With the arguable exception of inflation, Australia was an average performer during the period 1980 to 1985. But Australia has slipped to be among the

under-performers for real growth per capita and consumer price inflation since 1985, though recently it has improved its inflation performance.

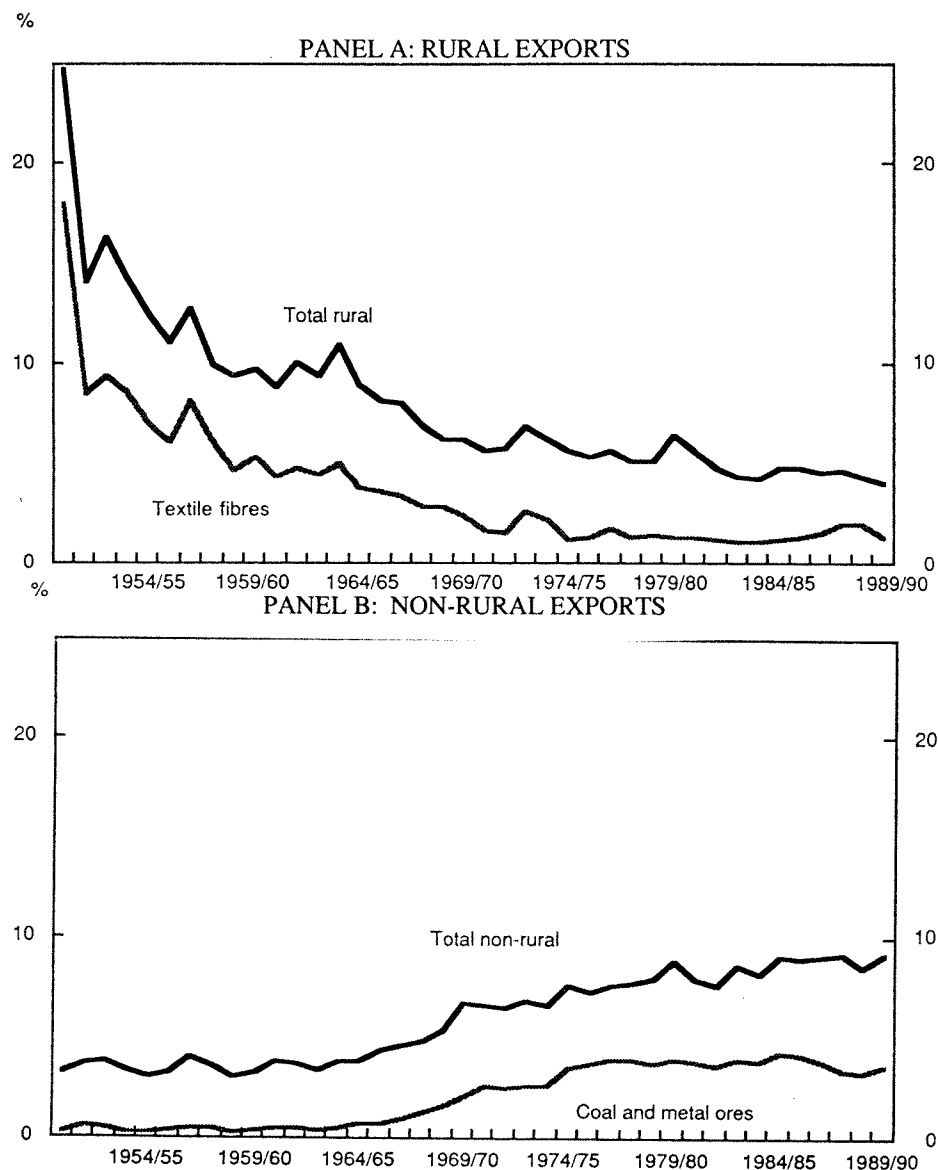
Another important factor is the different structure of the Australian economy compared with most other OECD economies. Commodities account for around 80 percent of Australia's exports (compared with the OECD average of 24 per cent), and manufactures make up over 80 percent of imports into this country (OECD average: 64 per cent) (Higgott, 1991, p. 5). Chart 1 plots the long-term trend in Australian exports, as a percentage of Gross Domestic Product, since 1950. It shows that while Australia's reliance on rural commodities has declined, coal and metal ores exports (mineral commodities) have grown strongly. Other non-rural exports, including manufactures, have only increased slowly. Because of this reliance on primary and semi-processed resource goods for its exports, Australia's economy is far more vulnerable to the vagaries of world markets and shifts in the terms of trade than are OECD countries generally.

The intractability of unemployment together with continued sluggish growth in many OECD economies has fuelled new doubts about the policy prescriptions put in place in the 1980s. Nevertheless, the policy response across the OECD to the present downturn mirrors that taken in Australia. No large OECD country has undertaken significant discretionary fiscal measures to counter the downturn, demonstrating a common commitment to medium-term fiscal policy. Also, interest rates have only been cautiously reduced - with the arguable exception of the U.S.A. (Commonwealth Treasury, 1991, p.2.5). Hence, my argument - if valid - is of some policy relevance, as it is in stark contrast to the fiscal policy settings now in place across the OECD in response to the present recession.

2: THE OBJECTIVES TO WHICH POLICY MAY EFFECTIVELY BE DIRECTED

The notion that government should use the policy instruments at its disposal to prevent deep recessions was an integral part of Keynes' basic vision (Keynes, 1936, pp.120, 127). It was Tinbergen (1952), however, who was the first formally to consider the policy assignment problem faced by policy-makers. His basic proposition was that the objectives of economic policy can be fully achieved only if the number of effective instruments was at least equal to the number of independent objectives. If there are more independent objectives than instruments, then one objective, at least, has to be downgraded or disregarded (Norton, 1973, p.12).

CHART 1: AUSTRALIAN EXPORTS, BY COMMODITY, AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, 1950 TO 1990



Source: R. A. Foster and S. E. Stewart (Reserve Bank of Australia), 1991, p. 10.

Theil (1958) later developed a more flexible policy assignment model, which allowed putting boundary limits on instruments as well as objectives. But it is the Tinbergen method that is still largely used by policy-makers. This is because of its intrinsic simplicity, as opposed to Theil's more complex model.

There are, essentially, two types of policy objective: ultimate and intermediate. Intermediate objectives are identified means (or constraints) that should be achieved (or removed, respectively), in order to attain the ultimate objective/s.

Politics should be primarily concerned with the pursuit of ultimate objectives. The utilitarian moral philosopher, John Austin (1832, pp. 295-298) argued that the "proper paramount purpose [of government] is the greatest possible advancement of the common happiness". But he warns against unconsciously assuming that this always equates with growth in national wealth.

Despite this important caveat, many economists regard the ultimate economic objectives as being the maximisation of real per capita consumption, subject to natural resource constraints, and the achievement of a fair distribution of national income. The other more commonly discussed objectives - full employment, price stability, and a sustainable balance of payments - are means to achieving these ultimate objectives (4).

Failure to achieve any intermediate objective can restrict long-term progress on the ultimate economic objectives. Fiscal policy impacts on each intermediate objective, often to differing degrees, depending on which objective it is primarily directed towards and how the other principal macro-economic policy instruments are configured.

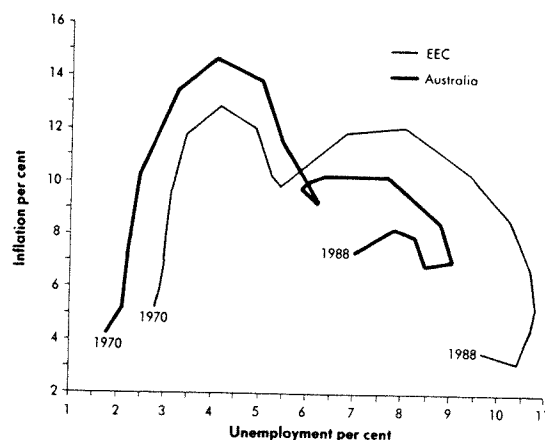
It is readily apparent that there may be conflicts between objectives. There are trade-offs. For instance, there is a perceived negative relationship, at least in the short-run, between unemployment and inflation. This relationship is commonly identified by means of the Phillips Curve. Once thought to be stable, it is now recognised that this curve can shift: out (to the

(4) I recognise, of course, that these three intermediate objectives are not the only factors important for the attainment of the common weal, or even the ultimate economic objectives. They are, however, the relevant intermediate objectives for which macro-economic policy-makers (both Ministers and bureaucrats) are usually assigned responsibility by the Government.

right) in respect of an adverse shock, and in (to the left) in response to events such as a sustained period of flat or falling real wages (Chapman, Dowrick, and Junankar, 1991, p. 38). Chart 2 shows the Australian and EEC Phillips Curves since 1970. It lends support to the notion that this trade-off can shift. Two, and possibly three, curves can be identified for Australia in the graph.

The successful attainment of one objective can assist progress on another. The automatic stabilisers within the budget are a good example. Unemployment benefits and progressive income taxation ensure that, in times of economic difficulty, a safety net is provided for the disadvantaged - in accordance with the distributive objective. These fiscal tools also help reduce the amplitude of the recessionary cycle by automatically injecting demand into the economy when most needed.

CHART 2: INFLATION AND UNEMPLOYMENT - PHILLIPS CURVES, AUSTRALIA AND THE EEC, 1968 TO 1989



Note: Three year moving averages used.

Source: Robert G. Gregory, 1991, using OECD, June 1990, *Economic Outlook*, p. 115.

The point is that one cannot effectively assign policy instruments by considering each objective in isolation. Governments have to decide which ultimate objective is to take priority when conflict between them arises - in Australia, at present, the growth objective takes precedence (cf. Commonwealth Treasury, 1991, p.2.33) - and then set the intermediate objectives in that context. I will now discuss each intermediate objective briefly in turn (5).

Full Employment: This term is often used to refer to the employment of labour, but it should refer to all economic resources. Idle resources (that is, those that are involuntarily unemployed) cannot contribute to national welfare. Both labour and capital may be temporarily frictionally unemployed while in search of better opportunities. In a perfect world, this search would take little time. The non-accelerating inflation rate of unemployment (NAIRU) describes this concept in terms of the short-term inflation trade-off. Involuntary unemployment is a clearer description of the demon with which policy-makers grapple for, unlike the search for better returns, the damage it does in pursuit of the ultimate objectives is substantial (6).

Unemployment of economic resources, including labour, implies output loss: both in the short-term (as it lies inside the production possibility curve), and in the long-term due to debasement of the level of human capital. This problem is particularly severe for the long-term unemployed (Chapman, Dowrick, and Junankar, 1991, p. 21). Unemployment is also a root cause of the lack of a fair distribution of income.

Inflation: The economic effects of inflation and inflationary expectations are, in the medium-term, corrosive of the real level of economic output, and may also produce unwanted redistributive effects - particularly if the

- (5) Two other issues deserve comment at this juncture: wages and structural reform. If these were treated as objectives, policy mistakes would ensue, for they are instruments - not objectives. Labour market and other structural reform are instruments for improving the economy's supply capacity: that being arguably the primary long-term causative factor of the rate of economic growth (Chouraqui, Clinton, and Montador, 1987, p. 7). Wages policy is an important instrument in Australia, and will be considered later.
- (6) An issue of widespread dispute is the question of what is the true level of involuntary unemployment. Keynesians put frictional unemployment at a lower level typically than do neo-classical economists. The debate goes further than that, though. There is dispute about what involuntary means. Is it involuntary in that the unemployed are merely unprepared to work at the going wage rate? Or is it involuntary because there are far fewer job vacancies than unemployed, and hence jobs are just not available in the present economic conditions? For a comparison of the differing views, see Plosser (1989) and Blinder (1988).

inflation is unforeseen. Also, by contributing to the higher nominal and real interest rates used to inhibit demand, inflation has had a redistributive effect through its underlying impact on the present recession (7).

The mechanisms by which inflation can severely retard the sustainable rate of growth include:

- an upsurge and increased variability of inflation increases the opportunity cost of holding money. Investors will prefer short-term over long-term claims, and debt over equity (Swamy and Tavlas, 1989, p.70);
- increased nominal interest rates via the Fisher effect (Parkinson, 1991, p.4). Resources are diverted away from productive investment and private saving is discouraged. Asset allocation is distorted (Morgan, 1990, p.8; Parkinson, 1991, p.21); and
- money demand responds more quickly to shocks. This leads to greater economic volatility. Thus, if macro-economic policy responds to these movements, it may become stuck in a “stop-go” cycle, further amplifying the instability (Ball and Cecchetti, 1990, pp.217-245).

These effects feed into the balance of payments. Firstly, lower savings force firms to seek more foreign investment funds. There is likely to be less investment in tradeables, because of the disincentives inflation creates for productive investment. Secondly, inflation may lead to higher real interest rates - contrary to the pre-float views of some Keynesian economists (e.g., Tobin, 1977, p.464). This is because inflation, particularly high and variable inflation, is indicative of economic instability. Foreign investors therefore demand a risk premium on their borrowing, leading to higher real levels of external debt (8). Thirdly, the exchange rate only adjusts with some lag to changes in the terms of trade. Hence, inflationary “noise”, reflected in real interest rate differentials, can have a volatile impact upon the exchange rate and the balance of payments. This is despite empirical evidence that real interest rate differentials only explain about one-fifth of changes in the real exchange rate, as opposed to the terms of trade which

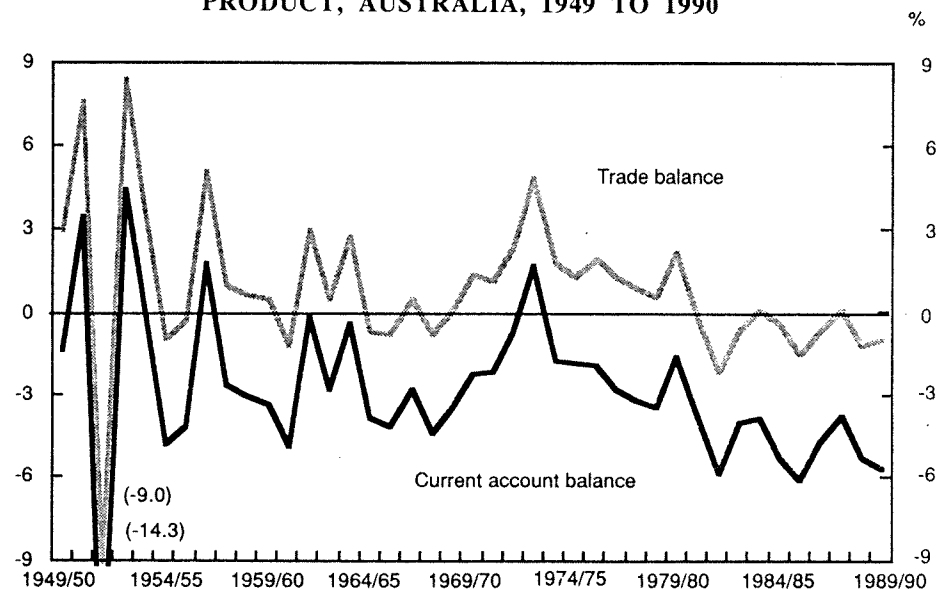
(7) There is also evidence that inflation led to many potential first home buyers being excluded from the Australian market in the 1980s (Cassidy, 1991, p. 18). On the other hand, people who purchased their homes prior to the boom in housing prices, and at the old fixed mortgage rate, have benefited enormously.

(8) Others argue that if the dollar is freely exchanged, inflation should force its value down, *ceteris paribus*, therefore creating the foreign investors' premium by their insistence on loans being denominated in foreign currency. Such a view posits the purpose of high interest rates, in respect of the balance of payments objective, as one of encouraging higher domestic savings.

explain up to two-thirds of such changes (Commonwealth Treasury, 1991, p.2.22).

Balance of Payments: The balance of payments can be a signal of domestic economic disequilibrium: expressed as imbalances between output and expenditure; and/or between savings and investment. Of course, if there were no resource misallocations due to inflation or market failure, the current account deficit would represent the economy's success in attracting foreign investment on the grounds of greater relative real returns. This would not signal any failure in macro-economic policy management or structural defect in the economy (9). Chart 3 locates the Australian post-war external account experience. It shows Australia's traditional position of being a long term capital importer. The chart also shows, however, a deterioration in the trade balance in the 1980s which has laid the foundation for the contemporary high current account deficits.

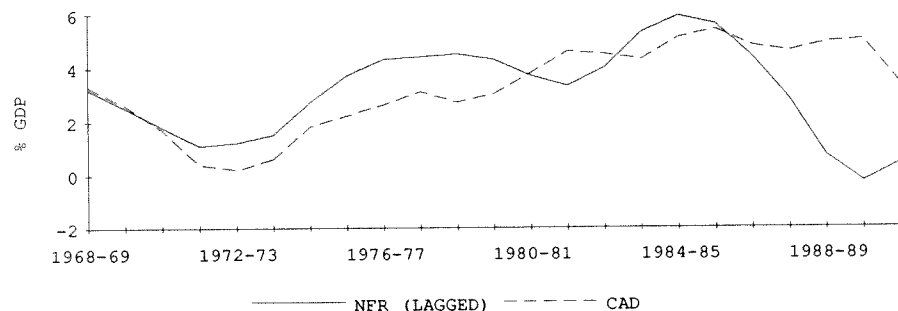
CHART 3: BALANCE ON CURRENT ACCOUNT AND TRADE BALANCE, AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, AUSTRALIA, 1949 TO 1990



Source: R.. Foster & S. Stewart (Reserve Bank of Australia), 1991, p.4.

(9) In this respect, it is pertinent to remember that Australia has been a significant capital importer for the greater part of its existence as a western economy.

CHART 4: NET FINANCING REQUIREMENT AND CURRENT ACCOUNT DEFICIT, AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, AUSTRALIA, 1968 TO 1991



Note: Three year moving averages have been used. The Net Financing Requirement has been lagged by one year. The Current Account Deficit figure for 1990-91 uses the Commonwealth Budget forecast for 1991-92 to derive the three year average.

Source: R. Foster and S. Stewart (Reserve Bank of Australia), 1991, pp.5, 60; Commonwealth Treasury, 1991, pp.1.2, 2.48.

The first ground for being concerned about a sustained high current account deficit is that it may be indicative of a long-term savings-investment imbalance, induced by a sustained period of relatively higher inflation and interest rates. Analysis by Murphy (1989, p.43) suggests that half the rise in foreign debt in Australia in the 1980s can be explained by the savings-investment gap.

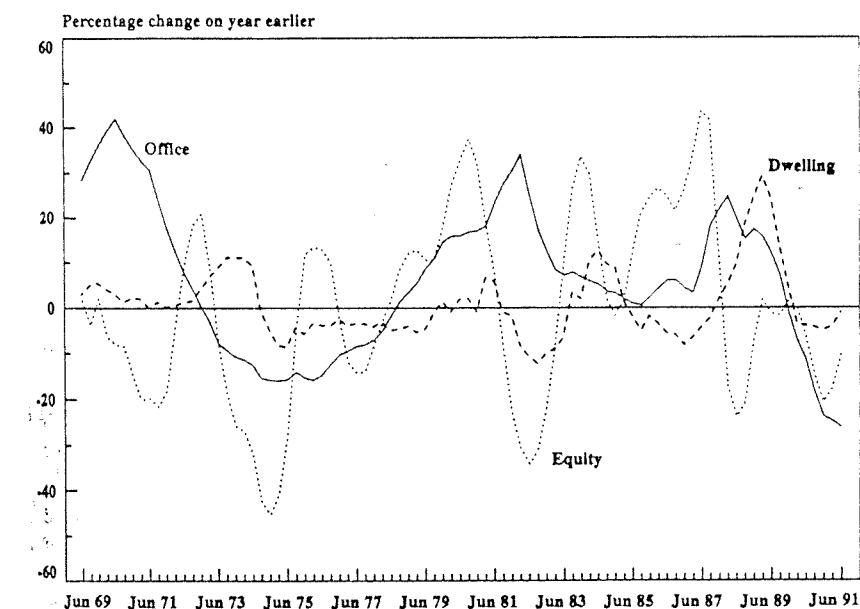
Secondly, persistent public deficits are claimed to put a floor under the current account deficit (e.g., Eltis, 1976). For this effect to be full, however, several conditions have to be met. Kearney and Fallick (1987, p. 139) identify several reasons why there may not be a close link between the government deficit and the balance of payments. Hence, it is not surprising that the reduction in the Net Financing Requirement in Australia in the second half of the 1980s has not been fully reflected in the current account outcome (see Chart 4 above) (10).

(10) Nevertheless, there may yet be large gains to be realised from reducing public debt if Murphy (1989, p. 39) is correct about a pipeline effect, because of reaction lags due to people requiring convincing evidence that any change in public debt is permanent.

Thirdly, foreign borrowing may be related to unsustainable asset price inflation. Chart 5 gives an indication of the recent volatility of asset price inflation in Australia. Sharp peaks in prices occurred in all three asset categories within the two years from June 1987 - a coincidence which had not occurred in Australia in the previous 20 years. When these speculative bubbles burst, highly-g geared businesses collapsed. As a consequence, many banks and investors incurred high levels of bad debt if they made poor lending choices. They may seek to recoup these losses by imposing higher lending margins on new borrowers, regardless of the quality of the prospective investment. Such behaviour reflects myopic time horizons among capital market players: a clear contradiction of the forward-looking rational behaviour assumption.

Fourthly, confidence is fragile. In another contravention of the rationality assumption, Fraser (1990, pp.12-13) argues that a country with a large foreign debt is in high profile with foreign investors. Their short-term operational horizon means that they are often influenced by the "latest news".

CHART 5: ASSET PRICE INFLATION, AUSTRALIA, 1969-91



Source: Commonwealth Treasury, 1991, p. 2.25.

and are not sufficiently far-sighted to maintain a view of the exchange rate based largely on the fundamentals.

Notwithstanding the apparent increased willingness of foreign investors to finance large current account deficits in the deregulated trading environment (Commonwealth Treasury, 1991, p. 2.36), Australia is a vulnerable (11), medium-sized, resource commodity exporter and a long-standing (if not virtually permanent) capital importer. Hence, a collapse of investor confidence, or of the terms of trade, has far more dire consequences for Australia than, for example, the U.S.A.. Given the imbalances and possible failures that the balance of payments can reflect, any responsible Australian government must ignore Pitchford's (1989a, 1989b, 1990) elegant theoretical arguments, and maintain vigilance on the balance of payments as an intermediate objective.

Thus, economic policy-makers in Australia must pay due regard to each of the three intermediate objectives if there is to be sustained progress towards the ultimate objectives. The configuration of the principal macro-economic policy instruments must, if at all possible, attempt to cover each of these intermediate objectives in a way that leads to sustainable progress in respect of the ultimate objectives. Each intermediate objective, if allowed to deteriorate and go unchecked, will place tough barriers in the paths of sustained economic growth and the achievement of a fairer distribution of income.

3. THE ECONOMIC CIRCUMSTANCES AND OUTLOOK

There are recurrent cycles in market economies. Policy-makers must recognise this if they are to have any practical comprehension of what impact the instruments at their disposal might have in the pursuit of policy objectives.

(11) I hesitate to use the word "open". Higgott (1991) points out, for instance, that there are other statistics that support a view that Australia is a closed economy, e.g., the share of Gross Domestic Product accounted for by exports is only 15 per cent - remarkably low for a middle-sized advanced country. Nevertheless, the income volatility associated with relying on commodities for export (due to the highly variable prices) leads me to conclude that Australia is highly vulnerable to exogenous economic shocks. To use Castles' (1988, pp. 42-46) terms, it is not the extent of trade that posits Australia as a vulnerable economy, but the structure of that trade.

The business cycle is the short-run oscillation of the macro-economy from trough to peak, and back. Activist counter-cyclical policy is, by definition, primarily concerned with smoothing out the business cycle. This is because Keynesian economists believe that deficient effective demand is the principal cause of economic slumps and unemployment. Hence, in a nutshell, if the government injects demand into the economy through easing fiscal and/or monetary policy, that deficiency can be removed and a higher average rate of real growth in output and expenditure sustained.

The role of econometric forecasting in this activity is crucial. Policy-makers need to know the value of the Keynesian multipliers to have an idea of how large an injection is required to avoid a slump.

One of the most fundamental challenges to Keynesian orthodoxy is the theory of real business cycles (e.g., Plosser, 1989; Nelson and Plosser, 1982). Proponents of this theory claim that it is not possible to reject the hypothesis that long historical time series for key economic variables are "non-stationary stochastic processes with no tendency to a trend line" (random walks) (Plosser, 1989, pp. 59-71). If so, real shocks associated with the secular component of the series contribute substantially to observed variations through their impact on capital accumulation.

Mankiw (1989, p.79) vigorously rejects these views. He points out that since the shocks are "real", and that the business cycle is the natural response to these shocks, it must be assumed that those shocks are large, random fluctuations in the rate of technological change (12). Mankiw asserts that there is no direct evidence for such substantial disturbances (1989, p.85).

Secondly, the synchronised nature of these shocks across nations contradicts real business cycle theory. Like the old classical view of economic fluctuations, it also relies on the intertemporal substitution of leisure to explain unemployment. Mankiw (1989, p. 79) reminds us that this is an unsatisfactory explanation. It trivialises the social cost of economic fluctuations, and encourages the conclusion that macro-economic policies are unnecessary. Finally, real business cycle theory also assumes a degree of rationality by agents that is difficult to sustain empirically. If we reject real business cycle theory, then, in accordance with Keynesian theory,

(12) Mankiw implicitly assumes that the other determinants of supply - labour, natural resources, and capital levels - are fairly stable series, although some might say that savings and investment are not stable. Nevertheless, the stock of capital is usually of such a size so as to be "reasonably" stable.

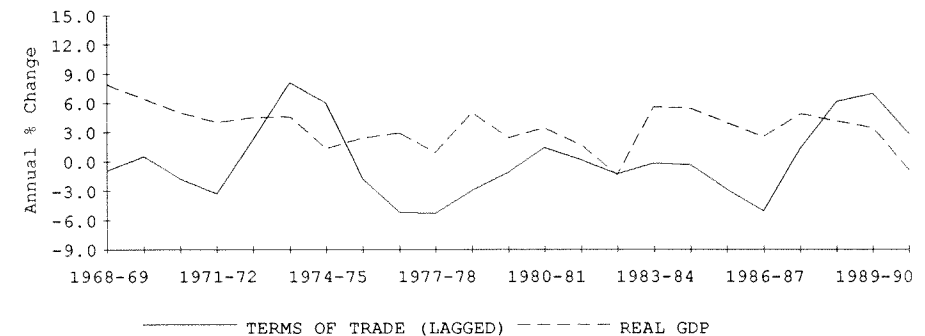
demand can be supplemented in the short-term, and supply can be affected by structural policies in the longer term (Chouraqui, Clinton, and Montador, 1987, p.7).

What then of Australia's situation? The high level of reliance placed on the income generated by trade implies that Australia is vulnerable to terms of trade shocks. These amplify the Australian trade cycle by reinforcing the underlying swings in the cycle associated with expenditure (Commonwealth Treasury, 1990, pp.2.13-2.15; Commonwealth Treasury, 1991, pp.2.20-2.22). Chart 6 below highlights this reinforcing effect. Lagged by one year, the three-year moving average for the terms of trade displays reasonable affinity, in terms of cycle turning points, with changes in real Gross Domestic Product. Only two turning points in the trend real level of output since 1968 have not been preceded by a similar turn-around in the terms of trade (1969-70 and 1976-77). Australian policy-makers therefore face greater difficulties in framing macro-economic policy than those usually posited by theory developed abroad.

In his seminal article, Salter (1959) showed the price and expenditure effects of terms of trade disturbances on the economy, by splitting it into two categories of goods: tradeables and non-tradeables. The disturbance causes a gap to emerge between production and expenditure, which manifests itself in a current account deficit. This is because the net effect of an adverse terms of trade shock affects the transformation (production) curve by a greater amount than it affects the indifference (demand) curve. To restore balance requires an increase in the price of tradeables relative to non-tradeables, if the shock is via a fall in export prices (Salter, 1959, pp.235-236).

The constraint this represents on being able to maintain a given rate of real growth is substantial for Australia. Salop and Spittaller (1980, pp. 115-116) point out that countries for whom the largest source of exogenous variance in aggregate demand is the foreign sector (i.e., countries like Australia), will find it advantageous to target the current account balance. This depends, of course, on the availability of an effective policy instrument. They conclusively show that the exchange rate is not that instrument (see also Commonwealth Treasury, 1991, pp. 2.37-2.38).

CHART 6: MOVEMENTS IN THE TERMS OF TRADE AND REAL GROSS DOMESTIC PRODUCT, AUSTRALIA, 1968 TO 1991



Note: The terms of trade is a three year moving average, lagged by one year.

Sources: R. A. Foster and S. E. Stewart (Reserve Bank of Australia), 1991, pp. 28 and 193; Commonwealth Treasury, 1991, p. 2.48.

Hence, the requirement for policy-makers to use the principal macro-economic instruments and structural reform to address the economic imperatives is amplified by Australia's vulnerability, in comparison with relatively autonomous economies such as the U.S.A..

4: THE VARYING IMPACTS AND LAGS OF THE POLICY INSTRUMENTS

This section is divided into two parts. Firstly, there is discussion of economic forecasting. There are problems with estimating the various parameters of a given model. Economic statistics are not perfect (13). There may even be disagreement over what those model parameters should be. More importantly, though, economic statistics almost invariably deal with past performance. They are very few forward indicators, and even fewer that can be relied upon as a useful guide for policy.

(13) For instance, important series such as the national accounts and balance of payments include many derived and extrapolated items because of deficiencies in data sources or delays in data collection.

Relatedly, the problems of knowing whether a given policy initiative may be, or has been, effective is complicated by two critical factors: lags in policy changes taking effect, and the role expectations may play in influencing public reaction.

Secondly, there is a broad discussion of fiscal policy in respect of these factors, and shorter discussions of the other key macro-economic instruments for effecting demand, monetary policy and wages policy.

4.1 The General Issues

In general, the information required for a proper assessment of a policy initiative's impact on aggregate demand are:

- a model of the economy that respects stock-flow identities;
- specification of the time-frame of interest;
- specification of the proposed and alternative policies, including any impact on the multipliers;
- stability in the model's parameters; and
- specification of how the policy change is likely to be seen by the private sector. Is this change anticipated or not? Is the change permanent or not?

(Buiter, 1985, pp. 59-60)

The dearth of suitable data makes this an unenviable task, and one of the most important constraints on successful macro-economic policy. This places policy-makers in the invidious position of not knowing whether an objective target is feasible, or whether a particular value for an instrument will produce the desired result (Norton, 1973, p. 9). This uncertainty results in the so-called recognition lag: the time it takes for policy-makers to be agreed that policy action is necessary ⁽¹⁴⁾. After that, there are further lags as policy-makers then have to agree both on what that course of action should be, and then to implement that policy.

⁽¹⁴⁾ This problem is very real in Australia where there is not a single set of policy-makers, because of the federal system of government. Even within the Commonwealth, macro-economic policy-setting involves advice and assessment not only from Treasury, but also from the Reserve Bank and the Department of the Prime Minister and Cabinet. The Government also receives advice from elsewhere; for example, the ACTU, business groups, etc. But having divergent sources of policy advice can also have its benefits. It can result in the Ministry having at their disposal differing perspectives on an issue, leading to better informed decision-making.

These "inside" lags are complemented by "outside" lags - the time it takes for policy action to take effect. This reaction factor, if not properly recognised, can cause intended counter-cyclical policy initiatives to be pro-cyclical. By acting too cautiously (because of the apparently sensible desire for getting confirmation of economic trends), or by acting over-zealously (through adjusting policy in response to seemingly every change in key variables), the impacts that flow from changing the policy settings may be too late, too often, and/or too small to achieve the desired effect (see Friedman, 1948).

Moreover, there is evidence to suggest that the average duration and variability of these outside lags has changed since financial deregulation in the early 1980s (Swamy and Tavlas, 1989, p.92). The lag for monetary policy is now estimated to be around 12-18 months in Australia (Commonwealth Treasury, 1991, p.2.32; Stutchbury, 1991a) ⁽¹⁵⁾. For fiscal policy, the impact lag is usually less, depending on the nature of the specific policy change. The lag is zero for some fiscal components such as the automatic stabilisers. Finally, the existence of lags means that in assessing possible changes to policy, the residual (pipeline) effects of past recent changes must be taken into account (Clark, 1991, p.30).

The importance of expectations has been recognised by economists for a long time. Keynes, for example, devoted an entire chapter to the subject (1936, Chap.12). Schumpeter (1943, p.259) was extremely critical of the assumption of full rationality in forecasting people's reactions. He claimed that it led to unrealistic expectations for the efficacy of the political process.

Lucas (1976) highlighted the fact that econometric forecasting which did not take account of the impact of a policy change on people's future behaviour was likely to be defective. In doing so, a new problem is created: dynamic interdependence. A change in policy induces a change in the economic structure, which in turn necessitates re-estimation of the policy parameters, which may then lead to further policy changes.

Kydland and Prescott (1977) agreed, but went further. They argued that these effects were systemic. A "time inconsistency" paradox existed. This meant that discretionary policy-making would always be sub-optimal. The social objective function can never be maximised because as soon as policy is

⁽¹⁵⁾ Of course, we should not assume that the outside lag for monetary policy will remain at 12-18 months. One of the lessons of financial deregulation has been that that lag is itself variable.

changed, private agents change their expectations of future policies, and therefore, their present behaviour. This results in unforeseen effects, inconsistent with the *ex-ante* assumptions upon which the original policy decision was made. Hence, in the long term, it may be better for governments to follow macro-economic policy rules, without feedback, rather than exercise policy discretion (16).

This analysis is, however, based on some strong assumptions, including a neoclassical labour demand function; forward-looking behaviour by private agents; and those agents knowing with certainty what the government's objectives are (Persson, 1988, p.521). The results must therefore be treated with scepticism. If wages are sticky, and there is information asymmetry between the government and the public, then the degree of sub-optimality may be less than that suggested by Kydland and Prescott. Hence, there are likely to be situations in which discretionary policy will improve future outcomes.

5.2 Specific Policy Instrument Impacts

Fiscal Policy: There are two major theories of consumption behaviour at odds with Keynes' view that consumers operate with a short-term perspective, and, therefore, that fiscal policy may be effective because it is disposable income that matters. These conflicting theories are the permanent income/life cycle set of theories, credited to Friedman and Modigliani, and Ricardian Equivalence.

The life cycle hypothesis suggests that individuals' consumption levels closely relate to their expected long-term incomes. For example, they save more during their working lives to help pay for the lack of income in retirement. Temporary changes in income therefore lead to only small changes in consumption, until such time that the change is adjudged to be permanent. The crux of the theory is that it is not only actual income which drives consumption and savings behaviour, but also expected income.

(16) The standard rules versus discretion story can be somewhat misleading. The real issue is whether policy-makers should respond to the signals - the feedback - they receive from the economy in response to their policy settings. A policy-maker can operate under certain rules, but those can be linked with feedback. For instance, there may be a monetary policy rule which says an observed one percent change in the underlying rate of inflation will be the trigger for a change in overnight interest rates. Kydland and Prescott, and Lucas, would still object to such a "rule".

The Ricardian Equivalence proposition is even stronger. Barro (1974) used it to suggest that, given perfect foresight and rationality, debt neutrality will result when certain conditions are met, principally that consumers act as if they live indefinitely. They are concerned with their children's future welfare as much as with their own. Consumption therefore depends on perceived total wealth. Any tax cuts or increased public expenditure, that raise public debt, to offset a perceived deficiency in demand will be negated through intergenerational transfers by private agents to pay for that policy easing. Counter-cyclical fiscal policy is therefore futile.

Ricardian Equivalence is a piece of theoretical dexterity of no practical use. Among the many criticisms include the following (some of these can be applied with lesser force to life cycle theories):

- it is wrong to assume that consumers concerned about their children's welfare will necessarily wish to leave a bequest (Feldstein, 1982, p.5);
- the level of rationality assumed implies a level of knowledge and foresight, and a capacity to make complex calculations, that strains credibility (Ando and Kennickell, 1987, p.215);
- it neglects market imperfections that can greatly restrict consumption choices (Poterba, 1988, p.413; Buiter, 1985, p.42); and
- it assumes that the government's objectives are "Pigovian"; that is, it is only interested in efficiency, not distribution (Persson, 1988, p.26).

Various econometric studies (Poterba, 1988; Boskin, 1988; Kotlikoff, Samuelson, and Johnson, 1988; and Deaton, 1985) suggest that the consumption reaction to a given change in fiscal policy is somewhat closer to the Keynesian assumption about the average propensity to consume than to the zero impact implied by Ricardian Equivalence. The results point to the marginal propensity to consume falling in the range 0.2 to about 0.5.

With Ricardian Equivalence rejected, it is necessary to assess the likely impact of debt financing a deficit. This has been the most common Keynesian method of responding to a cyclical slump in aggregate demand. This question of debt sustainability is especially pertinent for Australia, it being a commodity trader in an era of financial deregulation and relatively free exchange markets (17).

(17) This also involves the question of the government budget constraint. How the various policy instruments are configured can restrict the government's options for financing a budget deficit (see Dornbusch and Fischer, 1990, p. 592).

Chouraqui, Jones, and Montador (1987, pp.5-16) identify two sources of concern. Firstly, there is the twin deficits, or “crowding-out”, hypothesis. In an open economy, this suggests that higher public debt (which reduces savings) will lead to higher real interest rates. This stifles investment and induces capital inflows to correct the savings/investment imbalance created by the deficits. At the same time, however, upward pressure is placed on the exchange rate. Eventually, a new long-run equilibrium is reached in which foreign debt has risen by an amount commensurate with the increase in public debt (Murphy, 1989, pp.37-39). Secondly, there are possible links between the stock of debt and interest rates. Higher interest rates encourage private agents to prefer debt to assets, and persistent high public debt creates the fear that the government will use the “inflation tax” to reduce the debt burden. This induces lenders to demand a greater risk premium on their borrowing.

In response to this, if there is a Keynesian slump in aggregate demand, and there are myopic and/or liquidity-constrained consumers, then any fiscal injection will, at least in the short-run, be reflected in real variables - consumption and investment - rather than prices and interest rates (Blinder, 1988, p.279). The studies assessing the empirical relevance of Ricardian Equivalence discussed earlier strongly suggest that this impact will be sufficient to warrant not rejecting fiscal policy as a counter-cyclical instrument. Sieper (1987, pp.14-15) even suggests that rational expectations may, in fact, strengthen the hand of counter-cyclical policy-makers by making perfect stabilisation theoretically possible when policy is imperfectly implemented.

Buiter (1985, pp.25-26), using British data, showed conclusively that the seigniorage (inflation tax) argument has little plausibility. He estimated that inflation would have to exceed 67 per cent before it started to reduce real government revenue from money creation.

Nevertheless, to the extent that government debt is perceived as net wealth by some people, the debt sustainability argument applies. There will be some movement in the LM curve, as well as the usual Keynesian movement in the IS curve, from debt financing. Reducing public debt in response to a high current account deficit may promote capital formation and should contribute towards reducing that current account deficit. “Permanent”

deficits ⁽¹⁸⁾ reduce the effectiveness of fiscal policy for counter-cyclical purposes. These effects are maximised when taken from a previous position of fiscal equilibrium.

Moreover, there are distributional aspects of government debt - particularly high debt. Debt is usually held by the older, richer sections of the community, whereas tax is paid by all income earners (Buiter, 1985, p.22). Hence, retiring debt may assist in producing a fairer distribution of wealth, provided any offsetting reductions in government expenditure do not negate those redistributive effects ⁽¹⁹⁾.

Thus, there appear to be strong *a priori* grounds for tempering confidence in the fiscal instrument for counter-cyclical purposes to take cognisance of these possible longer term effects.

It has long been recognised that, if fiscal policy can affect economic activity, then the reverse can also happen. This implies that the appropriate measure of the fiscal policy stance is one that removes the cyclical effects.

This is not to say that the impact of these cyclical fiscal movements are negligible. The cyclical budgetary component mostly comprises changes in the automatic stabilisers, especially income tax collections and unemployment benefit payments. These can have powerful buffer effects against recessionary slumps ⁽²⁰⁾. Hence, they are the first weapon at the policy-makers' disposal in response to such slumps. Presumably then, governments should not react against any cyclical pressure on the budget by moving to cut expenditure or raise taxes.

There has been widespread dissatisfaction with the cyclically-adjusted budget balance as the measure of the fiscal policy stance (e.g., Chand, 1977; Muller and Price, 1984; Chouraqui, Hageman, and Sartor, 1990; Gramlich, 1990). In response to these complaints, Blanchard (1990, pp.6-11) proposed an indicator using the previous year's unemployment, inflation, and real interest rates as bench-marks for removing cyclical effects. The Treasury

(18) Some would argue that this even applies to those deficits regarded as sustainable in terms of being able to be “covered” by real economic growth.

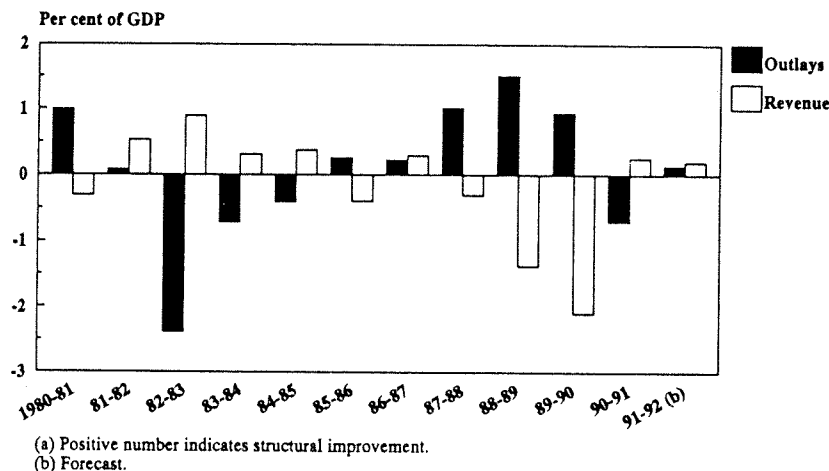
(19) This also assumes a progressive system of taxation.

(20) Indeed, it has been argued to me in conversation by a departmental colleague that the existence of the automatic stabilisers makes the likelihood of any depressions of the same magnitude as the 1890s and 1930s occurring now highly unlikely.

has adopted this robust and simple method (21). Chart 7 uses it to plot the estimated structural changes in the Commonwealth Budget since 1980. It provides a far clearer indication of the direction of fiscal policy than does the nominal Budget outcome or the old cyclically-adjusted balance. The 1989 and 1990 wage-tax trade-offs stand out clearly, as does the substantial increase in expenditure included in the last Budget of Liberal Prime Minister, Malcolm Fraser.

The other important indicator of fiscal stance is the net Public Sector Borrowing Requirement (or Net Financing Requirement), as it gives the total budgetary effect on national savings (22).

CHART 7: ESTIMATES OF THE STRUCTURAL MOVEMENTS IN THE COMMONWEALTH BUDGET, 1980 TO 1992



Source: Commonwealth Treasury, 1991, p. 6.19.

Monetary Policy: There is widespread empirical support for the view that the nature of the monetary policy instrument has changed greatly since the advent of financial deregulation and free foreign exchange markets in 1984.

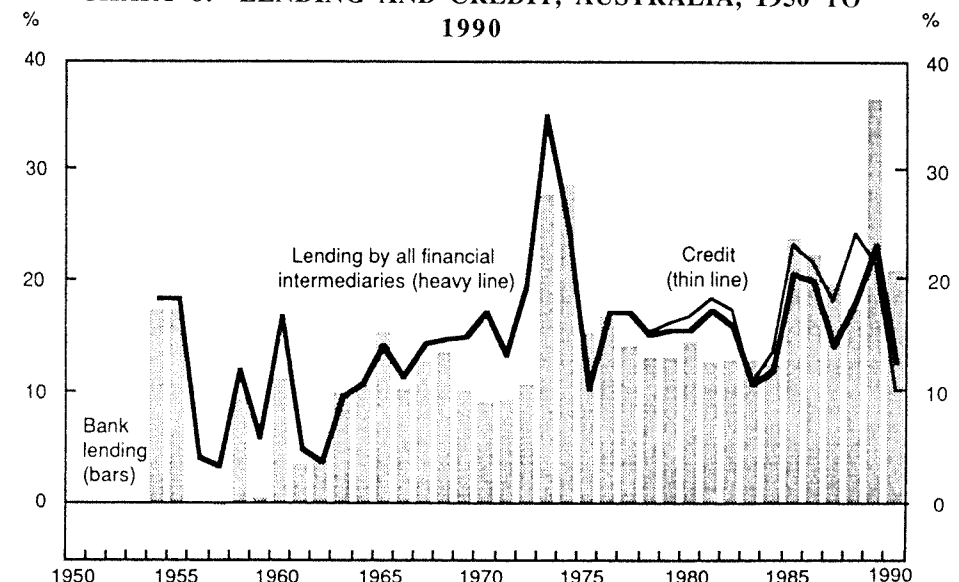
(21) There are some drawbacks, however. Decisions from earlier years with "pipeline" effects are not discounted, nor are the effects of other exogenous structural changes in the economy upon specific budget items (e.g., a long term decline in oil revenues because of lower production due to dwindling reserves would remain in the structural component) (Commonwealth Treasury, 1991, p. 6.17).

(22) Ackland (1989, p. 3) argues that the PSBR should also be inflation-adjusted. His econometric testing suggests that such adjustment improves the PSBR's ability to explain changes in real output and unemployment for Australia since 1967.

Firstly, monetary targeting collapsed as a method for control. This brought into question the confidence that monetarists had held in the strength of monetary policy, based on the quantity theory of money and an assumed relatively stable velocity of money (Swamy and Tavlas, 1989, p.83; Stiglitz, 1988, p.309).

Stiglitz (1988, pp.312-314) regards the interest rate as not being like a conventional price. It does not, of itself, provide adequate screening of loan applicants. Firms often act as if they are equity-constrained if denied bank credit. This, according to Stiglitz, partly explains why monetary policy is less effective in a recession. Interest rates do not constrain prospective borrowers, but rather the banks' willingness to lend. Banks may, in this sense, be seen as conducting their own monetary policy (see also Eltis, 1976, p.10). Chart 8 shows the long-term trend in lending and credit for Australia since 1950. The recessionary periods are obvious.

CHART 8: LENDING AND CREDIT, AUSTRALIA, 1950 TO 1990



Source: R. A. Foster and S. E. Stewart (Reserve Bank of Australia), 1991, p. 101.

With financial deregulation and open foreign exchange markets, firms unable to raise funds domestically can access foreign capital markets. The demand for credit becomes less sensitive to interest rate changes. A lower

interest elasticity of demand for money implies a steeper LM schedule. Other things being equal, larger changes in interest rates are required to achieve a given change in real output (Swamy and Tavlas, 1989, pp.74-83; Murphy, 1989, p.41). This recent experience, both in Australia and abroad, has a decidedly Keynesian air to it. This volatility may be a big enough problem to make it almost impossible to use probability, for predictive purposes, in respect of interest rates (23).

Monetary policy in Australia is now carried out through Reserve Bank intervention in overnight money markets by exchanging government securities for cash. These effects flow quickly through to other cash (at-call) rates. The impact on other short-term interest rates (e.g., mortgage rates) depends on the market's perception of whether the policy change is permanent (24).

Changes in the short-term end of the market, however, do not comprise the whole story. It is the real interest rate that is relevant for assessing monetary policy settings - not nominal rates. There is now agreement that the best guide to policy-setting is the yield curve, which is the difference between long-term (usually ten year bond rate) and short-term (ninety day bank bills) rates.

Long-term rates are least influenced by actual monetary policy, largely reflecting the market's expectations in respect of inflation. They also reflect market expectations about the future path of short-term rates, and a premium for the higher risk in holding long paper. Hence, a neutral policy stance is that of a slightly positive yield - i.e., long-term rates just above short-term rates (Stutchbury, 1991b). Monetary policy is tight when short-term rates are above long-term rates, producing an inverse curve.

Chart 9 shows the 90 day bank bill and 10 year bond rates, and derived yield curve, for Australia for the past 22 years. Again, the policy easings closely relate to the recessions and periods of sluggish growth.

What is important to note about this new approach as compared with monetary targeting is that the illusion of control maintained under targeting has been exposed.

(23) Keynes (1936, p. 149) foresaw that the impact of expectations on the marginal efficiency of capital could result in the interest elasticity of demand becoming volatile.

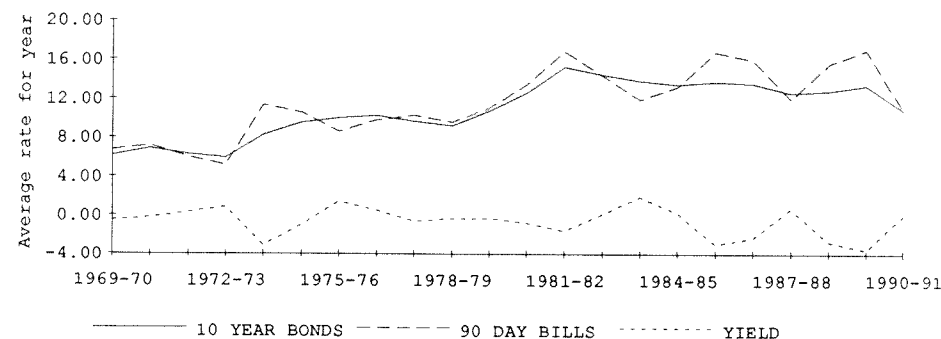
(24) Clark (1991, p. 30) puts this lag at about 3-4 weeks.

There is also the familiar issue of the bluntness of monetary policy. This limits its effectiveness as a short-term instrument in comparison with fiscal policy, by which it is easier to target certain groups or activities.

To deny a counter-cyclical role for fiscal policy begs the question of whether monetary policy should be used for this purpose. It is clear that both instruments affect all policy objectives, and impact upon each other. In deciding which instrument to primarily assign to which objective, however, the assessment should be made under *ceteris paribus* conditions. Both instruments are likely to be effective in altering real economic behaviour: a key question remains the degree of precision or predictability.

The foregoing discussion strongly points to monetary policy being severely handicapped in comparison with fiscal policy as a counter-cyclical instrument.

CHART 9: INTEREST RATES AND YIELD, AUSTRALIA, 1969 TO 1991



Note: Although not fully accurate, the yield curve plotted does show the direction and approximate strength of the changes in the curve over the period.

Source: R. A. Foster and S. E. Stewart (Reserve Bank of Australia), 1991, pp. 142 and 146; *Australian Financial Review* (for 1990-91 figures).

The outside lags are longer and, with financial deregulation, apparently more variable. It is easier to target fiscal policy on particular economic variables, or on certain groups. Finally, the evidence suggests that the degree of control retained over fiscal policy's direction and effectiveness is greater than for monetary policy. This is because, in setting monetary

policy, authorities have only limited control over the long end of the market (where market expectations reign supreme). Hence, the yield curve - and thereby the overall stance of monetary policy - is not entirely within the central bank's grasp. By contrast, the government effectively retains control over the structure of the fiscal instrument, if not the outcome of the cyclical component of the budget.

Wages Policy: The successful maintenance of the Accord agreement with the trade unions by the Labor Government in Australia throughout its term of office has been an event which has effectively thwarted many of the arguments raised against incomes policy as a policy instrument. It has given the Government the valuable option of a third instrument for macro-economic policy management.

The Accord has been effective in restraining real unit labour costs. It has contributed greatly to the increased employment levels through the 1980s, by changing the relative price of labour, and substantially cushioned the impact of the 1985-86 terms of trade shock (25).

The Accord also effectively determined inflationary expectations throughout most of the 1980s (Morgan, 1990, p.1). This is because it was assumed that nominal wage movements were the primary cause of inflation (cost-push). But with the asset price boom of the late 1980s, excess demand became the root cause of inflation (see Commonwealth Treasury, 1991, pp.2.31-2.32 and Table 5). The Accord, in the form it took at the beginning of this period, was not well equipped to respond to this type of inflationary pressure. It was at this stage, then, that the Accord was more closely focussed on achieving workplace reform in return for nominal pay rises. This move was designed to improve the supply capacity of the economy, thereby raising the level of demand that could be absorbed before transforming into inflationary and current account pressure. The Accord has been less successful, to date, in making progress on this front (Chapman and Gruen, 1990, p.33).

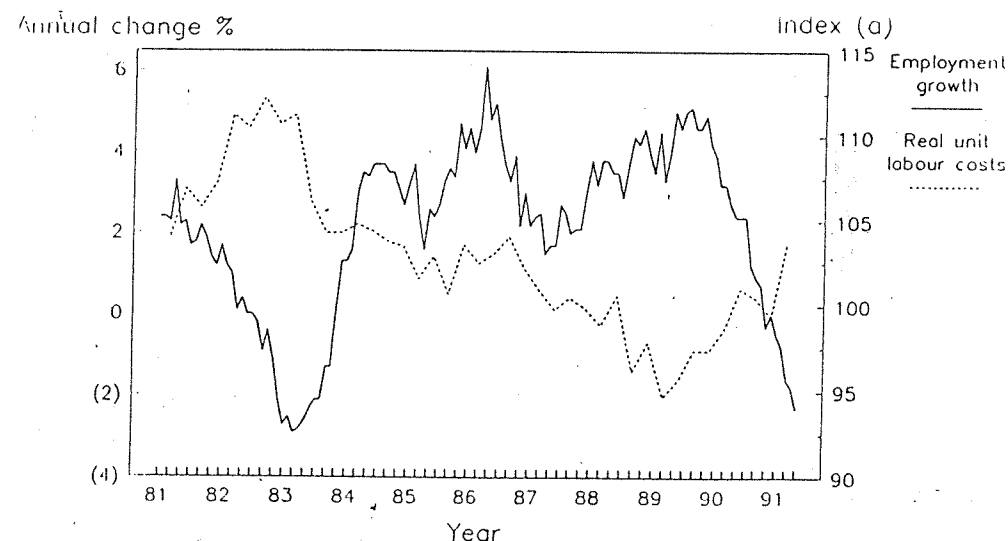
By keeping nominal and relative wages in check, the Accord does, nevertheless, continue to have a positive effect on the level of employment in the medium-term. It promotes job growth during the upswing, and cushions (or at least delays) the labour-shedding often associated with

(25) Chapman, Dowrick, and Junankar (1991, p. 50) have estimated that the Accord was responsible not only for causing the decline in real unit labour costs, but also for preventing what would have been a rise in these costs over the 1980s.

recessions. Although it did not extend to the latest recession, the econometric study by Chapman, Dowrick, and Junankar (1991) concluded that centralised wage setting in Australia in the 1980s contributed significantly to reducing both short-term and long-term unemployment (see also Chart 10).

Therefore, although the other principal macro-economic instruments have their strengths, fiscal policy is the superior instrument for counter-cyclical use against any significant slump in aggregate demand. The effectiveness of the Accord, however, does provide policy-makers with the option (if required) of being able to switch fiscal policy in other economic circumstances towards addressing the structural issues that result in a high current account deficit.

CHART 10: EMPLOYMENT GROWTH AND REAL UNIT LABOUR COSTS, AUSTRALIA, 1981 TO 1991



Note: Index base is average 1966-67 to 1972-73 = 100.

Source: Sen. Peter Cook, 1991, using Australian Bureau of Statistics data.

5. CONCLUSION: THE POLITICAL ENVIRONMENT IN WHICH MACRO-ECONOMIC POLICY IS FORMULATED

The ultimate objectives of government economic policy are the pursuit of the highest sustainable rate of real growth, and the achievement of a fair distribution of the national income. The main intermediate macro-economic objectives that directly affect the attainment of these ultimate objectives are full employment, low inflation, and a sustainable external account. Failure to achieve progress on any of the intermediate objectives can have severe macro-economic repercussions.

There are cycles in market economies. In Australia, however, the trade cycle is relatively more amplified because of a greater reliance on trade-generated income. As a result, Australia is quite vulnerable to terms of trade shocks. This increases the difficulties facing Australian policy-makers - in particular those associated with the external constraint.

Policy lags need to be respected by policy-makers if counter-cyclical activity is to be successful. Similarly, policy-makers must give greater credence to the concept of expectations. To the extent that public debt is perceived by some private agents as net wealth, there may be benefits in reducing high debt.

The argument so far can be encapsulated as follows. There may be a counter-cyclical role for fiscal policy. In periods of growth and/or in the presence of a high current account deficit indicative of domestic structural imbalance, however, there are strong grounds for assigning wages policy to the employment (and growth) objective/s. This allows policy-makers the choice of switching fiscal policy to the structural issues. Monetary policy should usually be assigned to the inflation objective. It may be necessary on occasions, however, to alter the monetary policy settings in response to a sudden significant change in real activity. This is to provide relief until such time that fiscal policy can be adjusted.

If there is a significant (Keynesian) slump in aggregate demand, owing to a major terms-of-trade "shock" or some other exogenous event, then fiscal policy should actively be used as long as is necessary to prevent calamitous levels of involuntary unemployment and loss of output. By active, I mean that allowing the automatic stabilisers to perform their "duty" (but not

changing the structural balance) will not be a sufficient demand injection to prevent a deep decline (26).

There are several features of the political environment which may have the capacity to overturn this analysis. Economic policy-making is an integral - if not arguably the most crucial - aspect of a government's responsibilities to its constituency. The political issues which most frequently impinge on the likely role of fiscal policy are:

- credibility and reputation;
 - conflict with or between the ultimate objectives;
 - conflict between the political environment and the economic cycle;
- and
- the activist-versus-cautious policy-maker debate.

In concluding this paper, I will briefly discuss these issues to test whether the foregoing account can be carried over into "real life" policy-making.

Credibility and Reputation: Persson (1988, p.520) stated the credibility problem as follows. A seemingly optimal policy is formulated on the basis of observed behaviour by private agents. This policy change, however, induces a response from those private agents. Hence, *ex post*, the actual impact of the policy may differ from the expected outcome, restricting the success of the *ex ante* optimal policy. This gives a strong incentive for policy to be continually changed. Any policy-making which involves the assessment of private reactions to ascertain its likely success can suffer from this time-inconsistency problem. The argument is commonly used to suggest that there is little incentive for governments to stick to low-inflation strategies.

But Persson (1988, p.522) and Barro and Gordon (1983) show that there is another side to this issue. Just as a government may lose credibility over time by changing monetary policy too often - and so altering the population's probable response to changes in interest rates (Morgan, 1990, p.1) - so can a government establish a reputation for sticking to a low inflation strategy in the face of temporary setbacks.

(26) That said, there is the very real problem of being able to distinguish a significant downturn from the usual cyclical flows that may be effectively addressed by not offsetting the automatic stabilisers within the budget.

Dropping the assumptions that government's objectives are strictly Pigovian and that private agents have homogeneous, forward-looking rationality, however, greatly reduces the relevance of the credibility argument for fiscal policy. If apparently more realistic assumptions are adopted - that private agents are heterogeneous (i.e., some are myopic and/or liquidity constrained, and some are forward looking), and the government has a distribution objective - then it has been shown (Rogers, 1986) that efficiency may be increased by deviating from the *ex ante* optimal fiscal initiative, in light of *ex post* information. The distribution objective, however, is likely to be impeded. The problem now is one of priorities, not credibility.

Alesina and Tabellini (1988, p.546) and Brennan and Buchanan (1985, p.83) assert that the time inconsistency problem creates an incentive for governments to debt finance. But this argument assumes that the government does not, or should not, care about distribution. Secondly, the costs of persistent debt finance should present an effective incentive to governments to avoid over-use of this policy option. Finally, the argument fails to appreciate that, in periods of a Keynesian deficiency in demand, use of the debt financing option can produce benefits that not only cushion the effects of the slump, but also improve the future income stream of the economy to such an extent that the intertemporal transfer is paid for.

Conflict with, or between ultimate objectives: For fiscal policy, the issue of conflicts arising with, or between, the ultimate objectives appears to be more critical than the credibility factor.

Governments are constantly obliged to trade-off the ultimate macro-economic objectives against one another. Because Keynesian macro-economics posits that the attainment of both objectives can be made easier by the successful manipulation of the principal policy instruments, it sometimes can lull policy-makers into neglecting the reality of this potential conflict.

Tinbergen (1952), of course, never suffered from any such illusions. Neither did Musgrave (1959, p.405), who argued that economic stabilisation must only be pursued when it does not conflict with the other principles of fiscal action. These other principles he identified as resource allocation (i.e., structural issues) and income distribution. Musgrave's proposal appears to have merit. Pursuit of counter-cyclical measures to the extent that the principles of resource allocation and income distribution are adversely compromised is defeating the ultimate objectives the attainment of which stabilisation is supposedly a means.

Conflict between the political environment and the economic cycle: This issue encompasses the theory of political business cycles (e.g., Alesina, 1989). There is much controversy about political business cycle theory (27). It is not necessary, however, to be an avid supporter of it to recognise the theory's underlying message: that "good" macro-economic management can falter at the altar of political expediency/reality (depending on your political views).

It is for the polity to manipulate the institutional environment in pursuit of its ultimate objectives according to the constitutional rules agreed by the citizenry. Hence, the motives and political objectives of the elected government are not always going to coincide with the apparent imperatives of pursuing the intermediate objectives of macro-economic policy. Provided the government does not step beyond the bounds set down by its constitution (28), decisions ultimately are made according to its' priorities. If those decisions turn out to be economically sub-optimal, and the electorate regards economic matters as the primary gauge of a government's value, then there is always the option of the ballot box.

Activist-versus-cautious policy-making: Should policy-makers follow rules without feedback, or should they use discretion? In less extreme terms, should macro-economic policy be pursued actively or cautiously? While this is the final point to be addressed, it is also, in reality, the entire question at issue.

Politicians are elected to act. They can choose to follow certain rules and principles; or they can choose to consider each issue as it arises on its merits. Surely, then, the whole rules-versus-discretion debate within economics is a blind alley. Those who vigorously assert that policy-makers should be held to macro-economic policy rules display an inherent distrust of politicians and the system which has been largely responsible for the high standard of living western market economies generally enjoy. Is there not a contradiction here? If they argued that the constitution should be changed by referenda to prevent politicians from fiscal or monetary policy discretion

(27) The disputes include whether governments can manipulate the economic cycle with precision, and whether political parties possess ideological as well as pragmatic (re-election) motives which shape their choice framework. See Swank (1991) for an assessment of this theory in an Australian context

(28) A proviso which can have some interesting possibilities. For example, see Brennan and Buchanan (1985).

(c.f., Brennan and Buchanan, 1985), then their position might be more credible.

On the other hand, over-zealous fine tuners can do untold long-term damage by calcifying people's expectations in a manner detrimental to effective counter-cyclical policy. They also occasionally display a reliance on theory and models that appears sadly misplaced.

My argument stands. Fiscal policy should be generally formulated according to the allocative and redistributive principles outlined by Musgrave. With Australia's heavy reliance on the foreign sector, this equates with targeting fiscal policy towards achieving external balance - progress on the balance of payments objective - to remove this constraint on sustainable real growth.

There are, however, two provisos. Firstly, there needs to be a wages policy instrument available to satisfy the Tinbergen policy assignment condition. The Theil social welfare function methodology is too difficult for practical use, as the Reserve Bank's unsuccessful checklist approach to monetary policy in the mid-1980s showed (Morgan, 1990, pp.2-3). Secondly, if it is recognised that a significant Keynesian slump in aggregate demand is underway or imminent, then the government should be prepared to act boldly with the fiscal instrument to offset that deficiency.

What this involves is the prerequisite skill of the statesman: prudence. The practical judgement to know when to stick to the "rules" and/or medium-term strategy, and when to change policy swiftly with conviction. When he said that decision-makers needed practical wisdom, Aristotle was correct.

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