

The pace of deficit reduction has been slow because of political opposition to the proposed 'budget savings' (perceived by many to be unfair and mean spirited) and adverse 'economic headwinds' such as slow global growth and falling commodity prices.

Therefore, monetary and fiscal policies are having limited impact on the economy and hence on the achievement of the government's objectives. Ideally, the growth rate would be higher than it is (say at 3.5%–4%), unemployment would be lower (say at 5%), inflation would be higher (within the 2% to 3% band rather than at 1%) and the measures taken to repair the budget would be more equitable.

The main policy emphasis is improving the supply-side of the economy e.g. through tax reform and infrastructure development. Governments around the western world are struggling to achieve their macroeconomic objectives through their traditional demand-side policies.

3.(2017:30a) The government has five macroeconomic objectives.

- Steady and sustained economic growth: There are two parts to the growth objective, firstly, reducing the short-term peaks and troughs of the economic cycle and, secondly, achieving a sustained increase in output over the longer term without causing problems elsewhere in the economy, such as inflation or environmental damage. In 2016–17 the rate of growth was about 2%, below the 3.5% trend or long-term average rate of growth. Growth in incomes rose a little faster than the rate of growth as a result of a recovery in the terms of trade.
- Low inflation: On behalf of the Government, the Reserve Bank aims to keep the annual rate of inflation within a 2% to 3% range over the life of the economic cycle. During 2016–17 inflation was below this target range at about 1.5% reflecting low wages growth, an output gap and a strengthening exchange rate.
- Low unemployment: The Government and Reserve Bank aim to keep the rate of unemployment close to the natural or non-accelerating rate of unemployment (NAIRU), although they don't put an exact figure on the level of NAIRU. The aim is to reduce cyclical unemployment close to zero, so that most of the remaining unemployment will be structural. In 2016–17 unemployment was about 5.5%, a level above the NAIRU level, while underemployment, a measure including hidden and disguised unemployment, was over 8%.
- Equity in income distribution: A fair income distribution is one where opportunities for rewards and incentives are balanced with access to welfare and social security. High pay and profits are available to people that work hard or act in an enterprising way while a social security network is available to protect vulnerable members of society. In 'fair' economies some of the unevenness in the distribution of market incomes is reduced by

a tax and transfer system (e.g. income tax, pensions and the provision of public and merit goods) to produce a more even distribution of final income. In 2016–17 the perception was that income distribution became more unfair (and the gini-coefficient had increased) as a result of the combined impact of globalisation, new technology, structural change and government attempts to achieve 'budget savings' as part of their deficit and debt reduction strategy.

- An efficient use of resources: An economy is allocating its relatively scarce resources efficiently when it achieves maximum productive efficiency (i.e. it produces products at lowest unit cost possible), maximum allocative efficiency (i.e. it produces products where costs of production reflects householders' benefit) and maximum dynamic or adaptive efficiency (i.e. it has the flexibility to adjust output to meet changing circumstances). In 2016–17 further economic reform was limited e.g. in areas of competition policy, foreign investment and labour markets. While some steps were taken to increase the supply of renewable energy, elsewhere permission was granted to increase coal production in Queensland.

While some of these objectives are complementary (for example, economic growth tends to reduce unemployment) other objectives may, in some circumstances, clash (for example, equity in income distribution may mean resources are used less efficiently).

## Chapter 13: Fiscal Policy

### Section A: Multiple Choice Questions

- 1.(2014:15b) A depreciation of the AUD will stimulate the economy. The government will collect more tax from individuals and companies.
- 2.(2014:17d) The government found it difficult to get Senate approval for its budget measures.
- 3.(2014:23d) Only a Keynesian economist would think like this. A new classical economist might even select option 'b'.
- 4.(2015:23a) Options (i) lower revenue, and (iii) more spending, are consistent with a rise in the budget deficit.
- 5.(2015:24a) This is known as financial crowding out.
- 6.(2016:18d) This is a strength compared to monetary policy at least.
- 7.(2016:20c) The decision to raise income tax is discretionary i.e. taken by the government. It will also have a redistributive impact on the economy.
- 8.(2016:24a) A cut in income tax is a deliberate policy change by the Government.
- 9.(2017:20c) New spending on infrastructure is a discretionary change in spending, the other options involve things that happen as a result of changes in the level of economic activity.
- 10.(2017:21a) Extra government borrowing may lead to a rise in interest rates.



- 11.(2018:21b) Social security and welfare spending amounts to about a third of the total.
- 12.(2018:24a) Changes in fiscal policy can have a relative quick impact on the economy.
- 13.(2019:17a) A recession is a fall in GDP. As the economy falls tax revenue falls and transfer payments rise.
- 14.(2019:18c) Demand for the Government bonds by foreigners will increase the demand for AUD. It is possible that the extra borrowing may push up domestic interest rates (option b). In turn the rise in interest rates could attract foreign investment which would lead to an appreciation of the dollar. This is the process known as financial crowding out.
- 2019:19d Budget repair involved reducing budget deficits and eventually reducing debt.

### Section B: Data Interpretation Questions

- 1.(2017:27) (a) (i) Government spending exceeds government revenue (or tax) over the accounting period; (ii) 2010 (deficit of 4.2% of GDP); (iii) Between 2009 and 2010;
- (b) A budget deficit can be financed by borrowing (selling government bonds), printing money (e.g. quantitative easing) or selling assets (e.g. government land);
- (c) In the period between 2014 and 2016 budget deficits fell from -3.1% of GDP in 2014 to 2.4% of GDP in 2015 and 2016. The impact on the economy depends on (i) the proportion of the deficit that is structural and the proportion that is cycle (i.e. affected by the level of economic activity) and the *change in the level* of the structural deficit. So when compared to a balanced budget these deficits appear to be expansionary, but when 2015 is compared to 2014 it is less expansionary or contractionary and in 2016 compared to 2015 it is neutral. The impact on the economy also depends whether the change in the budget deficit will have a crowding-in effect (e.g. whether there will be less pressure on interest rates and more resources available to support private sector spending).

### Section C: Extended Writing Questions

- 1.(2015:30) (a) Define the term 'budget deficit'. The government can finance the deficit by borrowing or by selling assets. They borrow by selling short-term and long-term Treasury securities that may be bought by institutions within Australia or overseas. The government can privatise assets (such as transport infrastructure and utilities) that are still under government ownership.  
Financing the deficit is not the same as correcting the deficit. Correcting the deficit requires either an increase in tax receipts or a reducing in government spending.
- (b) The answer to the question depends on whether you believe that Keynesian economists are right or whether new-classical economists are

right. Keynesian economists believe that a budget deficit (other things being equal) will be expansionary because it represents a net injection into the economy and that it will set off a multiplier process. They believe that without this injection the economy will be stuck with a GDP gap. The Keynesian approach may lead to a short-term improvement in growth and employment but lead to a build-up of longer-term problems (e.g. debt and inflation).

New-classical economists believe a budget deficit will have a limited short-term impact on the economy because of financial and resource crowding out (because borrowing leads to higher interest rates and government spending might replace rather than add to private sector spending) and debt issues (e.g. higher interest payments and loss of confidence about the approach to economic management). They believe the economy will self-adjust over time as e.g. labour costs fall. The new-classical approach (reduction in the budget deficit or austerity) may lead to short-term problems such as slower growth and higher employment but lead to longer-term gains (e.g. debt reduction, low inflation, lower interest rates and sustained growth).

Back up your answer with an appropriate AD/AS diagram that supports the economic viewpoint you have selected (i.e. Keynesian or new-classical).

- 2.(2018:31) The forecast budget balance seldom matches actual performance. In 2017-18 the mid-year forecast was for an improvement in government finances, through a combination of higher tax receipts and lower government spending.

Since the relative success of the fiscal stimulus package introduced to combat the impact of the Global Financial Crisis the government has been following a policy of budget repair by reducing the budget deficit to eventually reduce the level of sovereign debt. The process has been difficult because of so-called 'budget sabotage' from the Opposition in House of Representatives and the Senate because of the perceived lack of fairness in the 'savings' measures proposed, and because of the government's 'earnings problem' caused by the economy generally performing worse than forecast by the Treasury forecasts, and the effect this has on the level of the cyclical budget balance. The country experienced larger than expected falls in the terms of trade, commodity prices, growth, inflation, wages and profits. Overall, in the seven years from 2009-10 to 2015-16, there was a total revenue write down of nearly \$200b.

However, recently global and domestic economic conditions have improved, and, importantly, exceeded the assumptions made at budget time. There has been a rebound in some commodity prices and, therefore, in the terms of trade. Growth is nearly back to trend levels and inflation has risen to be within the 2% to 3% target, all good for taxation revenue and the cyclical budget balance.

What will the government do to its fiscal stance if the economy reaches a level of 'full employment'?