

## **MEDIUM TERM FISCAL POLICY ISSUES AND CHALLENGES IN AUSTRALIA**

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### **1. Introduction**

This paper focuses on key issues pertaining to medium-term fiscal policy in Australia. It builds on the paper presented at last year's Banca d'Italia fiscal policy workshop (Robinson, 2001). That paper presented an outline and analysis of Australian national and state government fiscal rules, with particular emphasis upon the national level.

As articulated in the 2001-02 budget of the Australian Commonwealth (*i.e.* national) government, the primary fiscal rule is "maintaining budget balance, on average, over the course of the economic cycle". The "supplementary" fiscal policy objectives articulated in that budget (Treasury, 2001a: 1.8) are:

- "maintaining surpluses over the forward estimates period while economic growth prospects remain sound,
- "no increase in the overall tax burden from its 1996-97 levels; and
- "improving the Commonwealth net worth position over the medium to longer term."

The key issues and challenges which govern medium-term fiscal policy in Australia are the following:

- the implication of significant current account deficits and substantial external debt for fiscal policy,
- fiscal sustainability,
- the fiscal implications of public infrastructure requirements,
- intergenerational equity, and
- the fiscal implications of an ageing population.

With the exception of the first, all of these issues and challenges also face the great majority, if not all, of OECD countries. It is the primary

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purpose of this paper to review the specific nature of these challenges as they face Australia.

Before proceeding to the main point of this paper, there are two points worth mentioning.

Firstly, given the recent background of Australian medium-term fiscal policy, it might be thought remarkable that the fiscal policy rules and objectives stated above make no mention of targets or objectives pertaining to public debt. As outlined in last year's paper, Australian fiscal policy in Australia in the second half of the 1990s was very much preoccupied with the reduction of net debt. Indeed, for a brief period at the end of the 1990s, the government enthusiastically embraced the idea that, with the considerable assistance of privatisation receipts, it would be able to achieve *zero* net debt. At the present time, however, with the national government's general government net debt at less than 6 percent of GDP, and with a measure of fiscal loosening in the 2001-02 budget, further debt reduction appears no longer to be a policy objective.<sup>1</sup> Achievement of the primary objective of structural budget balance will, of course, result in stable nominal net debt<sup>2</sup> (cyclical fluctuations aside) and the Government appears now to be content with this debt outcome.

Secondly, although the primary fiscal rule (of balanced budgets over the business cycle) has been the cornerstone of medium-term fiscal policy since the present Commonwealth government came to office in 1996, the budget deficit concept in terms of which the rule has been articulated has changed over the years. Prior to 1999-2000, the rule referred to the cash accounting 'underlying budget balance'. In the 1999-2000 budget, the rule was reformulated, with considerable fanfare, to refer to a new fiscal concept, the 'fiscal balance', which represented the accrual accounting equivalent of the cash underlying budget balance. Issues related to this transition from a fiscal rule articulated in cash accounting terms to one specified in accrual terms were one of the primary focuses of the paper which I presented last year (see also Robinson 2002). It is rather striking that, having made so much of the transition to accrual accounting, the government has in 2001-02 reverted to a cash accounting concept of the budget balance. The reasons for this reversion to cash accounting concepts, and its implications, are discussed briefly towards the conclusion of this

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<sup>1</sup> It is, nevertheless, perfectly possible that further privatisation will lower debt further in future.

<sup>2</sup> And, of course, in the trend reduction of both real debt and the debt/GDP ratio.

paper. However, it needs to be borne in mind that the cash budget balance and the fiscal balance are quite similar concepts, and the essence of policy has not changed.

## 2. The Current Account Deficit and CAD

As noted in last year's paper, the most important driver of Australian fiscal policy from the second half of the 1980s till the present time has been the external current account deficit (CAD). In terms of decade averages, the CAD grew from 1.8 percent in the 1970s to 4.7 percent in the 1980s and 4.4 percent in the 1990s<sup>3</sup> (Edey and Gower, 2000: 286). Associated with this has been a growth in net foreign liabilities, from 21 percent of GDP as at 30 June 1980 to 45 percent (1990), 54 percent (1995) and then 58 percent (2000) (Treasury, 2001b: 108).

Policy makers reacted to these high current account deficits with alarm. The view which initially guided policy was that the high current account deficits were a concern quite independent of the source and composition of those deficits. It was expected that high CADs would inevitably erode international financial market confidence, imposing a growing risk premium on domestic interest rates and producing a growing vulnerability to far more damaging sudden shifts in market sentiment. (Consistent with this analysis, the official view was that by the early 1990s, Australia was in fact already paying a significant risk premium on its interest rates.) There was therefore in the 1980s and early 1990s a widespread view that high CADs imposed a 'speed limit' on the rate of growth of the domestic economy.

This view of the nature of the CAD problem clearly dominated fiscal policy up to the time of the Asian financial crisis (see Treasury, 1996: 1.9). Notwithstanding that the Australian CAD was primarily driven by the gap between *private* investment and savings, as opposed to public sector deficits, it was regarded as essential that fiscal policy play a key role in addressing the CAD "problem". The "twin deficits" theory was an important influence underpinning this policy perspective. Official thinking

<sup>3</sup> As Edey and Gower note, because Australia has significant external net debt, the implicit capital repayment element of the nominal interest rate (via the Fisher effect) will exaggerate the CAD. When adjusted for inflation, the CAD falls to 1.4 percent in the 1970s, 3.6 percent in the 1980s and 3.2 percent in the 1990s. These figures (and the increase implicit in them) clearly remain high.

at the time was that the appropriate response to high CADs was policies to substantially raise the rate of national savings, and that a key part of this was fiscal policy aimed avoiding public sector dissaving. Avoiding public sector dissaving was supposed to require the avoidance of (cash) budget deficits. Implicit in this was a mistaken view that the cash budget balance was a measure of government savings. This was erroneous, of course, because it failed to recognise that investment expenditure – irrespective of whether undertaken by government or the private sector – represents an *application* of, rather than a *subtraction* from, national savings. This error was pointed out by critics in the subsequent policy debate. It eventually came to be generally recognised that the cash budget balance<sup>4</sup> was a measure, not of public sector savings, but of public sector “net lending” to the private sector. This did not, however, alter the official fiscal policy view. The policy rationale was then reformulated into a proposition that medium term fiscal policy could make the most appropriate contribution to dealing with the CAD “problem” if the public sector refrained from drawing, other than temporarily during a recession, on private sector saving. The fundamental fiscal rule of “maintaining budget (or fiscal) balance, on average, over the course of the economic cycle” flowed directly from this reasoning.

The initial policy responses to the CAD ‘problem’ were not confined to medium-term fiscal policy. At the end of the 1980s, short-run demand management policies were brought to bear on the CAD, with a deliberate tightening of both fiscal and monetary policy (Hutson and Kearney, 1999: 75-76; Bewley and White, 1990). This policy tightening helped push the Australian economy into a severe recession in the late 1980s. There were also a number of policy initiatives designed to increase private saving (including the introduction of compulsory superannuation contributions for most Australian workers, as discussed below).

In the early 1990s, these policies became the subject of intense debate amongst Australian economists and policy-makers. The threshold issue was whether a high CAD was in fact a ‘problem’ which Governments needed to worry about. Australian economists like John Pitchford (eg 1989) and Max Corden (1991) argued forcefully that there should be no presumption that large CADs were in themselves a problem. In Australia’s particular case, where the CAD was driven primarily by the gap between private sector investment and saving, there was, in the Pitchford-Corden

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<sup>4</sup> Or, more precisely, the “fiscal balance” measure.

view, no problem at all. Large CADs could easily arise from private sector decision-making (capital flows to take advantage of sound investment opportunities, and inter-temporal consumption smoothing at the consumer level) which was both rational and sustainable. In any event, they argued, to the extent that there might be some irrational private sector decision-making contributing to the high CAD, the costs of that irrationality would generally be borne by direct parties to the relevant transaction (eg through bankruptcy or poor equity returns) without imposing substantial economy-wide costs. These economists suggested that international financial markets would take these considerations into account, rather than simply punishing any country because of the level of its CAD.

These views were, of course, hotly debated at that time. Many aspects of the issue were canvassed, including the presence and extent of external costs which might arise from poor private investment decision-making. It is not the purpose of this paper to review that debate.<sup>5</sup> The key point is that Australia's experience with continuing high CADs during the 1990s has led to a major shift of opinion, including within official circles, towards the Pitchford-Corden position. As Gruen and Stevens (2000: 49) note, "few observers in 1980 would have considered it likely that a current account deficit of 4½ percent of GDP could be sustained for two decades. The fact that it has been.... has itself changed the nature of debate about the current account". Particularly significant was the fact that Australia's economy held up remarkably well during the Asian financial crisis at the end of the 1990s. Far from being punished at that time by the international financial markets for its high CADs, Australian interest rates benefited from the fact that Australia was seen as a safe haven for funds. Few Australian economists today take the view that Australia is being made to pay, or is likely under current policies to be made in future to pay, a significant risk premium on interest rates as a consequence of the CAD and the level of net foreign liabilities.<sup>6</sup>

<sup>5</sup> Indeed, it might be argued there are good reasons to suppose that policy makers may now have become too relaxed about high current account deficits (see Cashin and McDermott, 1998).

<sup>6</sup> At the present time, there is no longer a consensus amongst official economists on the issue of whether in the early 1990s Australia was in fact paying a significant risk premium due to its high CAD. On the one hand, Treasury department analysis has estimated the risk premium on Australian interest rates in the early 1990s as 3½ percent (by contrast with ¾ percent in the early 1980s and also again at the end of the 1990s) (Treasury, 2001: 118). By contrast, the Head of the Reserve Bank of Australia's Economic Research Department has recently suggested that a more 'natural' explanation of Australia's relatively high interest rates in the early 1990s is 'that markets (continues)

As a consequence of these experiences, in combination with broader currents of international economic opinion on the impact of current account deficits, Australian fiscal policy makers became in the second half of the 1990s increasingly relaxed about the CAD. The notion that macroeconomic demand-management should be used as a tool for restraining the CAD was completely discarded. The Commonwealth Treasury appears to have abandoned the notion that the sustainability of the CAD is a function of its magnitude, and to have moved a long way (perhaps too far) towards the Pitchford-Corden view that high CADs driven by private sector investment and saving decisions are not a problem (Treasury, 1999: 1.17, 3.23). The view now appears to be that it is not so much the level, as the source and composition, of the CAD, which can be a problem. Notwithstanding this, at the end of the 1990s the Government's medium-term fiscal strategy continued to be rationalised publicly by reference to CAD concerns (e.g. Treasury, 1999: 1.14). The question is obvious: if the level of the CAD is not, per se, a concern, why should medium-term fiscal policy remain preoccupied with the CAD?

Essentially, the official view has been reformulated to one that focuses not upon the level of the CAD, but upon the potential threat of unsustainable fiscal policies to external balance and market confidence. As the 2001-02 Budget Papers put it:

The fiscal strategy is not directed at particular current account outcomes, however, but at addressing one of the underlying contributions to unsustainable current account deficits: namely, unsustainable government borrowing. .... Sound fiscal policy can limit the risk premia attached to interest rates. Rising levels of government debt and uncertainty regarding future policy can weigh on investors' confidence, such that they require higher interest rates to induce them to finance Australian debt, both for government and private issuers..... The medium-term strategy assures investors that the CAD over time will largely be based on private sector decisions subject to market disciplines (*Treasury, 2001: 1.25-1.26*).

This policy shift is extremely significant. Essentially, it means that the CAD is no longer seen as a key fiscal policy concern *distinct from* the fiscal sustainability issue. An implication of this new view is that the only way in which the imperative of sustaining international financial market

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took a long time to be convinced that the step-down in inflation at the beginning of the decade would be sustained' (Gruen and Stevens, 2000: 61).

confidence would alter the preferred fiscal policy of the Australian government would be if the view taken by international financial markets of what constitutes a ‘sustainable’ fiscal policy differed from that which might be taken by domestic financial markets or from the policies which government might pursue if, hypothetically, it were not operating in the context of a globalised financial market.

### **3. Fiscal sustainability and the public sector capital stock**

The revised view of the implications of external balance for fiscal policy being taken with official circles essentially means that the undisputed dominant policy criteria for medium-term fiscal policy Australia at the present time is fiscal sustainability.<sup>7</sup>

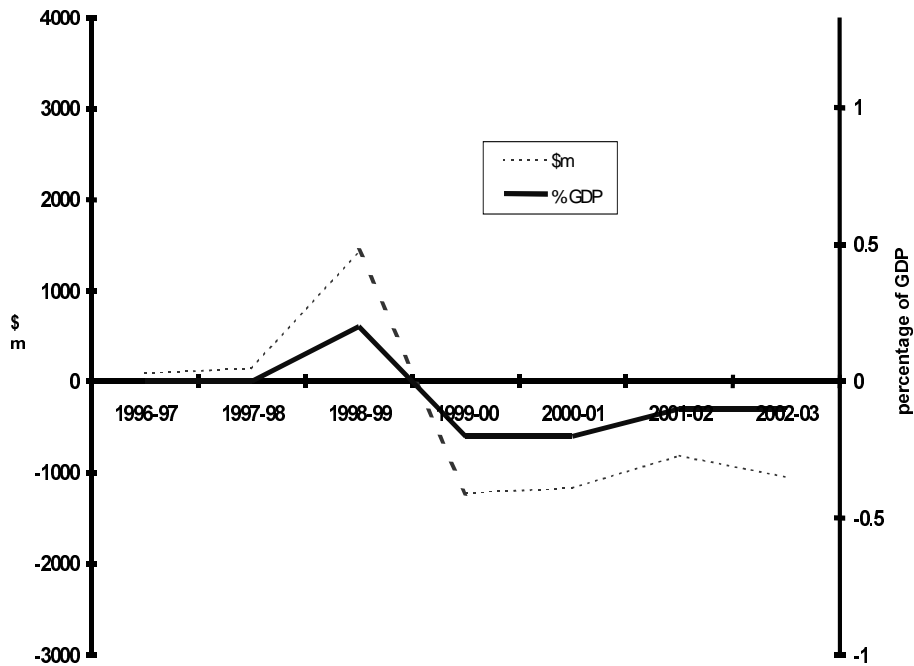
As outlined in last year’s paper, there has been an enduring tendency for Commonwealth Government fiscal policy to be guided by the notion that (general government) public debt is both a threat to fiscal sustainability and inconsistent with intergenerational equity. No distinction is made in this context between borrowing for capital purposes and borrowing for current purposes. Nor is it recognised that increases in debt do not necessarily threaten fiscal sustainability if the ratio of debt to the tax base remains moderate. Nothing has changed in this respect in recent Commonwealth fiscal policy developments, notwithstanding the opportunity presented by the move to accrual accounting to adopt a more discriminating view of the implications of the fiscal sustainability requirement.

The central problem with a medium-term fiscal policy of this type is, as noted in last year’s paper, its inherent anti-capital expenditure bias. Not only is the budget outcome targeted by this policy “improved” by squeezing general government capital expenditure, but – worse still – it improves even more if general government assets are sold. It is true that the Australian “underlying” cash budget balance measure was redefined in the early and mid-1990s so as to prevent the general government budget outcome being artificially boosted by the sale of public enterprise assets.

<sup>7</sup> At the risk of stating the obvious, fiscal sustainability may be defined as the avoidance of fiscal policy settings which, if maintained over time, would ultimately result in the burden of financial obligations rising to levels which would lead government to default, and which at some point prior to that would lead to a loss of confidence on the part of potential lenders.

Fig. 1

## Commonwealth General Government Net Capital Investment



Source: Commonwealth Budget Papers, 2001-2002.

However, it is not widely understood in Australia that this did not affect the treatment of receipts from the sale of *general government* assets, which continued to be treated in effect as ordinary revenue in the calculation of the underlying budget balance. Nor did this practice change with the introduction of the new quasi-accrual “fiscal balance” measure. It is significant in this context that the magnitude of Commonwealth general government asset sales over recent years has been so great that general government net capital investment has generally been negative, as indicated in the following chart.

This points to one of the central issues of Australian medium-term fiscal policy. The result of fiscal policies at the Commonwealth and State level which have focused upon a measure of the budget balance which fails



to distinguish between capital and current spending has been a long-term capital expenditure drought. In this respect, of course, Australia's experience has been little different from that of a number of other OECD countries. The implications of this capital spending drought have become quite serious in a number of areas. The very poor state of Australian railway system infrastructure – particularly in respect to long-distance freight services – is a particularly serious case in point.

The infrastructure funding problems posed by this type of fiscal policy are even more serious for Australian State governments than they are for the Commonwealth Government. This is because, firstly, the States have always played the dominant role in public sector infrastructure and, secondly, because some of the areas of public infrastructure for which the Commonwealth was traditionally responsible have moved out of the public sector as a result of privatisation. It is therefore hardly surprising that two of the States have in recent years moved away from the traditional focus upon the cash budget balance to a “golden rule” fiscal policy. One of these is Queensland, which had for years prided itself on a fiscal policy based on a ‘no debt’ policy, and which as a consequence of this policy and rapid population growth experienced a serious erosion of public infrastructure (Robinson, 1996). In 1999, Queensland shifted to a golden rule policy and has over recent years undertaken a significant program of reconstruction of public infrastructure, while at the same time firmly maintaining a sustainable and responsible fiscal position.

The anti-capital spending bias of a fiscal policy targeting the cash budget balance (or the “fiscal balance”) have, as in a number of other countries, had significant microeconomic consequences. In particular, this fiscal policy has undoubtedly been a key factor in the wave of popularity amongst Australian States for PFI/PPP-type policies under which the private sector directly funds general government capital expenditure projects. The concern here, of course, is not with the “privatisation” of such capital expenditure per se. Privatisation does, of course, offer efficiency gains in many areas, and where this is the case it should be prosecuted vigorously. The concern, rather, is with PFI/PPP projects which are driven not by efficiency gains, but by a desire to effectively move public debt off balance sheet. It is worth noting in this context that private sector participation in public capital projects in Australia has for many decades been very extensive in precisely the areas in which the greatest efficiency gains can generally be expected. In particular, Australian

governments have for a long time generally contracted out the construction phase of nearly all public infrastructure projects.

#### 4. Intergenerational equity and ageing population

Although the primary rationale for current medium-term Australian fiscal policy is fiscal sustainability, the claim is also made that the policy also meets the intergenerational equity criteria (eg Treasury, 2001a: 1.8). However, official policy-makers do not appear to have seriously examined the issue of intergenerational equity. The alternative, golden rule approach to fiscal policy is, of course, one which explicitly argues on intergenerational equity grounds for the spreading the costs of capital expenditure over time through the use of debt. Given this, the assertion the current Australia fiscal policy is consistent with intergenerational equity clearly requires some detailed theoretical substantiation. Such substantiation has, however, been absent. When the current Government put legislation through Parliament to implement a “Charter of Budget Honesty”, the legislation contained a provision apparently requiring the provision at five year intervals of an “intergenerational report” on fiscal policy. That report is apparently due this year, and will be of some interest when and if it is produced.

As generational accounting so effectively reminds us, the issue of intergenerational equity is not only one which relates to capital expenditure. Life cycle tax/benefit transfers are also extremely significant. One generational accounting studies of Australian fiscal policy suggested that, when the total picture is taken into account, it cannot be argued that fiscal policy is imposing a net burden on future generations (Ablett, 1998).<sup>8</sup>

An alternative way of getting some perspective on these issues is, of course, to consider the fiscal effects of demographic change. The most recent, and most pessimistic, projection of the fiscal impact of population ageing in Australia is a study by Guest and McDonald (2000). In their ‘base’ case projection, Guest and McDonald project that social expenditure, defined as the sum of social security, health and education expenditure, will rise from 20.6 percent of GDP in 2001 to 28.0 percent in 2051. Most of this increase will take place in the period after 2011, with

<sup>8</sup> This study was undertaken some years ago. The nature of fiscal policy changes since that time would suggest, *prima facie*, that the conclusion would hold even more strongly at present.

the main driver being social security expenditure, reflecting increased aged pension expenditure. Earlier estimates of ageing-related expenditure pressures, although somewhat lower, nevertheless also indicate a significant growth of expenditure (eg EPAC, 1994; Alvarado and Creedy, 1996).

These expenditure trends need to be put into context. The fiscal pressures for Australia arising from an ageing population, although significant, are not as severe as those of other developed economies. The OECD's 1996 study, for example, projected that the demographically-driven increase in social expenditure (which they defined as social security plus health) would be less in Australia than in any other OECD country (OECD, 1996). A central reason for this is a projected elderly dependency ratio which is the lowest of all OECD countries,<sup>9</sup> which in turn reflects immigration and fertility rates which are relatively high by OECD standards. Another key factor is the nature of Australia's retirement incomes system. Australia is the only OECD country to have developed a three-pillar retirement income model along the lines recommended by the World Bank (1994). The feature of this system which is of the greatest fiscal relevance is that publicly-funded pensions provide and income floor only, and are unrelated to the individual recipient's pre-retirement income (Khan, 1999). Supplementation of the public pension is provided by contributory superannuation. An important development occurred in the 1980s and early 1990s, when a framework of compulsory minimum superannuation contributions covering almost all Australian workers was introduced, under which contributions which reach the equivalent of 9 percent of wages by 2002/03 (Edey and Gower, 2000). It is also relevant that publicly-funded aged pensions are means-tested in Australia.

## 5. Fiscal balance vs cash balance

As indicated in my paper to last year's Workshop, one notable recent feature of Australian medium-term fiscal policy was its reformulation in accrual accounting terms in 1999. In the 1999-2000 budget, it was announced that the primary fiscal rule would henceforth be expressed as a

<sup>9</sup> In their base case projection, Guest and McDonald (2000: 50) estimate the aged dependency ratio for Australia in 2030 as 33.0 percent, far below the two countries with the biggest problem: Germany (49.2 percent) and Italy (48.3 percent).

requirement “to achieve fiscal balance, on average, over the course of the economic cycle” (Treasury, 1999: 1.14). In this reformulation, the accrual concept of *fiscal balance* replaced the former cash accounting concept of the *underlying budget balance*. As previously explained, whereas the flow counterpart of the cash budget balance is net debt, the flow counterpart of the fiscal balance is net financial liabilities. Net financial liabilities is essentially a *broad debt* measure which includes, together with conventional debt, other financial assets and liabilities such as the superannuation (pension) ‘debt’ to government employees and the value of government equity in public enterprises. As noted in last year’s paper, the fiscal balance measure is a conceptually more precise measure of the extent to which the (general government) public sector is drawing upon private sector saving to finance itself, and it is for this reason that the fiscal balance is known in the Australian Bureau of Statistics’ framework as ‘net lending’. Given the present national government fiscal policy objective of leaving private sector saving for the use of the private sector alone, the reformulation of the primary fiscal rule in terms of the fiscal balance made excellent sense. It was also noted that, as an indicator of fiscal sustainability, net financial liabilities is certainly a better measure than the traditional narrow net debt measure.

As noted at the outset of this paper, in the 2001-02 national government budget, the rule has been reworded again so that it now reads “maintaining *budget balance*, on average, over the course of the economic cycle”. The words ‘budget balance’ have replaced the words ‘fiscal balance’, and refer to the cash accounting underlying budget balance measure. The obvious question is: if, for all the reasons clearly articulated by Treasury, the fiscal balance concept permitted a more precise formulation of the thrust of current medium-term fiscal policy, why has the government reverted so very quickly to a focus upon the cash budget balance?

The answer is a simple one: in 2001-02, the budget went into deficit on the fiscal balance measure, while remaining in surplus as measured by the underlying cash budget balance. As projected in the official October 2001 Mid-Year Economic and Financial Outlook statement, the 2001-02 fiscal balance is expected to show a deficit of \$3.1 billion (0.4 percent of GDP). In part, the divergence between the fiscal deficit and the underlying cash balance arises from a revenue timing anomaly arising from a change in the company tax regime, which can be regarded as temporarily distorting

the accrual revenue figures (Treasury, 2001a: 2.4). However, even if were to adjust for this disturbance, there would probably remain a small deficit.

The Australian economy has not been in recession in 2001, unlike some other countries. Thus, in terms of the fiscal balance measure, the 2001-02 budget does not comply with the supplementary fiscal policy objective of “maintaining surpluses over the forward estimates period while economic growth prospects remain sound”. As noted earlier, there is debate about the appropriate stance of short-run fiscal policy stance amongst Australian economists. There is one school of thought which suggests that, given the lags of fiscal policy and the likelihood of an eventual Australian economic downturn arising from the world recession, a deliberate fiscal deficit in 2001-02 would have been perfectly appropriate. But this has not been the position of the Government. Hence the need to shift emphasis back to the cash budget balance in order to maintain the appearance of continued respect for stated fiscal policy principles. This is regrettable.

## **6. Short-run fiscal policy**

Although the focus of this paper is not upon short-run fiscal policy issues, a brief word on these is useful. A key point is that the present government has no fiscal rules which impose ceilings upon short-run deficits, in the manner of the Maastricht stabilisation pact principles. The present official view in Australia is that, faced with a recession, it is appropriate not only to permit the automatic stabilisers to operate unhindered, but also to make ‘cautious’ use of discretionary fiscal demand stimulus policies (Treasury, 2001a: 1.9, 1.26). There has, as one would expect, been considerable debate amongst Australian economists as to whether short-run fiscal policy should at the present time, in the face of world recession and uncertain recovery prospects, be more or less stimulatory than it actually is. Whether it is in response to a more challenging global economic environment, or simply as a political response to the political imperative posed by a national election in late 2001, the Commonwealth government did loosen the purse strings in the 2001-02 budget. Indeed, on one measure of the budget balance, the budget went into deficit. However, it is probably true to say that there is at the present time a much broader consensus than previously existed amongst Australian economists (official, academic and private sector) as to the appropriate principles governing short-run fiscal policy.

## **7. Conclusion**

This paper has presented an overview of key medium-term fiscal policy rationales and challenges in Australia. The most notable recent shift in Australian medium-term fiscal policy thinking has been a revised view of the role of the CAD 'problem' in fiscal policy. In the past it was seen as vital that fiscal policy be pressed into duty in the cause of lowering the high CAD. By contrast, the present view is that fiscal sustainability is the key concern.

Although Australia to some extent faces similar fiscal challenges to other OECD countries (such as the fiscal pressures of an ageing population), its fiscal position is generally a favourable one. There is certainly no fiscal sustainability problem. One central fiscal problem facing the country, however, concerns the state of public infrastructure. This problem arises in large measure from the continued pursuit of a fiscal policy which fails to distinguish between capital and current expenditure.

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