The Poverty of Conventional Economic Wisdom and the Search for Alternative Economic and Social Policies[1]

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ABSTRACT

The paper provides a critical perspective on the economic thinking that has constrained economic and social policy in Australia over the last decade and a half. In particular, attention is focused on two arguments: the belief in the efficacy of labour market 'reform' and specifically, increased real wage flexibility, as part of the means of improving employment; and, second, the rationale for fiscal tightening in terms of the need to reduce public debt and increase national saving both as proportions of GDP. It is argued that neither of these arguments is sufficiently intellectually coherent to warrant their continued uncritical use as foundations of economic policy, and most importantly as key parameters constraining social policy. This critique highlights the need for a more robust foundation for policy to tackle unemployment as well as a fiscal policy based on a much clearer debate over the pros and cons of public debt — a debate in which social policy-makers must play an integral role. Discussion of policy alternatives also allows for a consideration of so-called 'third way' policies. Novel or non-orthodox elements in the set of 'third way' policies need to be considered outside the constraints of orthodox economic thinking; specifically, in the light of criticism of conventional views on targeting inflation and assignment of interest rate policy, independence of the central bank, the assignment of fiscal policy to external balance, and the appropriate time-path of public debt.

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1 An earlier draft of this paper was presented at the Conference: "The Third Way: A Policy Framework for Australia?" University of NSW, 12th –13th July 2001. It has benefited from the comments of conference participants as well as from the comments of two anonymous referees. Remaining errors and omissions are, of course, my own responsibility.

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I Introduction

The aim of this paper is twofold: first, to highlight some deficiencies in orthodox economic thinking as it is applied to economic policy in Australia; and second, to draw out the implications for alternative economic and social policy. In the process, it is hoped that some light will be shed on so-called 'third way' policies.

It is necessary to state up-front that the critique of conventional economic wisdom presented here is not in a sense an 'external' criticism — for example, that economists are unconcerned with the social ramifications of supposedly economically efficient policy. The difficulty with this sort of criticism is that many economists would argue that their concern for social goals is reflected in their attention to economic goals. In any case, this sort of criticism does not address a key problem, *viz.*, that even on economic grounds, conventional economic thinking is far from robust.

Unfortunately, economists are generally unprepared to consider the existence of such deficiencies (unless of course they are raised by well-known orthodox economists), so powerful and pervasive is the hegemony of orthodox thinking in the discipline. As such, progressive social policy demands that practitioners of social policy take the economic argument up to the economists. Arguably this is the only means of achieving social change in anything like the short to medium term.

The discussion that follows begins by focusing on two keys areas of orthodox thinking: the importance of labour market flexibility in the fight against unemployment; and the conventional rationale for policies of fiscal stringency, which some may call austerity. It seems not unreasonable to suggest that, more than any other aspect of discretionary policy, it is the latter (at all levels of government) which has impacted on the goals of social policy.

Yet the implications of the criticisms canvassed below are not limited to these two areas of policy. Indeed, the criticisms of fiscal policy at a fundamental level are equally worrying for conventional views about the appropriate use of monetary policy, including the notion of central bank independence.

II Conventional Economic Thinking — What is it?

Before proceeding to a critique of conventional economic wisdom, it is useful to define as clearly as possible those elements of orthodox economic thought that constitute this 'wisdom'. This orthodox body of thought derives from what some would call 'marginalist' or 'neoclassical' economics, which in its various guises has dominated the profession's thinking since late in the nineteenth century. One aspect of this thinking, which theorists have traditionally assumed to rest on firm ground, is the notion that sufficient wage and price flexibility in a capitalist economy, together with sufficiently well-informed economic agents, would eventually impart a tendency for labour demand to adapt itself to labour supply. In other words, it is supposed that these conditions would, given sufficient time, push the system to a point of full-employment. Most explanations of unemployment — certainly those in orthodox circles — are effectively anchored in some way to this key proposition. Usually this entails an explanation of unemployment as ultimately traceable to some rigidity or imperfection in the working of markets, be it the labour market, or a combination of labour, product and financial markets.[2]

Not surprisingly the most common policy implication of this view is that a key role exists for policy in improving the flexibility of markets. And it is from this line of thought that more recent uttering about the need for real wage flexibility has emanated.

The very same theoretical background has also produced what orthodox economists would call a 'core' of usable macroeconomics: that the control of inflation is a task which should ultimately be assigned to central banks, and that independent central banks are best equipped for this task. Less obvious to the non-economist is the notion that the long-run growth trend in capitalist economies is ultimately driven by the growth in their output capacity. In short, the constraints on the long-run growth of capitalist economies lie on the supply side. As a long-run matter, government demand management policies have little potential to provide assistance, at least where markets are allowed to operate flexibly.

In essence this latter idea denies the possibility that insufficient demand for output could pose any long-run constraint on the economy's growth. This idea has a long history in economics, yet is one for which a coherent theoretical foundation has nonetheless remained elusive.

One other aspect of conventional economic wisdom relevant to the discussion below relates to the appropriate role for fiscal policy. In Australia's case, fiscal policy has for some time been seen as an inappropriate element of demand management policy, certainly in the medium to long-term.[3] Instead, the direction of fiscal policy has been dominated by concerns on the one hand about the public sector's contribution to national saving, and the implied connection between budgetary policy and the

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2 Some of these rigidities may well be seen as being consistent with the operation of rational behaviour (*cf.* Mankiw and Romer, 1992).

3 It should be added that, except in the short-term, demand management in a traditional counter-cyclical sense is pretty much anathema to orthodox thinking on unemployment.

current account, and on the other hand by the supposed desirability of reducing public sector debt as a proportion of GDP.

The dominance of these two notions in combination with a popular version of supply-side economics has in turn brought with it implications for the composition of budgets. It is useful to put the point in the words of one critic of the fiscal conservatism afflicting the European experiment, the parallels with some of the debate in Australian being particularly striking.

> The encourage[ment] [of] labour supply and saving … and [the unleashing of] an allegedly depressed supply of effort … is viewed as ultimately depending on reductions in government spending, because these are what can release the resources to be used to finance tax rate reductions. It is then clear that, if stabilization of the [public sector] debt to GDP ratio requires the formation of primary [budget] surpluses, supply-siders … will tend to rely almost entirely on spending reductions, in order to avoid major adverse effects on growth that they claim would result from heavier taxation of capital and other income.
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> More importantly and directly, however, emphasis on spending reductions tends to be imposed by financial liberalization itself, which, therefore is bound to affect significantly not only the severity of the budgetary stringency, … but also its form (Pivetti, 1999, p.323).

In other words, the fiscal stringency which forms such an important part of popular belief about the ingredients of sound economic policy tends to bring with it arguments in favour of a particular fiscal composition, one emphasising tax relief paid for by expenditure reductions.

It is also worth noting the link between the attitudes that have accompanied the liberalization of international capital flows over the last decade and a half (though arguably over the last 3 decades) and support for policies of fiscal austerity. That link makes clearer the connection in turn between arguments in support of fiscal stringency and another set of very old, yet hardly robust ideas in economic theory. As has not gone unnoticed by critics, support for financial liberalization has in no small part rested on the assertion that such liberalization imparts a discipline on policy makers — specifically, those framing fiscal policy. This discipline takes both the form of providing sanction against using expansions in domestic liquidity to finance government deficits and the financing of deficits with government debt at low interest rates (Pivetti, 1999 p. 322; see also Eatwell, 1995). Support for the first kind of sanction stems ultimately from the very same idea which says central banks should be responsible for inflation control: *viz.*, that inflation is a reflection of inappropriate monetary conditions. In a sense, support for the second idea becomes like a selffulfilling version of the old crowding-out argument, *viz.*, that increased government spending must inevitably be at the cost of reduced private sector spending.

III Challenging Orthodoxy: Labour Market Flexibility

Undoubtedly, the greatest scourge facing capitalist economies is the persistent inability of a significant percentage of the workforce to secure full-time employment. In the Australian debate over appropriate policies to deal with unemployment there has existed really two distinct approaches (not necessarily mutually exclusive); one favoured by the majority of the economics profession, the other by social policy practitioners. While both groups tend to agree that sustained economic growth is necessary but by itself is likely to be insufficient to bring about full-employment, there is less agreement about the additional policies required.

At least with respect to the factors governing employment, as distinct from labour supply, economists have typically focused their attention on flexibility in real wages in addition to stronger economic growth (*cf.* the survey by Le and Miller, 2000), or at least the necessity of allowing real wages growth to be slowed relative to productivity growth for employment gains. On the other hand, practitioners in the social policy area have tended to emphasise an alternative perspective focusing on helping those on the supply side of the market, *viz.*, with whatever lack of skills, experience and self-esteem which afflicts the unemployed, together with income support (*e.g.* ACOSS, 2001). This becomes particularly crucial in the case of the long-term unemployed.

The view which is adopted here however is that there is insufficient robust theoretical ground to support the notion, underlying virtually all economic discussions of employment, that real wages and employment are related in a systematically inverse way. In other words, the view is adopted here that no clear economic reasoning can be provided by which to suppose that in general a fall in real wages would lead to an increase in labour employment.

Some, particularly economists, might find this rather confronting, since the real wage-employment nexus has been a part of economic folklore for so long, that, to use the words of one economist, this notion is no longer seen as a theory of employment, but as an "immediate reflection of the facts".[4] Economists who feel this way should however bear in mind some long-standing results from rigorous capital theory, which tell us among other things that what have been hitherto regarded as the foundations for the real wage-employment nexus are illusory (Kurz

[4] These words are taken from a paper by Pierangelo Garegnani (1970, p. 426–427), which he used in describing the difficulty economists have in disengaging their minds from standard demand-supply conceptions of markets.

and Salvadori, 1995, Chapter 14; White, 2000a). Unfortunately, most empirical analysis ignores this fact and with it fundamental deficiencies in the way orthodox economists think about production.[5]

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[5] Amazingly, collections on unemployment such as that by Debelle and Borland (1998), and other work surveyed in Le and Miller *op.cit.*, demonstrate almost no cognizance of the serious deficiencies at a fundamental level in orthodox discussions of labour demand. An exception in this regard is Doucouliagos (1997) who, in relation to dissent on the neoclassical labour demand function, remarks on how "few of [these] criticisms have made their way into the empirical literature" (p.225). At the very least, the capital theoretic problems alluded to here should make one extremely cautious about orthodox interpretations of any statistical association between changes in real wages and changes in employment.

An anonymous referee has raised the point that phenomena such as "reswitching" have not been demonstrated empirically. There are a number of points which should be made in response and which more importantly mean that, regardless of its accuracy, this claim cannot be used in defence of the traditional real wage-employment nexus in question. First, it should be noted that the phenomena of most relevance to the present discussion is *reverse capital deepening* (i.e. where the rate of return to capital and the cost-minimising capital intensity move in the same direction and as a consequence so do the real wage and the cost-minimising labour intensity) rather than reswitching. Second, there appears to be very few empirical studies that specifically test for reswitching, or reverse capital deepening. Indeed, the notion of testing for these phenomena by reference to historical data is itself highly problematic. Instead what one needs to consider is the likelihood of technologies that would admit reverse capital deepening being included in the set of feasible technologies relevant to the choice of technique decisions of producers, as relative prices of inputs change (though it is not clear that this is something econometrics can shed much light on). The author is aware of a small discussion published recently on the probability of reswitching and reverse capital deepening, albeit in the context of highly simplified Sraffian pricing models, and which reports on a 'low' probability of both phenomena (*cf.* Mainwaring and Steedman, 2000; Salvadori, 2000; and Bidard and Carter, 2000 as well as the studies cited there). Certainly the extent of discussion is insufficient to warrant calling it 'conclusive'.

Third, the absence of empirical results either way cannot be used as a defence of the orthodox position that the absence of reverse capital deepening is the 'general case'. Orthodox analysis has no *a priori* basis on which to presume that what it considers to be the general case is in fact the general case. Such a defence would require a logically coherent argument as to why one should expect technologies admitting reverse capital deepening to be less likely than those that do not. No such argument has been provided by orthodox theorists. Finally, it should be added that the inexcusable use of the thoroughly discredited aggregate production function at the heart of much empirical work on labour demand would inevitably yield wrong estimates of the relations between output per capita, capital-labour ratios, real wages and the rate of return on production, since such production functions cannot exist outside a one-commodity world (*cf.* Bidard, 2000 as well as Garegnani, 1970). Yet the interpretation of any nexus between labour demand and real wages is itself based on this flawed orthodox conception of the production process. Moreover, what empirical work there seems to be, at least with regard to the Australian case, appears to assume away the very real world complexities that could generate reverse capital deepening.

These theoretical deficiencies in the orthodox argument concerning real-wages and employment also have a counterpart in the orthodox view of the structural aspects of the labour market, *viz.*, no clear systematic relation can be assumed to hold between *relative* wages and *relative* employment levels of different labour groups (*cf.*, White, 1997).

Nor is the rather popular assertion that depreciation-induced real wage reductions will stimulate employment by stimulating net export demand without its problems. Quite aside from the problems raised above, which are not without application to the open-economy (Steedman, 1999), there are two additional considerations. First, what matters in this case are relative inflation rates and hence what must also be considered in evaluating the effects of depreciation and subsequent wage dynamics on export demand are the possible alternative anti-inflationary policies. Second, the assertion in question lacks logical coherence for the world economy as a whole, *viz.*, it cannot be true for all economies. Rather, an improvement in employment in this case most likely entails one country exporting unemployment to another.

These problems are not the only ones that confront this popular idea that downward real wage flexibility is an essential part of improvements in aggregate employment. Considerations of the effect on aggregate demand of changes in income distribution as real wages change relative to productivity, should make one extremely cautious about assuming that a fall in real wages would make it profitable to employ more labour.[6]

In light of these concerns one should view an analysis of unemployment, free of any assertion that real wage reductions (absolutely or relative to productivity) are essential for employment gains, as analytically enhancing rather than restrictive.[7]

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6 Indeed, most discussions seem unaware of the idea that real wages may need to rise with productivity in the long-run in order to avoid deficient effective demand, a not unfamiliar result of non-neoclassical growth theory (*cf.* Pasinetti, 1974). Unfortunately and quite unjustifiably, any Keynesian — i.e. demand-deficient — perspective on growth theory is almost non-existent in the so-called "new" growth theory that has emerged since the mid-late 1980's (*cf.* Kurz and Salvadori, 1995).

7 It is worth adding that there appears at least at first glance to be some unease even in orthodox circles with the use of the traditional inverse real wage-employment relation as a basis for explaining changes in employment (*cf.* Abrahams and Haltiwanger, 1995; and Blanchard, 1997). I am indebted to an anonymous referee for drawing my attention to these papers. It should be noted that such orthodox unease amounts very much to the view that the traditional labour demand function is capable of shifts over the course of the cycle and even between cycles. The capital-theoretic criticism referred to in the text above however raises a more fundamental problem: whether or not there are any grounds for supposing that an inverse monotonic relation between real wages and employment *exists*, and in particular, whether it exists

This means of course that the key economic factor driving employment, and upon which policy must focus — other than supply-side measures (*e.g.* retraining, improving labour market information, etc.) — is economic growth. However, as is well known, for a small, open economy such as ours, this is very much influenced by the growth of the world economy. Indeed, part of the intended solution to the problems of the mid-1980's was a structural change in the economy which would enhance the external component of demand for Australian output.

Hence, in rejecting the notion that real wage flexibility provides a serious policy option in dealing with unemployment, and to the extent that our rate of growth is constrained by factors beyond the influence of policy, the burden falls all the more heavily on government's preparedness to provide sufficient financial resources, in respect of the structural problems on the supply-side of the labour market and in respect of both income and social support for those who lose out because of inadequate employment growth.

Recognition of this point brings into question what is meant by the notion of 'mutual obligation', certainly as it is applied to the unemployed. This notion seems difficult to fathom once one is prepared to admit that there exists no automatic mechanism by which the unemployed could trigger — via more effort for example — the necessary increase in available jobs to employ them. If one accepts the inadequacy of the idea that a significant portion of unemployment is somehow the choice of the unemployed by virtue of a lack of effort, then other than being in a position to take advantage of employment opportunities (*e.g.* having the right skills), it is difficult to see what the obligation on the unemployed is. At the very least, a non-orthodox view of unemployment, that in general individuals within the labour market are not in a position to influence the demand for their labour, would force one to re-evaluate the concept of obligation on the part of the unemployed in return for income support.

There is however a more serious obstacle which has for some time been put in the way of governments taking greater responsibility financially for the unemployed and their plight. Indeed, the same obstacle has been put in the way of increased government responsibility for maintaining the 'social wage" generally. And this obstacle derives from a second key plank in conventional economic thinking: the importance of fiscal stringency in 'sound economic management'.

IV Challenging Orthodoxy: Fiscal Policy

As noted earlier, policies in Australia that involve some measure of fiscal tightening have been based since the mid-1980's on either concern about the current account

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independently of factors which orthodoxy would see as causing "shifts" in such a relation/function.

and foreign debt or concern about public sector debt or both. In the last three years, the emphasis has been less on the former than on the latter, as the current account deficit as a proportion of GDP has fallen.

As others have noted, on closer inspection neither of these two justifications appear to be very strong. Considering firstly the view that government's contribution to national saving must be enhanced in order to prevent unsustainable growth in foreign debt, it is useful to note that this is in fact an amalgam of three propositions: first, that the growth of foreign debt as a percentage of GDP is inextricably linked to the growth or otherwise in the current account deficit (hereafter CAD) as a proportion of GDP; second, that the CAD is a reflection of inadequate national saving, given the investment activity Australia wishes to undertake; third, that since private sector saving propensities are resistant to fast change, the public sector must increase its saving to improve national saving.

As it stands, the first proposition is unobjectionable and so is the third proposition, assuming that the second holds. But this is just where the problem lies. The deficiency in this orthodox thinking is the notion that the CAD should be interpreted for policy purposes as an insufficiency of national saving. To the extent that this view implies that a rise in the national propensity to save (from either private or public sector initiatives, or both) will, given sufficient time, necessarily lead to a fall in the CAD as a percentage of GDP, then this view should be challenged. Such an interpretation relies crucially on the notion that the depressing effects on aggregate demand from a rising propensity to save will not have a depressing impact on the long-run growth path of the economy.

Orthodox thinking would lead to one of two results in the case of a rise in the propensity to save — either no depressing impact on the long-run growth of aggregate demand, with the latter dictated by the long-run rate of technical change (old-fashioned neoclassical growth theory); or possibly an improvement in the economy's long-run growth rate (new growth theory).

Yet both of these orthodox arguments rest in turn on similar propositions as the orthodox real-wage — employment nexus, and are as equally susceptible to challenge. The capital theoretic considerations referred to above are just as damaging to the orthodox belief that aggregate demand does not provide an independent constraint on the growth of the economy (White, 2000a).

The alternative view is that the attempt to improve the aggregate saving propensity, without an accommodating demand stimulus, will have a depressing impact on long-run growth. It then becomes less clear whether, even if the growth in the CAD is controlled, it falls as a proportion of GDP. In this light it is worth considering the alternative explanation for a falling CAD/GDP since 1998–99. Without much doubt this reflects a much improved trade balance as a percentage of GDP from 1998–99 to the present. From a national income accounting perspective (which seems to be used almost exclusively in orthodox discussions of this topic), the rise in net exports as a percentage of GDP must automatically entail a rise in private sector saving relative to investment as a proportion of GDP and/or a rise in public sector saving as a proportion of GDP. But accepting this means that it is no less possible to interpret the fall in the CAD as a percentage of GDP as the *cause* of a rise in national saving as a percentage of GDP.

As noted above fiscal stringency/tightening/austerity has also been justified in terms of being a necessary part of sound economic management. The manifestation of such management, on this view, is in the progressive decline in the stock of public sector debt as a proportion of GDP. On this basis, financial management by the consolidated general government, non-financial public sector would be judged as appropriate, since the net debt for this category has been falling as a proportion of GDP since 1995–96 (*cf.* 2001–02 Budget Paper 1, Statement 8).

For its part the present Commonwealth Government has made much of the reduction in Commonwealth general government net debt since taking office in 1996. In turn this result is seen as flowing from the "primary objective of maintaining budget balance, on average, over the course of the economic cycle. This objective allows fiscal policy to respond to variations in economic growth, while ensuring that sound government finances are maintained over time" (Budget Papers, 2001, BP1, p.1–3).[8]

As can be seen in Figure 1, which uses information from the 2001–02 Budget Papers (Budget Paper No. 1, Statement 8, pp. 8-24 — 8-25, Tables B3 and B4), the Commonwealth Government halved net debt as a proportion of GDP by 1999–2000 from its peak 1995–96 level. This halving was reproduced by the consolidated general government sector. Figure 1 also shows similar trends in the behaviour of the interest payments on net debt over the same period. Thus falling net debt as a proportion of GDP would have provided the basis for falling net interest payments, and in turn the latter would provide for a faster reduction in the stock of net debt, by improving the budget balance.

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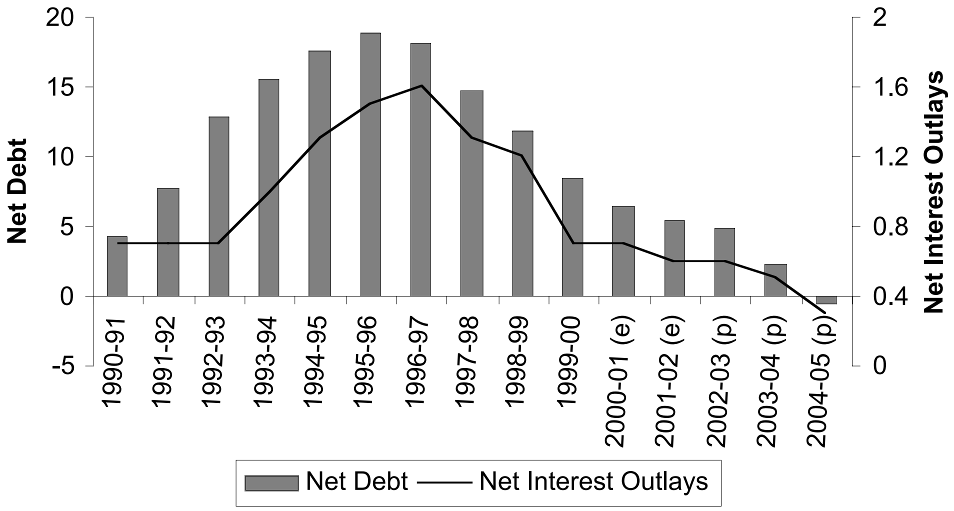
8 In fact, this was precisely the justification for a lessening of fiscal tightness in the most recent budget, in response to the slowdown in world growth, a fact that does not essentially alter the terms of the present discussion. It should also be noted that the fall in the net debt/GDP ratio of consolidated general government of all levels since 1995–96 also reflects, of course, falling State and local government net debt ratios (*cf.* 2001–02 Budget Paper 1, p.8–17).

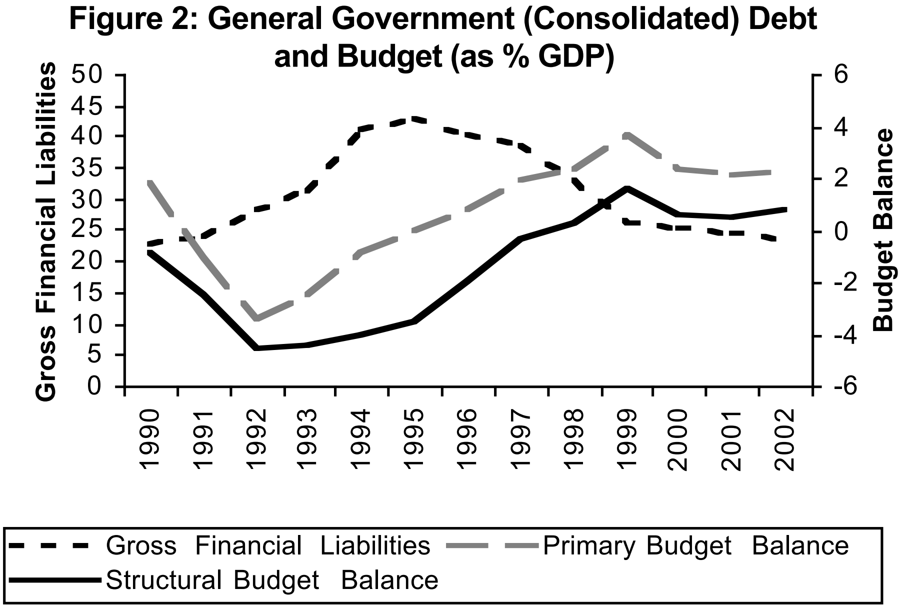
Figure 1: Commonwealth General Government Net Debt and Net Interest Outlays (as % GDP)



Three other points should be made in respect of the reduction in the net debt/GDP ratio. All three points are evident in Figure 2 below which is drawn from OECD data and shows the behaviour of Government gross financial liabilities, primary budget balances and structural budget balances from the early 1990's through to the present. The first and most obvious point is the similarity in movement between gross financial liabilities/GDP and the net debt/GDP of Figure 1.

The second point suggested by Figure 2 is that the reduction in net debt to GDP since 1995–96 is not wholly traceable to lower net interest payments on government debt. This is evident from the movement in the general consolidated government primary balances, *i.e.* budget balances excluding net interest payments. In other words, the fall in net debt/GDP also reflects the move from primary deficits to a continual string of primary surpluses.

The third point relates to the role of discretionary fiscal policy targeted towards reducing (increasing) the budget deficit (surplus) as distinct from cyclical changes in the budget balance. Figure 2 also shows estimates of the structural budget balance for the last decade. What are noticeable is the reduction in the size of the structural deficit from about 1995 and the subsequent move to a continual structural surpluses as a proportion of GDP. This suggests that at least part of the reduction in debt over the 1990's has been the result of intentional fiscal tightness and not merely the effects of cyclical upturns on the budget balance.



Source: OECD Economic Outlook, December 2000.

Having identified some facts that might reasonably be taken to suggest that reduction in public sector debt/GDP has been at the heart of the fiscal tightness of recent years, the important question is whether debt reduction is an adequate rationale. Interestingly the debate over this same question with respect to European monetary union has brought forth some criticisms that are pertinent to the Australian case.

A good starting point in this regard is the point made by Vaciago (1993) that debt in and of itself is not a problem, certainly in a growing economy — debt is only a problem if it becomes excessive. In effect, the critical question with respect to the debt is one of sustainability, *viz.*, the conditions under which the debt to GDP ratio will over time either remain constant or decrease from an initial level, where the initial level is near to or below the desired maximum level. As Pasinetti has emphasised, what economic reasoning *can do* is determine the conditions under which an economy can maintain debt to GDP at or below the desired maximum level. But there is little economic theory that can shed light on what this maximum should be (Pasinetti 1998, p.104).

In this regard it is worthwhile noting that the intention of the present Government (not dissimilar from that of its predecessor) appears to be a reduction in the net debt of the Commonwealth to zero, given its behaviour up to the present and its current projections of net debt. Yet it is nowhere clear why zero net debt is any more desirable than a positive net debt to GDP ratio, if the conditions for sustainability of the latter are feasible.

This last point leads inevitably to a first conclusion about current policy — or certainly, alternative policies: these should be premised on what is considered a desirable net debt to GDP ratio, which of course requires debate as to the other side of that debt, *viz.*, the social benefits of the government activity financed by that debt.

So what are the conditions under which government fiscal policy is sustainable — *i.e.* consistent with either a constant or falling ratio of public sector debt to GDP? The simplest way of thinking about this is that the ratio of debt to GDP will either fall or remain constant provided that the primary budget surplus fulfills the following condition:

$$\frac{S^p}{Y} \geq (i - g)\frac{D}{Y}$$

or:

$$\frac{S}{Y} \geq -g.\frac{D}{Y}$$

where S^P is the primary budget surplus, S is the total budget surplus, Y is nominal GDP, i the rate of interest payable on government debt, g is the growth rate of nominal GDP and D is the existing stock of public debt (Pasinetti, 1998, p.107). In other words, the run down in debt from having a surplus together with the effect on the debt to GDP ratio of a growing GDP will need to be sufficiently large to outweigh the effect of accumulating interest on the debt, in order that the debt/GDP ratio falls.

There are two key points to be made about this relationship. First, if the interest rate on debt exceeds the growth rate of GDP, then for a positive debt to GDP ratio to be sustainable, the primary budget must be in surplus. On the other hand, the second form of expressing this condition shows that the total budget balance need not be in surplus. A deficit is sustainable if it smaller than the product of the growth rate and the ratio of debt to GDP.

Second, given the growth rate of GDP and the rate of interest on government debt, the minimum (maximum) sustainable surplus (deficit) depends on the desired (or starting) value of the public debt to GDP ratio. Alternatively put, for a given i and g, the higher the desirable maximum debt to GDP ratio, the smaller (larger) the surplus (deficit) consistent with an actual debt to GDP ratio equal to or smaller than the desired maximum level.

In order to clarify the point further, Table 1 below uses OECD data for Australia to show the maximum primary budget deficit consistent with sustaining the gross general government sector debt to GDP at whatever level it was each year. It is evident from the table that for Australia since 1996 (though not including 1996 itself), given the growth rate of nominal GDP and the interest rate on long-term government debt, the actual budget result (*i.e.* Actual S^P/Y) has been *better* than required (Boundary S^P/Y) for maintenance of the debt to GDP and hence this ratio has fallen.

Table 1: Debt, Budgets and Sustainability

	Nominal Growth Rate	Long-Term Interest Rate	*D /Y*	Actual *Sp /Y*	(*i* -*g*)	Boundary *Sp /Y*
1996	6	8.2	40.1	0.8	2.2	0.89
1997	5.4	6.9	38.3	1.9	1.5	0.57
1998	5.7	5.5	33	2.3	-0.2	-0.06
1999	5.7	6.1	26.1	3.6	0.4	0.1
2000	7.8	6.4	25.4	2.3	-1.4	-0.36

It is useful bearing in mind one further point in respect of the concern over public debt and this is a point apparently applicable to most OECD countries.

> If one considers total indebtedness … (relative to GDP) the differences between various countries narrow down considerably. Those countries that have a high public debt show correspondingly low private indebtedness. In other words, the total debt position appears to be far less divergent when one considers total indebtedness than when one is concentrating attention exclusively on public indebtedness.
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> The exceptional expansion of public debt which has taken place in the past decade in some countries .. may not imply .. that undue expansion of current expenditure has taken place with respect to the possibilities of future expenditure .. but may simply reveal a [substitution] of private [for public] financial assets (Pasinetti, op.cit., pp.111–12).

Hence, both Pasinetti (1998) and Vaciago (1993), in their discussions of the Italian experience, have noted that arguments against the build up of public debt can be interpreted to some extent as arguments against the public versus private composition of that debt; at least to the extent that there are compensating movements in private sector debt as a percentage of national income. To the extent that what policymakers desire is really a different composition of total debt, the question arises whether there exists ways of changing this composition alternative to that of fiscal restraint aimed at reducing absolutely the ratio of public debt to GDP.[9]

While it remains to be determined whether such a relation between public and private sector debt holds in the Australian case, the discussion in this country concerning the significance of public debt could well benefit from further research on the behaviour of private as well as public debt in Australia.

V Are There Alternatives and is the 'Third Way' One of Them?

So what is to be drawn from this discussion of public sector debt? For the purpose of considering alternative economic policies, and ones which seek to replenish a social infrastructure worn down by fiscal tightening, a useful starting point is deciding on what role government should play in employment generation and in maintaining the social wage. Social policymakers must have an input in this debate.

Up till now the focus in the debate about fiscal policy has lacked a robust foundation. That debate has centred on the strategy of maintaining budget surpluses, with the assumption in the wider community (and one which policymakers do little to discourage) that the larger surplus the better. As noted already, for the government's part the emphasis has been on removing public sector debt *per se,* with the decision on what social infrastructure to fund subservient to this goal. Yet if no serious economic reasoning can be provided to justify the eradication of public sector debt and the accompanying fiscal tightening, then this strategy would seem to have things back-to-front. To be clear, if no robust economic argument can be provided to justify a preference for zero public debt over say a 30% debt to GDP ratio, while the former would involve a serious dismantling of social infrastructure, it appears difficult to see why the former should be the foundation of fiscal strategy. Government and society simply *must* deal with the issue of the social responsibility of policy as a starting point.

I would add that this should *not* be interpreted as a call for indiscriminate fiscal expansion. Clearly, governments need a fiscal strategy that avoids any risk of uncontrollable growth in debt as a proportion of GDP. This is particularly crucial for an economy where interest rates and growth are significantly determined by forces beyond the government's control. What the discussion above *does* say is that the social ramifications of any policy of fiscal austerity cannot be ignored and these

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9 I am indebted to an anonymous referee for pointing out that a thorough discussion of government debt should ultimately distinguish different types of expenditure — *e.g.* government spending devoted to "reproduction of the [economic and social] system" as against recurrent expenditure.

ramifications warrant a clear and robust justification, including why any particular debt to GDP should be considered desirable.

To this end the 'third way' emphasis on considering social policy goals simultaneously with the discussion of economic policy is to be welcomed. In particular, Latham (1998, p.6) is right in noting that an unfortunate aspect of much of the debate in Australia of the last decade and before has been a dichotomy of 'pro-society' versus 'pro-economy' views. It is worth adding that, in light of the discussion so far, part of the problem with this dichotomy, and one that has for the most part gone unnoticed, is that the underlying economic reasoning has been deficient. As such any discussion of policy alternatives should be premised at least in part on awareness of these deficiencies.

In essence, the Third-Way poses an age-old question in economics: what role exists for the market in achieving desired economic and social goals? In some measure however, the answers provided by the Third Way unfortunately reflect an orthodox economic thinking (or at least acquiescence to this thinking) specifically the interpretation of external problems in terms of deficient national saving and a role for real wage flexibility in improving employment. In the former case, as indicated in the discussion above, to the extent that alternative policies are successful in enhancing the performance of tradeable goods sectors, a higher saving ratio is part of the *outcome*. Certainly, it is nowhere explained in discussions of this matter how or why improved saving propensities would 'cause' an improvement in the current account, other than through slowing import demand by depressing growth itself.[10]

In the case of real wage flexibility and employment it is also suggested that this flexibility be accompanied by a strengthening of the minimum real wage (Latham, 1998a, 1998b), in its role as a safety net. The notion of strengthening a minimum living real wage is a welcome suggestion, in part because it moves away from the arguments of recent years that the safety net function for wage-earners should be left to the social security system.[11] Yet the acceptance of a role for real wage flexibility above the minimum, as a means of enhancing jobs growth, together with a minimum itself, in one sense presents a policy with incompatible elements. Eventually, flexibility above the minimum together with persistent unemployment will bring with it the politico-economic pressure to relax the minimum.

10 This however is not to deny that schemes such as a universal social insurance policy which can ensure lifetime income support (Latham, 1998, p.12) are not without merit on social policy grounds. The arguments in this paper question only their role as tools to solve current account problems.

11 And thus ultimately to the whims of the Treasurer of the day.

One other aspect of the Third-Way, which is not unrelated to the previous discussion is its view of globalisation and the mechanisms that need to be set in place to thwart the negative effects of global capital flows while seeking to take advantage of global trade flows (*cf.* Latham, 1999). Latham has suggested controls on speculative capital flows, *e.g.* a Tobin tax, and applauds the idea of economic blocs, presumably in the Asian area. These sentiments on globalisation reflect the important point that serious economic policy cannot ignore the danger of free-moving international capital flows. The chief danger in uncontrolled capital flows lies is the sacrifice in policy autonomy of national governments — specifically the ability to affect output and employment growth by both fiscal and monetary means (Pivetti, 1998; Eatwell, 1995).[12]

However, it is not clear that measures such as a Tobin tax are sufficient to seriously affect the ability of capital flows to interfere with national policies. It is conceivable that even a sizeable Tobin tax may only harm international trading and arbitrage flows while not preventing "feeding frenzies that lead to attacks on … currencies" (Davidson, 1997, p. 679). As such a chief aim of Australian governments should be to encourage a rethink of international financial arrangements, much more radical than any Tobin tax; arrangements which "should not require any nation to surrender control of [domestic policy] … [and which] put more of the onus of resolving current account deficits on surplus nations" (*ibid.*).

Yet supposing capital flows can be controlled, this raises important questions about policymaking, not the least of which is due to the likely added potency of interest rate policy. Effective controls over speculative capital flows would likely impart considerably more autonomy for central banks in the setting of interest rates (*cf.* Pivetti, 1996, 1998). Questions of the assignment of monetary policy and the independence of the central bank then take on greater importance.

Specifically, the question is whether or not and how policymakers are prepared to exploit this added autonomy, in particular whether policymakers are prepared to assign interest rate policy to the task of sustaining output and employment growth. This in turn raises the question of what alternatives to targeting inflation policymakers would be prepared to consider, given the current assignment of interest rate policy. And this inevitably brings into view the only other serious contender for targeting inflation — incomes policy. Indeed, the connections which the Third Way seeks to establish between broad macroeconomic and social policy seems reminiscent of the intentions (or spirit, though certainly not the eventual practice) of the early 1980's Price and Incomes Accord. And we have near to a whole decade of

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12 It is worth noting that orthodox thinking on macroeconomic policy would not see this as a particular problem, since that orthodoxy does not believe in the persistent influence of demand management policy on real variables.

experience with incomes policy and some valuable lessons to draw on (*cf.* White, 2000b).

In such a situation concern over the sustainability of fiscal policy — in terms of a constant or decreasing public debt/GDP ratio — could be eased by a successful alternative anti-inflation policy. With interest rate policy divorced from inflation control, it can, to the extent that there is room for greater interest rate flexibility downwards, serve both the task of stimulating output and employment growth as well as reducing the excess of interest rates over the growth rate and thus enhancing the limits of sustainable fiscal policy.[13]

VI Conclusion

The discussion above is an attempt to provide an alternative perspective on economic policy that starts with the recognition of some key deficiencies in conventional thinking about economics. In particular the discussion has questioned the validity of the commonly asserted negative link between real wages and employment. It has also questioned the extent to which a policy of fiscal stringency in recent years has been justified. Alternative policies must be premised on more robust conceptions of what role exists for market processes and what role governments must play in the eradication of unemployment and the provision of income and social support. This will inevitably require a clearer conception than has hitherto been provided by governments of the significance of public and private debt in the financing of economic and social policies.

The criticisms of conventional economic thinking canvassed above also have implications for some of the ideas associated with the 'third way'. This seems particularly relevant in respect of the labour market and to the extent that income and social support for the unemployed are conditional on the fulfillment of perceived 'obligations' on the part of the unemployed. The identification of these obligations needs to be rethought if one is prepared to question the orthodox belief in the general ability of the unemployed to affect employment opportunities. The critique of orthodox thinking on the usefulness of real wage flexibility would also appear to have some implications for 'third way' views about the labour market and employment.

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13 This point does not imply that current monetary policy completely ignores output and employment growth. Rather the point is about whether there is a coherent rationale for interest rate policy being the main instrument for targeting inflation. In the present writer's view the only rationale in orthodox thought is ultimately traceable to propositions about the long-run behaviour of real variables, propositions which are however no more coherent than orthodox propositions about an inverse monotonic relation between the real wage and employment.

The other critical aspect of the 'third way' in light of the discussion above is the response to pressures from globalisation, and in particular from the free movement of capital between economies. To the extent that a successful alternative set of policies is likely to involve some measure of controls on capital flows this will necessitate some fundamental rethinking of the role of both fiscal policy and monetary policy *vis a vis* their current assignment.

However, the importance of the impetus to debate over the links between economic and social policy provided by the 'third way' should not be understated, notwithstanding the acceptance of some questionable planks of conventional economic wisdom.

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