In the 80s macroeconomic policy came with a twist of lemon. Now it's on the rocks. GEOFFREY HARCOURT outlines some principles for a macroeconomic 'Middle Way' for the 1980s.

When I delivered my Donald Home Address Madness, Markets and the Middle Way in February 1992, I was called a squib for not ver, as I had been away from Australia for nearly ten years, I thought it would have been a bit of a cheek to arrive home giving detailed advice as I stepped off the plane, as opposed to raising key issues and identifying real problems in a more general way. I did make some specific suggestions in my Home Address, whenever I felt I was competent to do so.

What then of macroeconomic policy for a small open economy on the Pacific Rim which has an enduring and indeed horrendous balance of payments problem, an extremely serious unemployment problem and major pockets of unacceptable levels of poverty in what basically is still an affluent setting out systematically the detailed ingredients of my 'Middle Way' between planning and the unfettered market. I must try to do better this time.

One reason why I 'squibbed' was that I believed (I still do) that a necessary prerequisite was to analyse the implications when important markets—those for labour, property, foreign exchange, financial assets—do not behave in a socially optimum manner as the economic textbooks would have it. Only then would it be possible to think about policies which were designed to deal with the many by-products of their individual and collective impacts on the working of the Australian economy. More often relatively harmonious society?

Over the last 20 years or so, we have had a bellyful of 'deficit 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 income (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 shall assume for the purpose of this article—perhaps this shows my own lack of common sense—that at the federal level a Labor government is in office. 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, as well as well thought-out and integrated plans for the provision of social and industrial infrastructure 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 from the government sector needed to fit in with
the activity that the private sector is providing must be through government income (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 overseas trading, and lending and borrowing.

This way of looking at government outlays and income (G and T) brings to the fore some elementary and old-fashioned economic lessons which nevertheless are often forgotten. Government expenditure 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 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, relevant but are outside the rubric of this article. I am also abstracting 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 such a sharp distinction between current and capital expenditure should lead to a rethink about the nature and significance of government deficits and surpluses. Much of government capital expenditure consists of the provision of necessary social and industrial infrastructure, the returns to which only come in the medium to longer term. In an ordinary business which is both immediate and direct impacts on employment 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, relevant but are outside the rubric of this article. I am also abstracting 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 such a sharp distinction between current and capital expenditure should lead to a rethink about the nature and significance of government deficits and surpluses. Much of government capital expenditure consists of the provision of necessary 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 and transport are obvious examples).

Thus, it really is foolish economics to expect total government outlays to be covered by total income, regardless of where the economy is in the various stages of the trade cycle, or where it is at in its projected 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. Annual profits are, in fact, declared before interest payments on long-term borrowed funds are taken into account, and certainly after periodic amortisation reckonings. We can 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 outlayed on 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 government income greatly to exceed this associated estimate of government expenditure, 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 comparison of the Budget balance which cries 'disaster' if there is a shortfall, even when government income is adjusted to its 'full employment' level.

The Australian scene is complicated by our federal setup, 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, the accounting procedures used to measure the health or otherwise of government finances, and, second, implementing 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, that is, total expenditure on average is greater than income, 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 expenditure exceeding income.

All of this is not to belittle the extent of Australia's economic predicament or the need for extensive structural reform. The vast amount of restructuring required if Australia is to sustain a more competitive industrial structure 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 accumulation. This may require a rise in total government income even though, at the moment, there is heavy unemployment which needs steadily to be reduced. As in the UK, 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—meaning a consumer-led recovery—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—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 distribution of income. We
shall therefore need some rather nifty revisions of rates of taxation in order to restrain total consumption expenditure in an equitable manner. Moreover, the instability built into the consumption side of the Australian economy by the vast extension of credit facilities for all will make the task even harder. But it should not be beyond the wit of the bright young things in the Treasury to provide their political masters with a number of ingenious schemes from which the latter may choose in order to attain their desired ends.

Nor would I suggest keeping the brakes on consumption forever. 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 themselves3. However, I do think it is worthwhile remembering that Keynes and his closest colleagues in the 1930s 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. (Though, by the 1960s there had been a sea change in attitudes on orders of magnitude by Keynes' disciples, with negligible rates of unemployment now regarded as the aim.)

There is a moral here. The moral is not that we should rest content with these higher orders of magnitude but, rather, that when they are attained, in order then 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 government spending or generally encourage private spending. Such microeconomic 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 money wages and therefore the overall cost level—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.

Another aspect of restructuring associated with microeconomic policy and the role of government should be the provision of government help via information services and general back-up to exporters (and entrepreneurs involved in import re-placement), to help them find and then secure niche markets. This is an obvious lesson which Australia could learn from those Newly Industrialising Countries (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. Another lesson from the NICs is that we should leave tariff levels where they are, at least in the medium term.

We also need 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 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.

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1. I thank, but in no way implicate, Keith Abbott, Jonathan Michie, Peter Nolan, Claudio Sardoni, Ajit Singh, Rod Tyers and John Wells for comments on a draft of this article.
2. Incidentally, as I am writing about appropriate monetary policy, may I refer readers to the passages in the Home 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? I would now say that the Reserve Bank should insist and ensure that they are able to do this.
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 ten 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 it all at the time. Now that I am, I can't remember exactly when it occurred or who was there!