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The Economics of Politics And the Politics of Economics

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The Economics of Politics And the Politics of Economics

by

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Introduction

The first annual lecture in the Giblin Lecture Series, sponsored by the Department of Economics at the University of Tasmania and the Tasmanian Branch of the Economic Society of Australia, was held at the Faculty of Economics and Commerce, University of Tasmania, Hobart on October 9, 1996. Professor Geoffrey Brennan of the Australian National University gave this year's lecture on "The Politics of Economics and the Economics of Politics".

The lecture was introduced by Mr Stuart James, President of the Tasmanian Branch of the Economic Society of Australia, who set out the character of the planned series of annual lectures as follows:

Giblin's name is one most worthy of on-going memory.

An extraordinary man who was born and died in Hobart. Giblin trained in Statistics at King's College Cambridge. He became a teacher, gold miner, fruit-grower, politician and soldier before beginning his career as statistician/economist in 1919. From then until he died in 1951, Giblin exercised significant influence over economic policy making in Australia and made many substantial contributions to theory which are still applied today.

His official positions over the years included:

- *Tasmanian Government Statistician (1919-28);*
- *Member of the Committee of Enquiry into the Australian Tariff (1927-29);*
- *Ritchie Research Professor in Economics at the University of Melbourne (1929-39);*
- *Member of the Commonwealth Grants Commission (1933-36);*
- *Member of the Commonwealth Bank Board (1935-42); and*
- *Chairman of the Prime Minister's Finance and Economic Policy Committee (1939-46).*

While apparently never formally a part of the Department of Economics at the University of Tasmania, Giblin was very influential in its development.

Quoting from the First Giblin memorial lecture delivered by Douglas Copland in 1958 ANZAAS Conference in Adelaide:

> *In my own work in developing the Schools of Commerce and Economics at the University of Tasmania, Giblin's influence was decisive. Perhaps I know better than any of the economists of the day what it meant to come under [his] parental care.*

Copland went on to say:

> *The little School of Economics in Tasmania quickly established a reputation, and some of its early students have since enriched the academic and public life of Australia [and, might I add, so too have some of the later students]. It could be said the economists became one of Tasmania's leading exports!*

Prior to the move of the Economics Department to these new buildings there was the "Giblin Room" - the venue for many informal cricket matches and occasional study by the Department's Honours students. Giblin would, no doubt, have approved of the cricket matches (even if the Professors of the day did not) being a keen fan of the game and a notable sportsman in many fields. However, while the 'Giblin Collection' remains, alas the Giblin Room no longer exists and there is no other formal institution that currently carries his name at this University.

The "Giblin Lecture" should help overcome this deficiency.

Giblin's fundamental contribution may be described with the following words:

> *He shepherded a small bank of economists to preserve cohesion within the profession, provided links with Governments, and endeavoured to raise public awareness of the nature and dimensions of economic problems.*

Appropriate words, I think, to summarise the intent of this, and future, Giblin Lectures.

I trust that this evening's guest will also be able to make a contribution to "raising the public awareness of the nature and dimensions of economic problems".

Professor Geoffrey Brennan is the Director of the Research School of Social Sciences and Professor of Economics at the Australian National University. He has authored, co-authored or edited 14 books and monographs, two of which were co-authored with James Buchanan (1986 Nobel Prize winner in Economics). He has also written over 70 articles in refereed journals and over 30 papers in books over a wide range of topics ranging from public economics to economic philosophy.

Geoffrey Brennan earned his B.Ec and Ph.D at the Australian National University. He has been on the staff of the ANU, Virginia Polytechnic Institute and State University, George Mason University and a Visiting Professor at the University of Bristol.

Geoffrey Brennan is a Fellow of the Academy of Social Sciences in Australia and has served as Joint Editor for the Economic Record. He is Associate Editor for the International Review of Law and Economics and on the editorial board of the Public Finances Quarterly and the Journal of Economic Behaviour and Organization.

THE ECONOMICS OF POLITICS AND THE POLITICS OF ECONOMICS

Geoffrey Brennan[1]

Tonight, I am going to talk about the economic theory of politics – about what the economic approach (or what Paul Heyne calls the 'economic way of thinking' in the title of his admirable principles text-book) tells us about the nature of democratic politics. I am then going to use those thoughts about politics to try to give an account of what's going on in contemporary economic policy – what's wrong with it, why, and what we can reasonably expect to do about it.

I have not designed my remarks with an intention to offend, but I fear that almost everybody here may find <u>something</u> that I say offensive. I am genuinely sorry about this. I do my best to be agreeable. But so much of what I think is sufficiently contrary to popular prejudice that a certain disagreeableness is probably inevitable.In the great trade-off between charm and candour, I shall on this occasion choose the latter.

While I'm in introductory mode, let me note that every lecture of this quasi-sermonical type should have a text – some quote that more or less captures the essence of the message. I am taking for <u>my</u> text tonight a quip from the early twentieth century American humorist/satirist, Josh Billings: 'It ain't so much the things we don't know that hurts us' – 'it's the lots of things we <u>do</u> know that just ain't so!' I shall want to return to this quote at various points in my remarks to underline its relevance. I simply note that Billings' point is not just that common knowledge includes a lot of false beliefs, but also that it is those propositions about which there is greatest confidence, the ones that everyone more or less takes for granted, that are the most dangerous.

However, let me begin at the beginning – some remarks about the economics of politics.

II

The last two decades or so have witnessed the rise of a branch of economics – also a branch of political science – that involves the application of the intellectual methods and analytic techniques of modern economics to the study of political processes. This intellectual enterprise goes by various titles: 'public choice theory', 'rational actor political theory', 'modern political economy' – and it has various distinguishable strands, corresponding to different emphases. But all strands share the same basic assumptions about human motivation, the same

[1] I am grateful to David Vines for allowing me to bend his ear on some of the material discussed here and for providing encouragement and clarification. All remaining errors are my own.

commitment to understanding social phenomena as the outcome of interactions among more or less autonomous individuals, the same predilection for coherent, consistent argument, deriving conclusions by often long chains of logical reasoning, from a relatively small number of basic axioms. This development has not been universally applauded. Conventional political scientists have rather resented what they see as the imperialism of the economists. They have been inclined to see economic methods as too un-nuanced, too 'thuggish', to capture the complexity of politics. They have been unimpressed with the success of modern economic methods on their own traditional turf, and have not seen any reason why methods that have so conspicuously failed elsewhere should be applied to an area of enquiry which, as they see it, was getting on perfectly OK on its own. They have been particularly concerned at the importation of what they identify as a pro-market, individualist ideology – 'economic rationalism' in its political aspects.

All this opposition has hardly been quelled by the extraordinary success of 'rational actor political theory' within what is often (mistakenly in my view) called the 'market-place' of ideas. Certainly in the U.S., it is the fastest growing area of political science; it is represented in the major journals entirely disproportionately to the number of its practitioners. And although it remains a slightly eccentric specialisation within economics, the award of the Nobel Prize in economics to Jim Buchanan specifically for his public choice work and the gradually increased representation in the major economics journals speaks to a growing respectability in that discipline also.

Since I myself (along with Michael Brooks in the Economics Department here and Jonathan Pincus at Adelaide and a small number of others) have been heavily implicated in the development of public choice scholarship, it is hardly surprising that I find the arguments in opposition unpersuasive. Whatever else its faults, there are two important things that public choice theory delivers: The first is a broad, logical structure, a grammar of argument, that political science as a discipline essentially lacks. The second is an insistence within public economics (and the economic analysis of policy more broadly) that policy is an intrinsically <u>political</u> phenomenon: public policies need to be understood as the outcome of political processes, and an account of policy that ignores the political dimension is grossly inadequate. It is this second message that is of particular relevance to tonight's lecture and it is that message that I want to underline. Even if one does not find persuasive the particular models of political process that public choice theory provides, one should at least accept the force of <u>this</u> proposition: that no macro policy, no program of micro 'reform', no tax policy, no government action at all can be properly understood, and no recommendations properly made, without an explicit treatment of the political dimension.

III

I want now to say a word or two about the general picture of the political process that public choice scholarship offers. Because, although I think the questions public choice theory poses are proper ones, I part company with the answers public choice scholarship offers in one important respect. Public choice theory offers a picture of political processes as essentially a conflict and coordination of <u>interests</u>. People in their political roles no less than people in their market roles are taken to be driven in significant measure by self-interest: politicians want to be elected and exercise power; bureaucrats want to maximise their influence and the size of their bureaucracies; and voters want the best deal they can get for themselves. The central normative question that public choice poses is whether the processes of democratic electoral competition constrain rival parties to produce policies that are systematically in the interests of citizen voters – just as idealised market competition is supposed to do.

Now, I have no particular difficulty with the idea of maximising aggregate citizen interests as a normative test of political processes; but I believe the <u>description</u> of democratic politics as a game played out in the arena of conflicting interests is seriously flawed. This is because I do not believe that <u>voters</u>, the most important players in the democratic political arena, routinely or reliably vote according to their self-interest – and I believe that a proper application of the axioms of rationality show why this is likely to be so.

It may be useful to give a simple intuitive account of the basic point here. Contrast market and electoral choice. And, for the purposes of the conceptual exercise, hold everything else constant – and specifically the options of choice, say this watch and this pen. In a market context, if I choose the watch, the cost is the pen forgone. This pen is the 'opportunity cost', as economists put it; and the act of choice, in and of itself, shows us that the chooser values the watch more highly than the pen – at least in the relevant 'expected-utility' sense. This is the force of the economists' conception of choice as 'revealing preference' – and in the market context, the revealed preference logic goes through reasonably clearly. (It would, as Amartya Sen has pointed out, be reasonable to have certain conceptual quibbles about this reasoning – about the precise content of the 'preference' so revealed – but I want to set such quibbles aside here, to focus on what seems to me to be a more significant point, at least in the context of political theory.) Consider now the <u>electoral</u> choice between these same options. I am to choose between the watch and the pen as electoral outcomes. I mark my card (or pull the lever) for the watch, let us say. But what is the opportunity cost of this action? Certainly not the pen forgone. Or at least, not usually. Merely a <u>vote</u> for the pen forgone. The cost of my voting for the watch is the pen forgone only in the remote case in which there is an exact tie among all other voters. In all other cases, my vote has no effect on the outcome whatsoever: it is simply an expression of preference, to be valued as such and <u>not</u> because it brings about a particular electoral outcome. It is as if a 'veil of insignificance' lies between the exercise of the vote and the electoral outcome that finally emerges.

To take an analogy, voting is therefore rather like cheering at a football match. The crowd support may exercise an influence on the outcome of the game, and certainly all the cheerers care about who wins. But no one cheerer can plausibly believe that her particular cheering brings about the outcome that she cares about. Nor can a fan reasonably offer as the single motivating reason for her attendance at the game that her attendance causes her team to win. This does not mean, of course, that her cheering (or her voting) is unimportant – or that an arrangement that prevented her from attending the match and cheering would not be a significant rights violation. What it does mean, in the political analogue, is that the considerations that weigh in the choice among electoral options are more the aspects of these options that induce people to cheer for them, than those aspects that make the option better for each of them as consumption goods.

Let me stretch my watch-pen example here to suggest what may be at stake. Suppose you were asked to cheer for either the watch or the pen. What would make you choose? More, I suspect, what you see the watch and the pen connoting – what they stand for – than whether the one or the other would be handier at the moment. The watch, on this reading, is the symbol of time: it provides a metric of the past and the future, a measure of human mortality, a reminder of the fleetingness of human existence. Or perhaps it connotes to you human ingenuity, the complexity of the interaction of many mechanically connected parts. Or perhaps it suggests the tyranny of the externally regulated life – the need always to be moving on somewhere else, the 'bundy-clock' mentality.

On the other side, we have the pen – the pen which, as Winston Churchill said, is mightier than the sword. It stands as a central instrument of the life of the mind. Without it, no books; no record of human history; no communication across the centuries with other minds unmediated by the interpretative voices of intervening generations; no means of ordering and interrogating and developing our own thoughts. The pen in short stands for the written word – for language itself, the greatest and perhaps the most distinctively human of human accomplishments. In a contest on this symbolic turf, I cheer for the pen.

I accept, well enough, that all this is a bit fanciful – especially so, perhaps, for the economist. But I want to insist that these kinds of considerations play a disproportionate role in politics – precisely because political outcomes are disengaged in a critical way from the individual action of each voter. In fact, I think these symbolic considerations also play a role in markets – in the jobs people choose, or the cars they buy or the houses they live in – because these things are connected to questions of self-identification; the meaning that attaches to them, their intrinsic significance as distinct from the consumption benefits provided, are important. However, in politics, symbolic considerations play a much more dominant role. Markets may be an arena in which self-interest predominates, but politics is the domain of the expressive, the symbolic, of 'intrinsic' rather than instrumental action.

Now, if all this is accepted at the level of voter behaviour, it ought also to be seen as the primary motor of candidate behaviour. Electoral competition will take the form of parties choosing and developing affective rhetorical ambience around salient popular symbols. Some of those symbols will doubtless be political and 'party-ideological' in nature; some may not be inherently political, but will be appropriated to party political purposes. Policies will be chosen as much for what they connote as what they actually deliver. And issues of high symbolic efficacy (abortion, euthanasia, regulation of alcohol use, censorship, gender relations, and so on) will predictably play a major role in political debate – even where they are not matters of explicit political contestation.

One way of articulating all this is to say that whereas markets can be thought of as an arena in which interests are the mainspring of action, politics (or more generally collective decision-making contexts where individuals are characteristically non-decisive) has to be thought of in other terms. One traditional way of expressing this is to say that politics is dominated by 'opinion'. I am not sure that this description captures all that is at stake in the idea of preference-expression for its own sake – the symbolic or expressive dimension of electoral behaviour – but the emphasis on opinion does make clear that interests as such are not the mainsprings of action in the political arena. And that is one critical piece of the argument I want to develop here tonight.

The picture is, however, complicated by the fact that there may be opinions about interests, that play an important role in politics. And of course, that's true of contemporary politics everywhere in the West and not least in Australia. To use the terminology I would prefer, the point could be put this way: the idea of the 'public interest' is an important political symbol, and common ideas about what promotes the public interest make up an important part of the 'opinion' on the basis of which political contestation takes place. It is at this point in the argument that we move from the economic theory of politics to the politics of economics.

As we do so, however, I want to emphasise one implication of the foregoing argument that seems to me to be important. The implication is this: that widespread economic errors are political facts. Let me repeat this point, because it is basic to my argument: widespread economic errors are political facts.

In one sense, the rest of my talk can be looked on as an illustration of this proposition. But let me show why this follows from the foregoing general propositions about the nature of politics. Suppose most people believe, as I think they do, that Australian foreign indebtedness is a major problem, that Australia is in the process of selling off its patrimony (for gender correctness reasons, I would have liked to use the word 'matrimony', but that seems to have the wrong connotation). Note further that the creation of anxiety about such matters is a specific role of the opposition in the context of adversarial politics – certainly, in a context like Australia's where so much of the public and party-political discourse is preoccupied with economic matters. The opposition has a clear interest in persuading the electorate that something is seriously wrong, that something drastic – changing the government, specifically – has to be done. And it is so much easier to do this if one can seize upon anxieties that are already there in the electorate and fan them into something that will induce electoral action – something that will induce voters to stand up and boo the government. In this sense, 'debt trucks' and the like are the very stuff of adversarial politics; and they are so whether or not the messages they make salient are properly a cause for anxiety or not. There are no particular electoral gains in educating the public: politicians are not economics lecturers. Politicians use popular beliefs: there are no advantages to them in correcting them. In any case, many politicians will believe many of those widely accepted propositions themselves. And once politicians, whatever the state of their beliefs, have publicly committed themselves to particular propositions about what's wrong with the current policy regime and what ought to be done about it, it ceases to be a matter of mere intellectual argument as to whether those propositions are right or wrong: it becomes a matter of political argument. The rhetorical devices of democratic politics take on a life of their own.

In what follows, I want to focus on a couple of particular examples of such rhetorical devices and examine them in greater detail. Both of them are propositions about economic matters. One is general. The other more specific.

The first proposition is that the 'economy' is essentially something to be 'managed' by policy. Essentially, this is the idea that the success or otherwise of the 'economy', however exactly such success is to be defined, is an artefact of government action, or inaction. All political parties seem to believe this. That is, governments rejoice (and oppositions lament) whenever some salient indicator (the rate of g.d.p. growth, or the balance of payments or the inflation rate or the unemployment rate (of which more anon)) comes in looking good – and obversely when the indicators look bad. Each release of economic data is the occasion for an exercise by the government in showing how well it is doing and by the opposition in showing how badly the government is doing. Of course, governments will on some occasions try to disown responsibility – but this will only be when the figures turn out badly and when the opposition can point out the government's efforts to wriggle out of something that, as the opposition puts it, 'we all know' is really the government's fault.

The idea that the economy has a life of its own – that much of what goes on now in the economy would go on whatever the policy details, that many of the things that are going well for us and many of the things that are going less well for us are mainly things over which we exercise very little control – these ideas don't seem to be widely abroad in public discourse. And it isn't only the politicians who are responsible for this, I think. The inflation of policy rhetoric has suited us economists pretty well. It has added to our sense of importance. It has allowed us to pretend that we largely control as well as understand the processes by which 'our golden soil and wealth for toil' are delivered.

A little intellectual history as an aside here. Adam Smith, the person who is commonly regarded as the father of our profession, makes in all his works only three references to his famous 'invisible hand'. The first of these is in an essay on 'astronomy'; the other two (one in *The Theory of Moral Sentiments,* the other in *The Wealth of Nations*) relate to the economic order. This suggests what I think is actually true, that Smith thought of the economic order and astronomy in rather similar terms. Both are orders that can be understood, and their progress can be predicted. But the movement of astronomical bodies is not an object of human control – even of much human influence. And I think Smith thought much the same of the economic system. Though Smith did believe, and so do I, that a belief to the contrary and extensive action on the basis of that belief could do some harm – possibly a lot of harm, depending on just how radical and extensive the policy action is.

So, I want to assert two things: first, that the idea that economy is primarily an artefact of public policy is false; and second, that this false idea is one that we are going to find it very difficult to correct. This means that we can relax about the 'Asian tigers'. The fact that they are growing faster than we are is not our fault. It doesn't show that we Australians are lazy, or that our economy is riddled with inefficiencies or that we aren't outward-looking enough. Nor does it show that if only we could imitate those country's policy strategies, or somehow otherwise make ourselves more like them, that our growth rates would increase. Almost certainly the opposite.

We can relax too about the fact that prospects don't seem to be as bright now for Australian prosperity as they were in the 1950s. Or that we are not now one of the two richest countries in the world (an honour that Australia and Argentina are alleged to have shared in the 1890s). These things are not our fault either. The simple fact of the matter is that the world prices of virtually all the commodities in which Australia has a comparative advantage have declined systematically over the century (rural products and minerals, mainly). This has not impoverished us. We enjoy a very much higher average standard of living now than we did in 1900, or in 1950. It <u>has</u> meant that our relative position in the international league tables has declined a bit – but these measures are tricky, and they don't have much value as an index of policy success anyway. And none of it means that we need government policy to change our economy, to increase our value-added, to promote Australian products world-wide or whatever. Funnily enough, most of this value-adding and trading activity goes on (often imperceptibly, to be sure) without policy assistance – and sometimes in spite of it.

My message here is meant to be mildly encouraging. We probably don't need to be as anxious about our future economic prospects as a lot of the rather breathless policy talk makes out. However, false beliefs generally have undesirable consequences – and the undesirable consequence in this case is that our attitude towards public policy as the chief engine of economic success almost certainly leads us to overreact to changes in information, to try to do too much – usually with perverse consequences.

So much for the more general proposition. Now to the more specific one – a widespread false belief, whose perverse consequences are considerable, painful and probably long-lasting. Let me creep up on this example with a couple of observations about the current economic scene.

One of the most striking features of the current policy debate is the way in which unemployment seems to have quietly slipped off the policy agenda. I don't mean by this that a rise in the national unemployment rate from 8 percent to 9 percent would not occasion some remark – expressions of regret by people in high places, and perhaps a few more job training programs to show that something is being done or a few more TAFE or university places to get the numbers of unemployed down. (University education is probably cheaper than the dole, and in these post-HECS days the government gets much of the cost back anyway). No; I don't mean that <u>changes</u> in the unemployment level don't cause some comment. But it is I think remarkable that <u>levels</u> of unemployment that even a decade or so ago would have been unthinkable have become accepted as a more or less inevitable feature of modern economic life. Neither of the parties say much about it, but there <u>is</u> a more or less clear consensus that unemployment will hover around the eight percent level for the rest of the decade, and may slip out to nine or ten if things don't turn out too well. All the macro policy instruments seem set for that outcome – and I take it that that means that the chief players are reconciled to that state of affairs. There are, of course, puzzles for the economist in this. Just why <u>has</u> the so-called 'natural rate of unemployment' in Australia slipped from one or two percent to about eight percent over the last forty years? But the more astounding puzzle is the <u>political</u> one. How is it that the Australian voter will vote for parties that deliver double-digit unemployment (as they did for the Labor party in 1993) or resoundingly for parties that don't seem at all disposed to do anything about eight percent unemployment (as they did this year). Presumably the current Liberal government thinks that it can win office next time around with unemployment levels basically unchanged. Why otherwise would they commit themselves to policies that will, if anything, make unemployment rates higher? And my sense is that they are right. If they lose the next election it will not be because voters think unemployment levels are too high. <u>That</u> issue seems, at least for the time being, to be off the political agenda. Why?

Orthodox public choice would provide one possible reason – namely, that most citizen-voters (the ones who are still <u>in</u> jobs and whose jobs are tolerably secure) actually benefit from a bit of unemployment. It keeps costs down, and services like gardening and housekeeping very available. But if this <u>were</u> the explanation, the puzzle would be to explain why the same electoral response has never been witnessed before. Or anywhere else. Besides, as I have already indicated – in painful detail – the idea that voters vote their individual self-interest is logically implausible.

It seems to me that the essential reason that the public has become tolerant of unemployment levels that are ahistorically high is that they have become persuaded that another issue is even more important than unemployment. This other issue is the balance of payments – for which read 'foreign indebtedness'. This nostrum – that Australia has a long-term balance of payments problem, one that shows itself in an ominously increasing level of international indebtedness – has actually a long career, but it is only in the last few years that it has become a genuine election-winner. Let me state here that though I believe this proposition to be largely mistaken, I certainly don't think the mistake is unique to the general public: it seems to be believed by a lot of politicians on both sides of the house, and it almost certainly originated among the economic experts.

Why do I think that it is this idea above all others that is the guiding light of current economic policy? Well, essentially because it seems to make sense of a great deal of recent policy action. Go back for a moment to the beginning of the current unemployment episode, and to the rhetoric of that master-rhetorician and greatest treasurer of them all, Paul Keating. Remember those quips about Australia becoming a 'banana republic' – and the 'recession we had to have'? Why was it again that we had to have it? Well, I think the answer is that we were perceived to have a balance of payments problem: exports were too low; imports too high. If we continued forever at the rate we were going, we would end up mortgaging the country. Exports, it was recognised, depended on demand in the rest of the world – something we couldn't control. But imports could be curtailed by slowing down the domestic economy. And slow it down we did. Fast. The Reserve Bank just stopped money supply growth dead in its tracks.

The only problem with this strategy was that on its own, it had no termination date. The only way to keep imports down was to keep unemployment levels up. Presumably, the government of the day believed that their general micro-economic reforms would increase international competitiveness in our export and import-competing industries and that we would eventually 'micro-reform' our way out of the macro problem. Presumably, the current government believes the same about its labour market reforms and its own pursuit of the micro reform agenda. Maybe; though it rather sounds like a 'wait and see' strategy to me.

There was, however, another strand to the policy story. Given the conviction that the central economic problem for Australia was excessive and increasing foreign indebtedness, perhaps we could solve the problem by <u>saving</u> more. At the macro level, saving more would mean less import consumption with the same national income level – so as savings rose, it would be possible to adopt more relaxed fiscal and monetary policies and achieve higher employment levels. Hence an array of policies designed to stimulate savings – first, the switch to consumption tax and away from income tax (in both the Labour and the ill-fated Hewson versions); next, the superannuation arrangements, again to boost national savings; and overall, a general budget strategy of deficit reduction (and thereby increased public savings).

If this <u>is</u> a fair description of the general motivations and economic understandings that surround Australia's recent policy history, there are several ironies and one puzzle that remain.

The ironies revolve around the fact that various policies to increase savings (including the GST and the Keating superannuation deal which came in for some criticism at the time for hurting the poor) would, if successful, have accommodated lower unemployment levels: given the prevailing priorities as to goals, higher savings and higher employment were complements and the welfare lobbies who wanted the latter but not the former had inconsistent objectives. Such ironies aside, the remaining puzzle relates to the role of the exchange rate. Why did the policy-makers not allow the exchange-rate to solve the problem? After all, under a regime of fixed exchange rates, the traditional solution would have been to devalue – raising the price of imported goods in Australia and lowering the price of Australian goods abroad. Why, under a system of floating exchange rates, did the exchange rate not achieve an equilibrium level that would sort all this out? Did the Reserve Bank intervene to keep the exchange rate artificially high? Are we, in effect, using an unemployment rate of eight percent or so as a device for keeping the exchange rate high? If so, it seems to be an extraordinarily high price to pay for a paltry reward.

My suspicion is that the exchange rate has not been allowed to go into free fall for a combination of reasons – first, because there is doubt as to whether the resultant changes in export and import prices would have much effect; second, because a certain amount of our foreign debt is denumerated in overseas currencies and depreciation simply serves to increase the Australian dollar liability; third, because there is a fear about the effects of making the Australian dollar a speculative currency; or fourth, because of a fear that if the exchange rate fell too low, too much prime real estate would fall into the hands of foreigners.

But rather than speculate further about the motives of the policy-makers, let me stand back from the detail to make two basic points. The first is that Australia is bound to be a net capital importer under almost any conceivable policy regime that leaves international capital markets any role at all. Australia is a small population sitting on a large, resource-rich land-mass: the idea that Australians would generate enough savings domestically to fund all Australian projects at rates of return equal to those elsewhere seems deeply implausible. Manifestly, people outside the country want to lend to Australians: we are a stable country with a better than average record of monetary and civil stability. That desire to lend means that the value of imports is always going to be greater than the value of exports – and will be so unless net foreign capital inflow is stopped. And to do this would require such draconian policy measures – measures which would cause so much harm to Australia and be so alien to free market principles – that if we were to impose them overtly, there would I like to think be an outcry from economic experts and citizens alike.

Yet as I see it our current policy regime involves an attempt to achieve much the same ends indirectly, and covertly.

The second point is that, although the current level of unemployment is almost certainly not <u>exclusively</u> a product of policies expressly designed to produce it, at least some proportion of it is. When Keating inflicted on us the recession he assured us we had to have, it did make a difference – and when the current government rhetorically created the eight-billion dollar black hole, the slash-and-burn expenditure reduction policies implemented to fill that hole will surely serve to slow the rate of recovery. If even only one or two percentage points in the unemployment rate are the product of government policy, that is still two percentage points we could do without. A six percent unemployment rate may not be much to write home about, but it is a very good deal better than eight percent.

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The story I have been telling tonight represents my own effort to make some sense of recent and current Australian economic policy history. The essential theme of that story is that we are currently pursuing what seems to me to be a false God – or better put, fleeing from a false demon – the demon of Australian foreign indebtedness. The price we are paying for this flight is, I think, by the standards of policy impacts, a pretty sizeable one – probably about two percentage points of unemployment, with all the attendant pain in both the short and the long-term that that involves.

If this is accepted, what should we do about it? Part of the point of the earlier sections of this lecture is that probably not much <u>can</u> be done. (They don't call economics the dismal science for nothing!). Of course, one can take the 'academic economist' approach and try to tell people to look again at the facts and the arguments, tell them that they may be wrong about the problem and that, in any case, the cure may be worse than the disease. But, as I've said, once economic nostrums are sanctified politically, once political parties are committed to policy regimes that depend on particular views as to 'what the real economic problem is', there is a very considerable political investment in those economic views, and very formidable rhetorical resources mobilised in their defence. That is what I mean in my title by the '<u>politics</u> of economics'. One policy response then is to treat these false economic theories as political facts – as constraints in the system that one must work with and around. After all, not all policy responses to a perceived international indebtedness problem are equally bad. Some of the policies implemented may even, on independent grounds, be quite good. There is nothing unfamiliar to the economist about constrained optimisation: the trick is always to recognise and understand the constraints.

So we can try direct assault on false beliefs. Or we can try to moderate the worst <u>effects</u> of those false beliefs. Or, as a third possible option, one might contemplate what I'll call the 'institutional' route: that is, aim to so structure the policy process that economic policy is substantially de-politicised. How this might be done, whether indeed it is really feasible, and whether any cure might even here be worse than the disease, are matters that go beyond my time or scope tonight. But it's long been recognised that one of the chief problems for democracy is how to assign power to the so-called 'experts' without undermining basic democratic principle. We economists often simplify this problem to the point of assuming it away, by taking it as self-evident that all of us (or at least the one who's speaking) have all the answers and are solely motivated by a desire to promote the public interest. Public choice theory, the economics of politics, has I think successfully challenged those particular presumptions – at least in principle: in practice, we economists continue, I'm afraid, to think pretty well of ourselves. Josh Billings' little quip is, I think, no less pointed for us than it is for the ordinary citizen/voter: 'It ain't so much the things we don't know that hurts us, it's the many things we do know that just ain't so'.