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## **MONETARY AND FISCAL POLICY INCONSISTENCY IN AUSTRALIA AND ITS WIDER IMPLICATIONS**

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### **ABSTRACT**

This paper discusses the current inconsistency between monetary and fiscal policy in Australia and its wider implications for policy mix design. Largely as a result of the resources boom, the Australian economy has reached its supply constraints and is effectively at full employment with significant inflationary pressures. At the same time as an inflation-targeting central bank has been restricting aggregate demand with contractionary monetary policy, governments with high budget surpluses have run expansionary fiscal policies by returning large portions of these surpluses to the private sector through spending and income tax cuts. Two questions are addressed. Firstly, why has coordination failure arisen, especially under governments who pride themselves on their economic responsibility? The answer is located in a preference for rules-based policy stances, and an inadequate appreciation of the extreme difficulties inherent in devising independent rules for autonomous agents that are consistent under all relevant circumstances. Secondly, what remedy is available? Here it is argued that, in view of the above difficulties, a suitably designed mix of rules and discretion is required, specifically a combination of flexibly implemented rules and constrained discretion.

JEL codes: E61, E62, E63, E65, E52.

Keywords: Macroeconomic policy coordination; Rules-based policies; Fiscal responsibility.

### **1. Introduction**

After seventeen years of positive growth, the Australian economy is in an unprecedented position compared to other periods in its history, and in a fortunate position compared to other industrialised countries. The main causes have been high external demands for resources driven largely by China and India, as well as internal changes such as a range of deregulations prior to, and during, the expansion period. The boom has resulted in an economy close to full employment, rising average real incomes and large government budget surpluses. The benefits have been accompanied by a range of problems, however – increased inflationary pressures, rising interest rates, skill shortages, underinvestment in public infrastructure, declining productivity, large current account deficits, high household indebtedness, and rising inequalities in wealth distribution. While most of these are natural concomitants of prolonged booms, their severity has been exacerbated by inadequacies in the macroeconomic policy approach taken in managing the later stages of the boom. These inadequacies provide salutary lessons for policy makers in economies at or near full employment, as well as reasons for re-assessing currently conventional thinking behind orthodox approaches to the design of the macroeconomic policy mix.

The prolonged growth period has run from 1992 to the present. For almost the entire period, monetary policy has been based on inflation targeting by an independent central bank. Fiscal policy, on the other hand, has been decided by the conservative Howard government for most of the

boom (1996-2007) along with its successor, the Rudd labour government, from late 2007 to the present. Although announcing a fresh approach to policy, the current government has not, however, abandoned the thinking underpinning the stance of its predecessor. Both governments have accepted the current philosophy of setting monetary policy and fiscal policy in medium term frameworks, of providing both policies with anchors, and of using quantitative rules to constitute the anchors. The macropolicy problem under discussion thus spans both governments and is not an idiosyncrasy of one alone.

The problem is one of inconsistency, or coordination failure, between monetary and fiscal policies. The later boom years have resulted in upward inflationary pressures which the central bank is obliged to reduce using contractionary monetary policy. At the same time, the government, faced with large budget surpluses, has implemented ongoing programs of spending and tax cuts, taking the view either that it was returning the rewards of the boom back to the people or that it was assisting households with the rising cost of living. The result is inconsistency between an expansionary fiscal policy aimed at pleasing the populace, and a contractionary monetary policy aimed at reducing inflationary pressures. Although there is now considerable awareness of the inconsistency, there was far less (if any) public awareness when the inconsistency first became apparent, perhaps because of the then government's claims to be a highly responsible economic manager.

The primary question is thus not the existence of inconsistency, but the deeper question of why it has arisen. How did macropolicy in Australia get into this muddle? What sort of ideas were guiding thinking on the appropriate ways to conduct monetary policy, fiscal policy and their coordination? The muddle is not confined to Australia, moreover, but might well be experienced by other countries with similar general ideas concerning appropriate policy mixes and similar circumstances of strong growth and budget surpluses. In seeking a diagnosis and cure, I present three main arguments. The first is that recent Australian monetary and fiscal policy stances have been inconsistent for two reasons. One is the usual conflict between political and economic considerations in which political arguments dominate economic arguments. The second (and more fundamental) reason is the conflict lurking in rule-based approaches to policy formulation in which each branch of policy is governed by a different rule. Depending on the context, such rules may be either consistent or inconsistent, with the probability of inconsistency increasing if they have been formulated more or less independently of each other and without attention to their interactions in all relevant circumstances.

The second argument is that achieving a combination of policy rules that will be consistent for all relevant cases is unlikely, and perhaps impossible. The root cause is the potential clash between independent rules that are formulated for autonomous agents and directed towards different objectives. Where two independent agents exist with *independently* devised rules for their different goals, the probability of the independent rules forming an internally consistent set for all relevant circumstances diminishes towards low magnitudes, if not to zero.

This leads to my third proposition. If one branch of policy is to be (largely) rule-based, then it is at least arguable that the best available (or least unsatisfactory) policy mix is one in which all other policy branches are (largely) discretion-based. A workable solution to the policy mix design problem is thus a combination of (essential) rigidity in one branch and (essential) flexibility in other branches. Having all branches rule-based delivers too much rigidity and hence highly probable inconsistency under some circumstances, while having all branches discretion-based generates too much flexibility and, again, highly probable inconsistency.

Four qualifying comments are in order. First, in describing policy stances as rigid or flexible, I am speaking of their essential nature. It is possible to have a rule with degrees of flexibility in its application – current monetary policy in Australia operates this way as noted below. And it is possible to have a discretion-based policy that needs to accommodate to rules in some form, either external rules governing another policy or internal guidelines, for example. The position proposed here may be briefly described as an amalgam of flexibly implemented rules and constrained discretion.<sup>2</sup> What is undesirable is both excessive rigidity (little or no room for judgment) and excessive flexibility (do as you please). Second, to simplify matters and to keep in contact with the main elements in the current Australian situation, only two policy branches (monetary and fiscal policy) are considered, but the argument can easily be generalised to multiple policy branches. Third, in this context, I mean by a rule a statement that specifies a target in terms of some specific, quantitative outcome. I do not mean rules which are vague, non-specific or qualitative, such as, for example, that one agent must not do anything that would conflict with the outcomes pursued by another agent. Finally, my discussion is not based on mathematical models where the necessary assumptions create large gaps between such exercises and reality, but on discursive argument which, being conceptual and factual, proceeds on a level of abstraction closer, and more relevant, to practical policy making. Some recent literature and economic modelling is discussed at the end of the paper, along with comments on their differences from the present argument.

## 2. Monetary Policy in Australia

The Reserve Bank of Australia (RBA) deploys monetary policy in pursuit of three objectives: the stability of the domestic currency, the maintenance of full employment, and the economic prosperity and welfare of the people of Australia. Since mid-1993, the RBA has met the first of these objectives, and also contributed in its view to the other two objectives, by using interest rate control to target the inflation rate.<sup>3</sup> The monetary policy rule, formulated in a manner allowing a degree of flexibility and judgment in its application, is currently expressed as follows:

In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.<sup>4</sup>

Unequivocally rigid rules are explicitly rejected by the RBA.

...unlike the specifications in some other countries, Australia's inflation target is not thought of as a 'hard-edged' band within which the inflation rate is to be confined in every period. ...Rather, the target band is an expression of the average to be achieved over a period of years. As such, there is sufficient flexibility for policy to take account of short-run developments in employment and economic growth. In other words, there is some scope for policy to play a role in stabilising short-run business cycle fluctuations. In the longer run, ...the main contribution that monetary policy can make to growth and prosperity is to keep inflation low.

This is a rule-based approach, with an inbuilt degree of discretion or flexibility to deal with short run variations and forecasting difficulties. It will be described here as *a rule-based policy with short term discretion in application*, the rule being binding in the medium and long terms and the flexibility restricted to the short term. At the time of its introduction, its imprecision and short term flexibility were widely criticised by many commentators (including the OECD and IMF), and the New Zealand approach, with its more precise wording and hard annual target, was seen as world

best practice. Nowadays, variants of the ‘soft-edged’ approach are commonplace, with New Zealand moving to this type of approach in 2002. In addition to its primary objective of inflation targeting, the RBA has also been willing to use monetary policy to stimulate output and employment directly, *provided* inflation is under control. However, output and employment have the status of secondary objectives, to be actively pursued if and only if the primary inflation objective is not jeopardised.

During the long growth period, movements in the official cash rate have been both upwards and downwards as the RBA pursued its inflation and stabilisation objectives. However, as the economy moved closer to its supply constraints, inflationary pressures strengthened and monetary policy has been continuously tightened – from May 2002 to the present, twelve successive increases have lifted the cash rate from 4.25% to 7.25%. In addition to passing on these cash rate rises, the major Australian banks have recently increased market rates by additional amounts (up to 0.6%) to cover the higher costs of acquiring funds due to the sub-prime crisis in the US. Higher interest rates in Australia are thus largely due to tighter monetary policy, with additional contributions from private banks.

Recently, signs have appeared that monetary tightening has led to reductions in demand. Growth has weakened and consumer and business confidence have declined. In addition, the appreciation of the \$A (partly due to higher interest rates) has helped contain the inflation rate depending on the extent of price pass-through by firms. However, rising oil and food prices driven by factors outside government control are working in the opposite direction, and have helped push the CPI inflation rate to a 17 year high of 4.2%, well outside the band. For the moment the RBA is holding the cash rate steady, but has signalled a willingness to raise it again should the inflation outlook further deteriorate.

### **Fiscal Policy in Australia**

Over the past quarter century, fiscal policy in Australia has aimed at medium term fiscal consolidation, the specific goals being budget surpluses and debt reduction, without eliminating traditional stabilisation responses in the short term when judged appropriate.<sup>5</sup> From its inception in the mid 1980s, the medium term strategy has been rules-based in one form or another, although the nature of the rules has evolved over time. In the 1985-86 budget, the government committed itself to a ‘trilogy’ – not to raise the tax revenue to GDP ratio, not to raise the government expenditure to GDP ratio, and to reduce the nominal budget deficit – the overall aim being to increase public, and hence national, saving in response to rising current account deficits.<sup>6</sup> The early 1990s recession interrupted the process, but the medium term goal was not abandoned and was enshrined in a commitment by the then government to reduce the budget deficit to GDP ratio to a target of around 1% by mid 1996-97.

The next stage in the evolution of fiscal management was a ‘Charter of Budget Honesty’, a more apt name for which might have been ‘Charter of Fiscal Responsibility’. This document portrayed responsible fiscal strategy as being based on (i) ‘principles of sound fiscal management’, and (ii) ‘public scrutiny of fiscal policy and performance’ through various reports. In relation to (i), fiscal policy was to be set in a medium-term framework and governed by principles largely (but not entirely) related to solvency or sustainability. These principles referred to (a) the careful management of financial risks, including the maintenance of government debt ‘at prudent levels’, (b) adequate contributions to national saving, (c) moderating fluctuations in economic activity as appropriate while taking account of ‘the economic risks to the nation and the impact of those risks on the Government’s fiscal position’, (d) the pursuit of spending and taxing policies consistent with

reasonable stability and predictability in the tax burden, (e) the integrity of the tax system, and (f) the financial effects on future generations. Further, the fiscal strategy statements issued with each budget were to specify the government's 'fiscal objectives and targets', and any fiscal policy actions 'that are temporary in nature, adopted for the purposes of moderating cyclical fluctuations' as well as indicating '*the process for their reversal*' (emphasis added). The over-riding concerns with solvency, sustainability, debt and surpluses are apparent, as are the heavy qualifications on, and wariness of, anything other than a very short term stabilisation role for fiscal policy.<sup>7</sup> The overall intention was to constrain discretionary fiscal policy (even in the short run if deemed appropriate), and to install a medium term bias towards maintaining budget surpluses.<sup>8</sup>

In 2002, the first Intergenerational Report outlined the government's strategy of fiscal sustainability in the light of population ageing. Within the medium term framework, key priorities were 'achieving budget balance, on average, over the economic cycle', keeping government debt at low levels, and maintaining 'disciplined' fiscal policy. Supplementary objectives were to maintain fiscal surpluses while growth was sound, not to increase the overall tax burden from 1996-97 levels, and to improve government net worth.<sup>9</sup> With continuing strong growth, the maintenance of cyclical budget balance was never put to the test, however, allowing the government to concentrate exclusively on its other objectives.

Having inherited a large budget deficit from its predecessor in 1996, the Howard government aimed to return the budget to surplus and to repay virtually all government debt. The first objective was achieved by 1997-98, and for the rest of the long growth period, budget surpluses were the norm. However, in managing the size of the surplus, it employed a rule-based policy apparently symmetrical with the earlier budget deficit target, namely, a budget surplus to GDP ratio close to 1%. Any funds in excess of this target were either disposed of by spending or returned to taxpayers through income tax cuts. Two sovereign funds were established as repositories for part of the surplus – the 2005 'Future Fund' (which was simply prudent action to meet the large, growing and unfunded pension entitlements of federal public sector employees), and the 2007 'Higher Education Endowment Fund' (to support capital works and research facilities). The government apparently took the view that it was acting responsibly in following the 1% rule, and that funds exceeding this requirement could therefore be returned to the private sector instead of being accumulated. Its position was supported in 2005 by the Australian Treasury which argued strongly against any tightening of policy (whether discretionary or via automatic stabilisers) to counter inflationary pressures that might arise as the economy approached its supply constraints. The Treasury view was that the large positive terms of trade shock would lead to a large nominal and real appreciation of the exchange rate, the effects of which would be sufficient to moderate, and even possibly *reduce*, domestic inflation.<sup>10</sup> The government may also have been persuaded by the ideas that intergenerational equity required a portion of the windfall gains to be paid to current generations, and that with the budget balance virtually constant as a proportion of GDP, fiscal policy was effectively 'in neutral' and hence not in conflict with monetary policy. In any case, the size of its largesse was enormous. Eslake (2008: 3) has estimated that of the projected \$457 billion increase in revenue from 2003-04 to 2010-11, \$435 billion had been, or would in future be, either spent or recycled as tax cuts so that only \$22 billion (about 5%) remained as saving. Similarly, Laurie and McDonald (2008: 41-2) have indicated that out of a projected rise in revenue of \$391 billion from 2004-05 to 2010-11, the government planned to dispend \$314 billion (or 80%) through spending or tax cuts, from which they concluded that, effectively, 'the additional revenue from the commodity boom has been spent or provided as tax cuts'.<sup>11</sup>

In its first budget (May 2008), the new government continued with the same general fiscal strategy of its predecessor, albeit with some useful, but limited, modifications. The target budget surplus to

GDP ratio remains, although this has been raised to a minimum of 1.5%; the bulk of the potential surplus is still being returned to the private sector through an ongoing program of spending and income tax cuts projected to continue for the next three years; and an expanded range of sovereign funds are still being used as repositories for the somewhat larger remaining surplus.<sup>12</sup> Government spending in real terms has been increased by 1.1%, rather than being reduced or at least held constant. In addition, an earlier rule which further limiting tax revenue collection has been revived – the tax to nominal GDP ratio is not to rise above the 2007-08 level, that is, an expected 24.7%. Should this ratio ever be in danger of being breached, the government will be obliged to cut taxes regardless of circumstances, thus creating a bias towards expansionary fiscal policy. A perspective on the Australian Treasury's position is given by Henry (2008), which mostly focuses on monetary policy and contains only a brief discussion of fiscal policy.<sup>13</sup> A distinction is drawn between ill-disciplined fiscal policy which creates problems for monetary policy, and disciplined fiscal policy which enhances the effectiveness of monetary policy. The reader is left in little doubt that current fiscal arrangements belong to the latter category, and that fiscal policy is viewed as playing a supportive role to monetary policy, and not a conflicting role. The idea of coordination failure is notably absent.

### **Fiscal Rules**

The intention of fiscal rules is to impose fiscal 'responsibility' or 'discipline' on governments to avoid 'profligacy' or 'irresponsibility'. On this view, politicians cannot be trusted sufficiently, and their taxing and spending decisions need to be restrained by (apparently) neutral or technical fiscal rules, regardless of prevailing circumstances. Even in a liberal democracy, the wishes of the majority are to be subordinated to such rules. Fiscal responsibility, however, is a normative, theory-dependent concept – fiscally responsible action in a New Classical framework will differ very significantly, for example, from its counterpart in a Keynesian framework. But responsibility in anything, including fiscal policy, surely consists in *appropriate behaviour under the circumstances*. It is not something that can be captured by quantitative rules applicable to all events, times and places.

The notion of fiscal rules at least goes back to the early years of the 20<sup>th</sup> century, a common rule then being that budgets should be annually balanced, the so-called 'Treasury View' against which Keynes and others successfully railed in the 1930s. This is an extreme case of a tight numerical rule, namely, that budget balances (or budget balance to GDP ratios) should not deviate from zero. In the late 20<sup>th</sup> century, fiscal rules of a generally numerical nature have returned from exile during the immediate post-war decades, and are now key drivers of fiscal policy in the European Union, the UK and Australia.<sup>14</sup>

At the inception of the European Monetary Union in 1992, the two important fiscal rules to which member states had to adhere were:

- (i) a budget deficit to GDP ratio not in excess of a target of 3% (except under exceptional circumstances, and even then the excess should be limited and temporary); and
- (ii) a government debt to GDP ratio not in excess of a target of 60% (unless it is on a downward trajectory and approaching this level at sufficient pace).

These rules were consciously directed towards the goals of maintaining fiscal solvency, and greatly restricting any stabilisation role for fiscal policy. Given that automatic stabilisers increase the cyclical deficit in a recession, the scope for fiscal policy to increase the structural component is drastically reduced. As intended, fiscal policy was reduced to playing second fiddle to monetary policy which carried the primary stabilisation burden. On paper, many EU member states appear to have satisfied these requirements most of the time, but doubts have arisen as to whether these

targets have been met genuinely or merely as a result of manipulation of financial accounts;<sup>15</sup> if correct, these doubts indicate that the rules are actually generating fiscal irresponsibility rather than the intended responsibility. Later, in 2005, reforms to the Stability and Growth Pact occasioned by the difficulties of large member states in meeting their obligations resulted in some relaxation of the rules, but without abandoning an underlying, rules-based framework for fiscal policy.

In this context, it is interesting to note that, because of their emphasis on solvency, the EU fiscal policy prescriptions are asymmetrical. While the rules restrict the capacity of deficits to combat recessions, no restrictions or guidelines are given for surpluses as a means of dampening sustained booms because solvency is not in question. A concealed assumption here seems to be that expansionary fiscal policy, and hence the possibility of fiscal irresponsibility, is always associated with deficits and never with surpluses. Recent Australian experience shows, however, that this incorrect view can allow governments to be fiscally irresponsible by pursuing expansionary fiscal policy during booms when large budget surpluses arise.

Although not a member of the Euro zone, the UK has adopted two, somewhat less restrictive, fiscal rules, namely, that over the economic cycle:

- (i) the budget balance for *current* spending will be kept in surplus, and
- (ii) the net public sector debt to GDP ratio will not exceed 40%.

No numerical restriction is placed on the budget balance for *capital* spending, although the second rule places a broad limit on the amount that can be financed through borrowing. The motivations for these rules when they were introduced in 1998 were not only to achieve economic stability and fiscal responsibility, but also intergenerational equity between current and future taxpayers in relation to current spending.<sup>16</sup>

### **Current Orthodoxy on Monetary and Fiscal Policy**

A brief review of mainstream views concerning macroeconomic policy may help clarify the policy coordination problem that has arisen in Australia. Three main lines of thinking are pertinent. First, monetary policy is viewed as necessary and sufficient for stabilisation, from which it follows that fiscal policy is unnecessary for this purpose. Non-discretionary fiscal policy can play a minor supporting role through automatic stabilisers but is not really required, while discretionary fiscal policy is to be avoided, not only because it is unnecessary but also because its clumsiness (a tendency to pro-cyclicality) only complicates the work of monetary policy. For stabilisation, then, monetary policy is all that matters. From here it is a short step, for the unwary, to the conclusion that, because monetary policy is all that matters, fiscal policy does not matter at all for stabilisation and hence can be used for other purposes. In a budget deficit context, one of these purposes will be solvency, but the solvency concern disappears in a budget surplus context, leaving fiscal decisions to serve any other purposes deemed desirable. The *non-necessity* of fiscal policy to stabilisation can easily, and mistakenly, slide into the *irrelevance* of fiscal policy to stabilisation.

The second line of thinking is that responsible economic management should divorce itself as much as possible from political decision-making. Politicians, parties and sometimes even public servants cannot be entrusted with macroeconomic decisions because, being dependent on votes, driven by ideology or prone to short-termism, they are easily tempted into a range of sins such as irresponsibility, profligacy, inconsistency or irrationality. As large a distance as possible should thus be put between the political and macroeconomic arenas. Monetary policy was the obvious first candidate, and granting central bank independence created the required distance. The next logical step would be to transfer control of fiscal policy to some independent body, such as a fiscal policy board or committee, or even the central bank. This step is currently close to impossible, however,

because it clashes, in liberal democracies at least, with core political values.

The final proposition in the orthodox trilogy is that responsible policy is (essentially) rules-based. Imposing a monetary policy rule in the form of an inflation target locks central banks into responsible behaviour by preventing inappropriate (or even ‘rogue’) actions by an independent authority. But given that independent fiscal authorities are currently out of the question, governments then fall back on a second best solution by adopting self-imposed rules to ensure responsible conduct. The nature of the rules and extent of their restrictiveness are matters of debate, but the important idea is that rules are necessary to impose responsibility on the wayward. When the bodies formulating these rules are also influenced by the idea that governments should not become larger (or that smaller governments are better), such rules are naturally expressed as GDP ratios; budget deficits, public debt and budget surpluses become natural candidates for capping as a proportion of GDP.

This seems to be a neatly integrated system with no apparent coordination problems, so it is not surprising that little or no attention has been paid to coordination by its advocates. A system that has monetary policy focused on stabilisation, with central bank independence and any rules promoting responsibility, and fiscal policy focused on sustainability, solvency or the management of government finances, with adopted rules guaranteeing responsibility, would seem to be in good order because it consists of the responsible management of two different objectives by means of two different policies. Yet, as the Australian experience shows, this policy-making philosophy has a concealed coordination problem capable of undermining pretensions to responsibility.

### **An Analogy**

Imagine a vehicle with two drivers. Each is independent and is responsible for two instruments related to vehicle performance. Driver M is in charge of engine temperature with the primary responsibility of keeping the temperature between prescribed limits but, once this objective is achieved, M has the subsidiary responsibility of ensuring that the speed of the vehicle is compatible with passenger comfort. Driver F, on the other hand, must ensure, first, that at the end of each day’s travel the ratio of the amount of fuel left in the tank (or alternatively added to the tank) to the distance travelled does not exceed a prescribed figure and, second, that the ratio of emitted pollutants to the daily distance travelled is below a nominated figure. Both drivers have access to the accelerator, brake, gears and steering wheel and, while they may talk to each other, neither has authority over the other.

Assuming the stipulated levels and ratios are achievable under a range of conditions, it is clearly possible for the two drivers to satisfy all objectives simultaneously and to operate the vehicle in the required manner without conflict. But it is equally clear that this may not happen for two reasons. First, under *favourable* driving conditions, either driver may *choose* a manner of driving that satisfies their individual objectives but interferes with the objectives of the other. For example, if the engine temperature is low, M may increase speed, but this could result in unsatisfactory fuel or pollutant ratios for F who will respond by reducing speed. The resulting conflict leads to sub-optimal, fluctuating outcomes. Second, under *unfavourable* driving conditions, conflict can arise when the full spectrum of prescribed targets is *impossible* to satisfy. For example, the road may become unseasonably (unexpectedly) muddy, and while M’s objectives can be achieved in relation to temperature and passenger comfort, those of F (fuel and pollutant ratios) cannot, because of the tougher conditions. In either case, both drivers cannot reach their prescribed targets simultaneously.

What is to be done? An obvious response is to encourage the two drivers to negotiate so that all

objectives can be simultaneously achieved under varying conditions. But this is not actually a solution in this situation – partly because the drivers were always free to talk to each other, partly because agents may disagree in their best judgments as to how to drive under existing conditions, and partly because, in the end, autonomous agents are free to act independently. The problem lies, not in the objectives of the drivers, but in the design of the system. Solutions can then only be found by altering the design, not by manoeuvring within the existing setup. Clearly a shift from two independent drivers to one independent driver will remove inconsistency. Either a single driver is put in charge of all instruments – either M or F alone, or a joint committee of M and F. Or one driver is given authority over the other as in a pilot/co-pilot arrangement. Or, if such proposals are unacceptable (for political or other reasons), the only remaining option is to give one driver full autonomy (say M), and the other driver (F) a subordinate role of constrained independence in which that driver is only free to operate in ways that do not conflict with the objectives of the autonomous driver. Note that there is *no* solution to the original coordination problem that satisfies all requirements under all conditions – which is why, in the real world, we typically have but one driver whose behaviour is only partly governed by rules.

### **Can Responsible Fiscal Policy be Autonomous with Central Bank Independence?**

When government passes monetary policy control to independent central banks, the autonomy of governments that claim to be economically responsible is considerably reduced as regards other branches of policy. In particular, the government's fiscal policy freedom is curtailed. Responsible economic management requires that fiscal policy (as well as other policies) be consistent with monetary policy, so that no component in the policy mix conflicts with the stance taken by the autonomous monetary authorities. All policies need to be working either in concert with monetary policy or at least not in conflict with monetary policy. Evidently, it is irresponsible to run an expansionary fiscal policy alongside a contractionary monetary policy during a boom, and *vice versa*. There may be disagreements as to the appropriate stance of policy under given circumstances, but the initial ceding of control over monetary policy to the central bank is based on the belief that the central bank is the appropriate body to call the shots in relation to interest rates and inflation.

Some governments do not seem to appreciate the full extent of what is given away when, by their own decision, central bank independence is granted. They do not merely cede total control of one branch of policy as if that branch were separate from other branches, but also control of the *general* stance of *all* other policies whose outcomes interact with those of monetary policy. The independent central bank not only calls the shots on inflation but also lays out to a responsible government the general field of fire in which that government may direct its own arsenal – what weapons to fire, how quickly, over what distance and other such matters remain within the purview of the government, but it no longer has total freedom to deploy its non-monetary weapons as it pleases. This remains true regardless of whether rule-based or discretion-based policies are employed – neither the rules nor discretion can be inconsistent with the monetary policy stance. As soon as one policy agent is given independence, any other policy agent must accept restricted autonomy in a supporting role if the economy is to be managed responsibly.

### **What Constitutes Responsible Fiscal Policy for Contemporary Australia?**

For countries with inflation-targeted monetary policy, an independent central bank and large budget surpluses, responsible fiscal policy should complement monetary policy and not hinder it. When monetary policy is strongly contractionary, fiscal policy needs to be either contractionary or, at least, neutral so as to minimise interest rate rises. Expansionary stances are evidently off limits. It

is therefore advisable to let budget surpluses rise to their maximum levels under existing fiscal settings, and not reduce the capacity of automatic stabilisers to achieve this by imposing rules that generate smaller surpluses. Changes to fiscal instruments should not be such that, by interfering with the work of monetary policy, they lead to interest rates higher than necessary. If, for political reasons, the government wants to reward present generations, it can choose non-demand-augmenting ways of doing this in a supply-constrained economy. The key is to quarantine or defer payment of the reward to more appropriate times and with more appropriate arrangements. One sensible suggestion is to pay a portion of the surplus into pension accounts, so that these funds only add to demand on a staggered and drawn-out basis as people retire.<sup>17</sup>

The second important element in a responsible fiscal policy under these circumstances is to deposit the bulk of the surpluses into sovereign funds which will invest in nation building and provide resources to meet looming future challenges. The Howard government took a very small step in this direction, and the Rudd government has taken a slightly bigger, small step, but the strides actually need to be as large as possible. The surpluses have arisen during an unprecedented boom which, while likely to be long-lasting, will nevertheless end and may never be repeated. Rather than fritter the returns of this ‘once-in-a-lifetime’ event away in self-defeating, demand-enhancing measures, the funds should be saved and used at appropriate times for nation-building and the sustenance of future economic and social welfare. Infrastructure spending on transport, communications and education will increase supply capacity and ease inflationary pressures in the medium term, though the timing of the spending in the short term needs monitoring.<sup>18</sup> In avoiding the ‘resources curse’ that has afflicted many resource-rich countries,<sup>19</sup> the general model to be followed is the Norwegian one where, commencing in 1990, Norway placed the funds from its oil bonanza in a Petroleum Fund for the future benefit of the nation.

### **The Difficulty of Formulating Independent and Consistent Policy Rules**

It is in the nature of rules to be rigid and inflexible, this remaining true even when their implementation is accompanied by a degree of flexibility in the short term. And when expressed without qualification, rules are also universal or non-contingent for the agent to whom they apply. In the event that qualifications are present, they are usually only included to cover circumstances that are exceptional or to allow time for existing or intended convergence towards rule-conformity.

Since the future is unknown and unpredictable, it is difficult to formulate any economic policy rule that is appropriate under *all* circumstances.<sup>20</sup> This is why qualifications are made, or an element of discretion allowed for a period. But what is on a far higher plane of difficulty is the task of devising, for the behaviour of autonomous agents whose actions affect the same outcomes, rules that are (i) independent of each other, and (ii) consistent under all circumstances. In fact, it can be argued that the difficulty is so great that, while solutions may not be logically impossible, their probabilities are close enough to zero to label them practically impossible. The core problem is that rigidity is incompatible with future uncertainty. Human ingenuity falls far short of conceiving of all relevant situations in advance and, even if it were so able, of knowing how to devise a relatively simple, workable rule to cover all such eventualities. The situation is analogous to the impossibility of writing complete contracts, a well known principal-agent problem.<sup>21</sup> This is an important reason why significant elements of discretion are advisable at various points in policy making. In responding to new situations, one might choose to restrict the movement of one hand, but restricting the movements of both hands is only an open invitation to sub-optimal outcomes.

### **Rules and Discretion**

Past debates on the rules/discretion issue have typically been cast in either/or terms, that is, as rules *versus* discretion. Rules offer certainty, predictability and stability but suffer from rigidity and non-adaptability to changing circumstances. In addition, as argued here, inconsistency between rules generates irresponsibility and sub-optimality which can undermine stability and predictability. Discretion provides flexibility and adaptability to changing conditions, but also permits irresponsibility and waste. Unfortunately, no universal solution to this problem seems possible. However, as with exchange rate systems, the most practical (or least unsatisfactory) solutions seem to be pragmatic combinations of flexibility and stability that locate themselves towards either end of the spectrum.

Monetary policy based on medium term inflation targeting represents an essentially rule-based policy where rule application is *softened* by discretion in the short term. Given that this approach remains in place and that it is too difficult to create an internally consistent system of rules for all branches of policy, it would seem advisable to base other policy branches, including fiscal policy, on an essentially discretion-based approach in which the application of discretion is *hardened* by some rules or guidelines. Just as governments have previously committed to quantitative fiscal rules, they can easily commit to *qualitative* fiscal rules that limit their fiscal discretion. Such rules (possibly set out in a ‘Charter of Fiscal Policy’) might be that fiscal policy stances are not to counteract the monetary policy stances of an independent central bank, for example, or that fiscal policy be based on public guidelines which, while not binding, encourage good practice and require justification before departures are made. Devising workable, discretion-limiting constraints is a large and complex issue beyond the scope of this paper, but further discussion on the nature and specific forms that such restrictions might take appears worthwhile.

### **Comments on Some Recent Literature and Modelling**

The December 2005 issue of the *Oxford Review of Economic Policy* was entirely devoted to fiscal policy issues but, while several papers dealt with coordination matters, none focused directly on the concerns raised in this paper. Solow’s discursive paper, for example, touched on the coordination issue in brief and general terms, concluding perceptively that ‘If fiscal policy is to be used as a policy instrument, as well as monetary policy, then this raises the issue of the interaction between these policies, especially when monetary policy is delegated to the central bank. Coordination is certainly important, and it is difficult. It may be getting more difficult as inflation targeting spreads’.<sup>22</sup>

Garnaut’s paper discussed Australia’s recent experience, posing the question of whether the effectiveness of rules-based policies was conditional on circumstances. His diagnosis was quite different from that advanced here, however. Australia’s rules for monetary and fiscal policy were considered as a package with no internal consistency or coordination problems. As a result, his divergent conclusion was that this package ‘has worked well enough’ in the 15 years up to the end of 2005 – ‘nothing has happened yet that would suggest that serious misjudgements were made in the recent conduct of macroeconomic policy in Australia, or, indeed, in the conduct of budgetary policy’. There was a risk, however, that the package would perform much less successfully if circumstances changed, the chief risk being a decline in the terms of trade if the resources boom ended. For that reason it would be prudent to increase public saving by holding back more of the surpluses, but if the boom continued for a long time, the current rules would be ‘entrenched by their success’.<sup>23</sup>

The model developed by Leith and Wren-Lewis gave fiscal policy a stabilisation role in complementing monetary policy under certain realistic circumstances. Although noting that ‘how

the two policies should work together remains relatively unexplored', their primary consideration was how the two roles of *fiscal* policy (short term stabilisation, and medium to long term solvency) might interact under different institutional structures for fiscal decision making (2005: 593). They were well aware, however, that the difference between their conclusions and received wisdom derived from the gap between the model's benevolent policy maker and real world policy makers, and that Australian experience was relevant to the issue of whether the targets of rules should be one-sided or symmetric.

The paper of greatest interest from a coordination perspective, however, was that by Kirsanova *et al* (2005) which used a dynamic model to investigate interactions between monetary and fiscal policy. The monetary authority (MA) was always assumed benevolent, while the fiscal authority (FA) may be either benevolent or non-benevolent. Non-benevolence occurs when an authority aims for output unequal to the potential level and/or discounts the future too much (that is, necessary but unpleasant action is postponed to a future time about which the policymaker cares less). Three conclusions are reached in this setup:

(i) The best outcome occurs when both the MA and FA are benevolent and cooperate with each other. The FA cooperates by allowing MA nearly all the burden of stabilisation, and only undertakes gradual debt control.

(ii) Almost the best outcome occurs when the MA is benevolent, and the FA is not benevolent but displays Stackelberg leadership. Since the FA knows that the MA will counter any undesired effects of its actions, it will not use fiscal policy to produce undesired effects even though it might like to.

(iii) The worst (and possibly very bad) outcome occurs when the MA is benevolent, and the FA is not benevolent and does not acknowledge that MA can counter the effects of its policy. A non-cooperative repeated game, in which the FA plays Nash, leads to conflict or 'civil war' between the two authorities. If the FA undertakes expansion, the MA replies with contraction; the FA then redoubles its efforts, the MA counter-escalates, and so on. Because the MA always counteracts the FA, the only outcomes are higher interest rates and debt levels.

Although conclusion (iii) comes closest to a conclusion of this paper, there are significant differences in three areas. First, the mode of analysis in the model is mathematical with quite particular assumptions and definitions, whereas the analysis here is conceptual, factual and less reliant on assumptions. For example, benevolence in the model is tightly defined in terms of targeting potential output and possessing the correct discount rate; in reality, however, the MA and FA may believe they are acting benevolently (or responsibly) by following appropriate rules, these rules not necessarily having any *direct* connections to potential output and discount rates. A quite different notion of benevolence is in play here. Second, the context of the model concerns the opposite side of the coin, as it is one in which expansionary fiscal policy is associated with budget deficits and higher debt, and the fiscal rule focuses on debt management or solvency. By contrast, the Australian case involves fiscal expansion occurring in the presence of budget surpluses and zero debt, and with fiscal rules mainly tied to surplus management. The two situations are not symmetrical because solvency is an asymmetrical issue. Finally, there is a difference in explanation and causality. Whereas the model is grounded on the characteristics and motives of the authorities – the disastrous third case is generated by the non-benevolence and wilfulness of the FA – the underlying cause in my discussion is the system of rules itself, not necessarily any non-benevolent characteristics of the players.

Also important in this context is an earlier paper by Dixit and Lambertini (2003), which begins with the insightful remark that 'fiscal and monetary policies interact in reality, and these interactions can lead to very different macroeconomic outcomes than those predicted by the analysis of one policy in isolation'. In their investigation of this issue with a mathematical model containing monopolistic

competition and nominal rigidities, four cases are analyzed:

(i) Joint commitment by the two authorities in determining policies, this cooperative regime leading to the first best (socially optimal) outcome. (In the other three cases below, MA and FA act non-cooperatively).

(ii) Monetary policy and fiscal policy are both discretionary.

(iii) Monetary policy is discretionary and fiscal policy is rule-based.

(iv) Monetary policy is rule-based and fiscal policy is discretionary.

It will be noted that one vital combination is missing, namely, the case examined in this paper where both policies are rule-based. Although not investigated, the authors nevertheless make significant comments about this case, using what appears to be argument by elimination rather than argument by examination. In presenting the implications of their analysis for the ‘design of monetary and fiscal institutions’, they suggest that if monetary policy is to be rule-based (or ‘committed’), then fiscal policy should be rule-based as well. The same conclusion is expressed elsewhere as follows: ‘Commitment achieves the second best only if it can be extended to both monetary and fiscal policy’, and ‘Our finding suggests that commitment to a monetary rule *not* accompanied by commitment to a fiscal rule is not enough’ [to maintain low and stable inflation].<sup>24</sup> If the arguments of this paper have any substance, this conclusion is inadequate and misleading. Having both policies rule-based is not a sufficient condition for satisfactory outcomes under all relevant conditions, and achieving consistency between rules (and especially sets of rules) that are feasible in reality is difficult, if not impossible.

The contribution of the present paper is thus a conceptual-logical discussion of a case that is significant in real world policy making, yet does not seem to be adequately treated in the literature, including the mathematical-logical papers discussed above. This is not to say that it cannot be mathematically analysed (accompanied by the usual limitations of such models), but the task will need to be done on a case by case basis for each particular combination of rules (or sets of rules), that is to say, without the benefit of any general analysis.

## Conclusion

In large part, the case for monetary and fiscal policy rules is based on the provision of greater stability, predictability and efficiency, and the prevention of irresponsibility and prodigality. No corresponding case can be made, however, for *combinations* of rules capable of generating serious inconsistencies between independent branches of policy. Rules that interfere or conflict with each other can be destabilising, irresponsible and wasteful. Australia is currently a good example – under an apparent fiscal responsibility created by following independently formulated fiscal rules, reduction of the surplus to low levels is providing pro-cyclical stimuli inconsistent with the countercyclical actions of the independent central bank under its monetary policy rule. The result can only be interest rates higher than necessary. Furthermore, these fiscal rules have permitted governments to squander the large gains of the commodities boom by returning most of the surpluses to the private sector rather than accumulating them in sovereign funds for purposes of nation building and meeting serious future challenges.

The argument that Australia’s policy coordination failure is due to each branch of policy being (essentially) based on independent rules leads to the proposition that there are serious dangers in adopting a general philosophy of rules-based approaches for each branch of policy. This is because it is extremely unlikely, if not impossible, that combinations of rules can be found which are consistent for all relevant cases. It is further suggested that if monetary policy is to be essentially rule-based, then the case for fiscal policy to be essentially discretion-based is strengthened. As a strategy for policy mix design, an amalgam of flexibly implemented rules for monetary policy and

constrained discretion for fiscal and other branches of policy would appear to be an approach that merits further exploration.

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## ENDNOTES

<sup>1</sup> I should like to thank for helpful comments and criticism.

<sup>2</sup> This terminology differs markedly from that advanced by Bernanke *et al* (1999: 6, 293) who describe inflationary targeting as ‘constrained discretion’. In my view, this puts the cart (discretion) before the horse (rule). In the medium and long terms, the rule is the dominant, over-riding element which cannot be evaded, while discretion is a subordinate, useful element relevant to the short term. Although less succinct, ‘rule-based approach with flexible implementation’ is a more accurate description of inflationary targeting than ‘constrained discretion’.

<sup>3</sup> As Macfarlane (2006:82-6, 98) notes, the current Australian approach rests on ‘two pillars’ – inflation targeting introduced (unilaterally) in 1993, and full central bank independence arriving later in 1996.

<sup>4</sup> Reserve Bank of Australia (2007)

<sup>5</sup> In relation to domestic issues, the most significant factors driving this new medium term strategy were, initially, Australia’s large current account deficits and concomitant rises in net foreign liabilities to apparently alarming levels and, more recently, the ageing of the population and associated future rises in the cost of publicly provided health services, again to apparently alarming levels. See Gruen and Sayegh (2005) for further discussion.

<sup>6</sup> Note that, in general, the first two commitments place no constraint on the budget deficit to GDP ratio, but the third commitment ensures it will fall so long as GDP rises. The overall aim of the strategy was to increase public, and hence national, saving in response to rising current account deficits.

<sup>7</sup> See Commonwealth of Australia (1998: 3-10). Although not legislated until 1998, the Charter was the foundation of the government’s fiscal policy from 1996, its first year of office.

<sup>8</sup> Gruen and Sayegh (2005: 631) comment that the explicit medium-term approach to fiscal policy was modelled, in both language and focus, on the medium-term approach recently adopted for monetary policy. Given the perceived success of inflation targeting, it seemed ‘a logical next step to put fiscal policy on a similar footing, with the expectation that similar benefits in terms of credibility and sustainability would be generated’.

<sup>9</sup> See Commonwealth of Australia (2002: 1-3, 15). The strategy remained essentially the same in the second Intergenerational Report of 2007 (Commonwealth of Australia 2007: 2, 5-6).

<sup>10</sup> See Henry (2005: 5-7, 10). This reasoning has not stood the test of time.

<sup>11</sup> Other writers also characterize Australian policies as rules-based. Garnaut (2005: 525-6, 528-30) summarily describes monetary policy and fiscal policy as ‘a couple of simple rules’, namely, inflation targeting and ‘small and steady fiscal surpluses’. Gruen and Sayegh (2005: 619, 630, 632-3) view Australian fiscal policy as grounded on rules, although they also associate it with ‘constrained discretion’ in the Bernanke *et al* sense which, when recast in the sense used in this paper, is equivalent to a rule-based policy with short term flexibility in implementation. Henry (2008: 2) describes Australian inflation targeting as a ‘policy rule’.

<sup>12</sup> There are now four sovereign funds – a federal public servant pension fund, an education fund, an infrastructure fund, and a health fund – although spending from the last three (which are usefully directed at nation building) will not commence before 2009-10.

<sup>13</sup> The two main monetary policy issues discussed are a defense of the current inflation targeting regime and a repetition of the argument that exchange rate appreciation significantly dampens inflationary pressures.

<sup>14</sup> The issues discussed in this paper have smaller relevance to US policy making because the US has neither fiscal rules nor inflation targeting.

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<sup>15</sup> Buti *et al* (2007:115) have argued that under the fiscal rules of the European Monetary Union, ‘governments have strong temptations to use accounting tricks to meet the fiscal constraints’ and that such ‘accounting gimmicks...have greatly contributed to the loss of credibility of [the] fiscal rules’. See also Coeure and Pisani-Ferry (2005: 606), and the references in Buti *et al* (2007).

<sup>16</sup> This argument is somewhat weakened by including education spending and pension liabilities in current spending.

<sup>17</sup> The idea is similar to the plan proposed by Keynes to prevent inflation accelerating in Britain during World War II – workers were to receive wages rises, but payment would be deferred until after the war (preferably during the next economic downturn). See Keynes (1940).

<sup>18</sup> An indication of the underinvestment in infrastructure is given by the fact that, after 17 years of growth, Australia only ranks 20<sup>th</sup> out 25 OECD countries in terms of the proportion of GDP spent on infrastructure.

<sup>19</sup> Gregory thesis, Dutch disease.

<sup>20</sup> For example, with domestic inflation now partly driven by long term external forces over which agents in the domestic economy have no control (oil prices, commodity prices, food shortages, climate change etc), some Australian economists (including the RBA governor at the time inflation targeting at 2-3% was introduced) have proposed raising the targeted inflation band.

<sup>21</sup> See, for example, Milgrom and Roberts (1992: 127-31).

<sup>22</sup> Solow 2005: 513, see also 514.

<sup>23</sup> Quotations in this paragraph are from Garnaut (2005: 524, 526, 530) respectively.

<sup>24</sup> Quotations in this paragraph are from Dixit and Lambertini (2003: 1522, 1538, 1523, 1534) respectively, with emphases in the original.