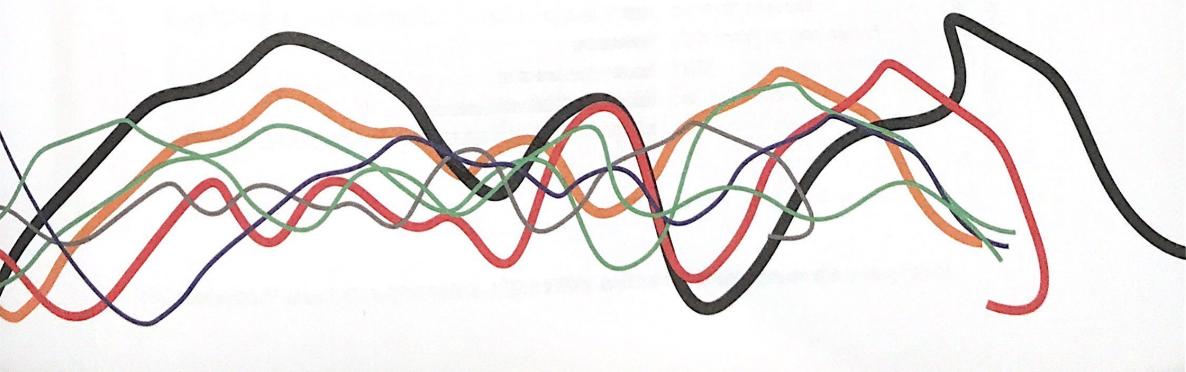


12

Fiscal Policy

Chapter concepts

- *the concept of fiscal policy*
- *the components of government revenue and expenditure in the budget*
- *the nature of balanced, surplus and deficit budget outcomes*
- *differences between planned and actual budget outcomes*
- *methods of financing a budget deficit and the uses of a budget surplus*
- *the distinction between automatic stabilisers and discretionary fiscal policy*
- *the distinction between budget outcomes associated with fiscal stabilisers and outcomes associated with discretionary fiscal policy*
- *the concepts of expansionary, contractionary and neutral fiscal stances*
- *the impact of different policy stances on the level of economic activity*



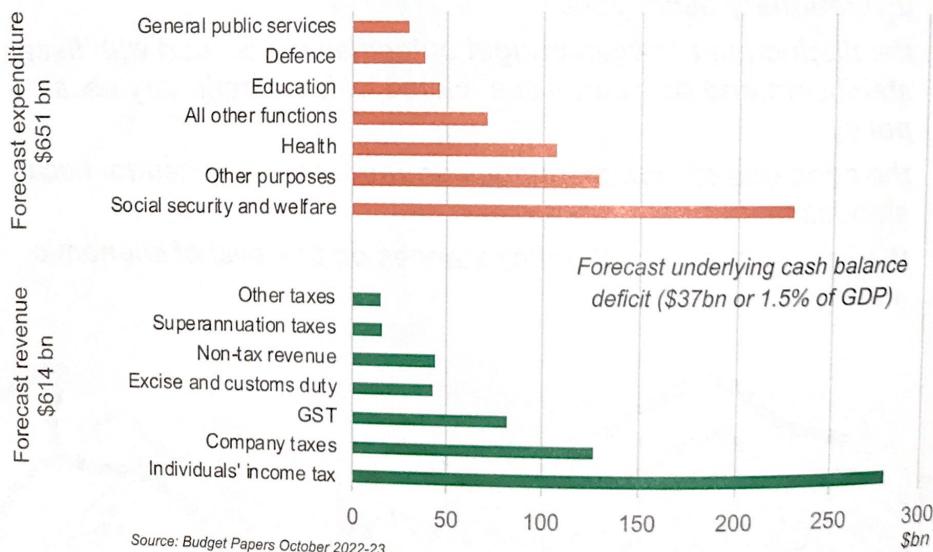
Government revenue and expenditure

Every individual, household, business firm or organisation has a budget in which it identifies its sources of income and the ways in which those funds will be spent over a period of time. In the same way, the Federal Budget, usually delivered in Parliament in May each year, estimates government revenue and spending plans for the coming year. As shown in figure 12.1, projected revenue for 2022-23 was \$614 billion, and forecast expenditure was \$651 billion, leaving a deficit of \$37 billion (or 1.5 per cent of annual GDP).

The Commonwealth Budget has three functions. Firstly, it decides how revenue will be raised, and allocates funds to areas of need. Budget allocations don't really change much from year to year, because they are determined by the funding needs of the public sector. For example, education spending can't be cut by 20 per cent one year then raised by 20 per cent the next, because it is an essential public service that provides for the needs of school-age children. Funding allocations are partly driven by the political process, as the government of the day needs funds to support its initiatives (recent examples being the National Disability Insurance Scheme, and projects on the Infrastructure Priority list).

Secondly, the budget plays a role in income redistribution. Wealthy households pay higher rates of tax, and those on lower incomes receive more government support (both direct and indirect) than those on high incomes. Thirdly, the government can use the budget to influence the level of macroeconomic activity. (i.e. to stabilise fluctuations in the business cycle). In Australia, the first time a budget was deliberately used for this purpose was in 1951-52, when the budget

Figure 12.1 2022-2023 Budget: expenditure and revenue



was designed to 'cool' the booming post-war economy with inflation above 15 per cent, and unemployment less than one per cent.

Prior to the early 1950s, governments thought it sensible to balance their budget (ensuring that revenue and expenses were similar). Keynes argued that this 'balanced budget policy' could actually destabilise the economy because government expenditure was tied to revenue. In a recession, when revenue fell, a balanced budget would actually mean lower government expenditure – just the opposite of what the economy needed to restore levels of spending and output. Keynes advocated for an 'interventionist' economic policy, suggesting that governments should use fiscal and monetary measures to reduce the adverse impacts of business cycles.

John Maynard Keynes (1883–1946) was a British economist whose ideas were a significant influence on macroeconomic theory and government policy.

Budget outcomes

The 'outcome' of the budget refers to the relationship between government revenue and government spending. There are three possible outcomes:

- a balanced budget, where revenue and expenditure are equal ($G = T$):
- a surplus budget, where revenue is greater than spending ($T > G$); and
- a deficit budget, where spending exceeds revenue ($G > T$).

In general, a surplus budget will occur when GDP growth is strong and the economy is close to full employment. A deficit budget will occur in the opposite scenario when GDP growth is relatively slow or when the economy has contracted.

It is almost certain that the actual budget result at the end of the year will differ from the planned outcome, for a number of reasons. Should there be a downturn in economic activity, business conditions would be tougher and taxation revenue from households and businesses would fall. As a result, the actual deficit would be worse than the planned deficit. On the other hand, an unanticipated upswing in economic activity after the announcement of the budget would result in rising government revenues and lower welfare spending, in which case the actual outcome would be a smaller deficit than the forecast outcome. Changes in conditions in world markets could also impact on the budget outcome. Higher costs (perhaps resulting from rising oil prices) would put pressure on the budget because they signal higher transport charges. A fall in commodity prices (perhaps a fall in iron ore prices) would have a significant impact on tax revenue.

Learning activity

Applying mathematical techniques

Refer to the web sites of government treasuries in other countries, such as the United States, United Kingdom, New Zealand, Canada, France, Germany, Singapore or Japan. For the latest year, find out whether the budget in those countries is in deficit or surplus. What is the level of accumulated government debt in the country you have chosen? Calculate the government debt per head of population.

Exogenous factors (economic shocks) could also cause the actual outcome to differ from the predicted result. This has been evident in recent years, with bushfires and floods in the eastern states; the coronavirus pandemic; and the Ukraine War. These events could not have been anticipated in the Budget forecasts for the relevant years. A predicted small surplus for 2019–2020 turned to a significant deficit, for example, when the government was forced to introduce economic support measures during the initial stages of the pandemic.

Budgets and government finance

When the government records a budget deficit, then the difference needs to be financed – usually this is through government borrowing. A budget surplus will mean that the government is now saving and can use the surplus funds to retire past debt.

A budget deficit will have an expansionary effect on the economy because there is a net injection of funds into the economy. If planned government spending was \$500 billion and planned government revenue was \$450 billion, then the deficit or net injection is equal to \$50 billion.

There are four main methods a government can finance a budget deficit:

- selling new government bonds to domestic and/or overseas residents;
- borrowing from the central bank;
- borrowing from overseas; and
- selling government assets.

The most important method is by selling new government bonds, known as Commonwealth Government Securities (CGS). This method normally accounts for around 95 per cent of the government's borrowing requirement. A bond is a financial instrument which raises funds for its issuer (in this case, the government) in return for a rate of interest payable to the buyer. They are guaranteed by the government and are very popular with institutional and private investors. They can be bought by both domestic and foreign residents. In 2022, of the \$892 billion worth of CGS on issue, 45 per cent were owned by overseas residents.

Government bonds are one of many types of financial instrument available to investors with surplus funds. As they are guaranteed by the government, bonds are very safe and so the rate of interest offered will reflect their secure status.

When the government issues new bonds it is competing for funds in the financial market. This can lead to interest rates rising which can discourage private borrowing. Economists call this 'crowding out' – private investment spending is said to be 'crowded out' by the higher government spending. But selling bonds to domestic residents has the advantage that it does not affect the money supply – the public withdraws money from the banking system to pay for purchases of securities. When the government spends the borrowed funds, the net effect on the money supply is nil.

A second method of financing the deficit is to borrow from the central bank (Reserve Bank of Australia). This is referred to as 'printing money'. While this will have the desired expansionary effect on the economy, it could lead to higher inflation rates because it is directly increasing the money supply. The Reserve Bank has recently stated that it will not finance the current government's deficit.

Thirdly, the government could borrow from overseas to fund a deficit, but this is rarely used. It would mean the government would seek loans from foreign banks or governments rather than issuing new government securities. If the government used this method it would directly add to the government's foreign debt and result in an appreciation of the Australian dollar due to the inflow of money capital. An appreciation would counter the expansionary objective of the planned budget deficit by reducing net exports.

The final method the government could use is to sell government (public assets). It can do this by 'privatising' government business enterprises or by selling government property such as public land and/or buildings. While this method can raise finance, it is not used often because it can compromise the level of public services delivered in some situations.

When the government borrows to fund its deficit, it increases the government debt. Is this a problem? In 2022-23, the government's net debt was \$572 billion. The annual interest payments on this debt equaled \$13.6 billion. There is an

Government borrowing leads to an increase in public debt. The interest payments on this debt may have a significant opportunity cost.

An important point is that governments should always borrow to fund public investment - this helps to share the burden of borrowing between current and future generations ('intergenerational equity').

What impact does a surplus have on public finances? The surplus could be used to retire (pay off) government debt built up by past deficits, held over to fund future expenditure, or returned to taxpayers (perhaps as a direct payment, perhaps as a tax cut). All three happened in the mid-2000s, when Australia was one of the few countries in the world with no public debt. Australia still has a comparatively low government debt (about 23 per cent of GDP in 2022) even after the spending stimulus that was necessary during the coronavirus pandemic.

Stabilising the economy

Government economic policy is countercyclical - its objective is to 'smooth' the ups and downs of the business cycle. Fiscal policy has an important role to play in meeting this objective. Firstly, however, we need to understand that there are automatic mechanisms that play a role in smoothing the fluctuations associated with the cycle.

Tax revenue rises as GDP rises, as shown by the positively sloped line. The transfer payments line is negatively sloped, because claims on welfare fall as economic activity rises. If we start at the Budget balance point and the economy slows, tax revenue falls and transfer payments rise, pushing the budget into deficit and stabilising the economy to some extent. Alternatively, if we start at the Budget balance point and the economy expands, tax revenue rises and transfer payments fall – automatically pushing the budget towards surplus and slowing the economy by reducing aggregate spending power.

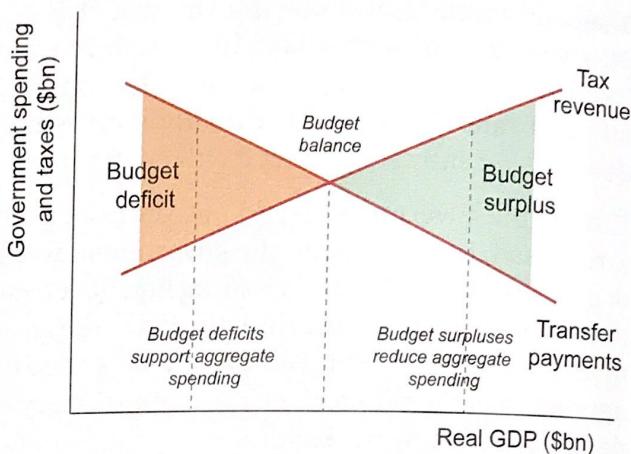


Figure 12.2 Automatic stabilisers

Automatic stabilisers

Even if the government makes no decisions about changing its revenue or spending patterns, the budget balance will vary over the course of the business cycle due to the impact of automatic stabilisers. When the economy is in the contraction phase of the cycle (slower growth), tax revenue falls and welfare payments rise, so the budget balance moves into deficit (the orange section of figure 12.2). When the economy is stronger, tax revenue rises and welfare payments fall, so the budget balance moves into surplus. Income taxes and transfer payments act like an economic shock absorber! They limit the rise of aggregate spending in a boom, and increase it in a trough. Essentially, the taxation and transfer payments stabilisers mean the budget deficit will automatically increase as the economy contracts, and automatically decrease as the economy expands.

Automatic stabilisers do not prevent fluctuations in the business cycle, and are not by themselves sufficient to completely counteract the peaks and troughs in economic activity. Generally, the action of automatic and discretionary stabilisers will be complementary, unless discretionary policy decisions are poorly timed.

Discretionary fiscal policy

Discretionary fiscal policy refers to the changes to expenditure and revenue that the government makes in the budget to stabilise the economy. We will examine three possible fiscal stances described earlier – expansionary, contractionary, and a balanced budget stance.

An expansionary policy stance

In a period of slow economic activity, it is appropriate to use an expansionary budget in order to stimulate spending. An expansionary policy stance is usually associated with a deficit budget – where planned expenditure is higher than

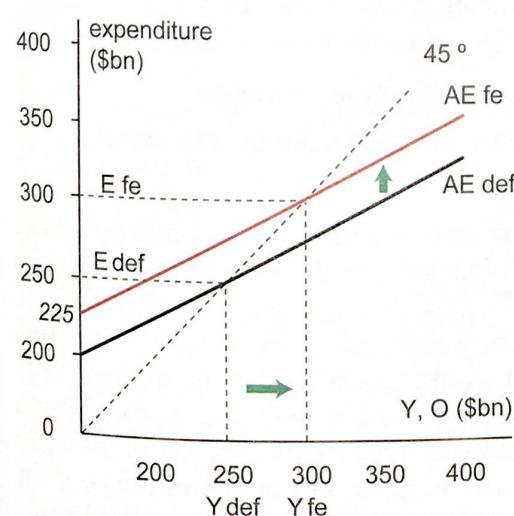
revenue. Policy measures to stimulate household and business spending could include:

- reducing income tax to increase household purchasing power;
- cutting corporate tax to stimulate business spending on inputs, employment and investment; and/or
- increasing government spending on infrastructure, such as transport and communications projects;
- direct payments to households and/or firms.

A budget deficit will always have an expansionary effect because there is a net injection of funds into the economy. But what if the budget deficit is reduced from one year to the next? For example, if the deficit in year 1 is equal to \$20 billion and in year 2 the deficit has fallen to just \$10 billion - is this still expansionary? The answer is yes. Assume the multiplier equals 2.5. in year 1, real GDP will increase by \$50 billion (20×2.5) and in year 2, real GDP will increase by \$25 billion.

We can analyse expansionary fiscal policy using the macroeconomic models developed in chapters 9 and 10. Figure 12.3 uses the Keynesian model. The economy is initially at Y_{def} - the phrase 'deflationary gap' is used to describe the output gap that exists between the current level of income and that which could be achieved at full employment (Y_{fe}). To close the gap, the budget takes an expansionary stance using some combination of the discretionary measures mentioned above. These policies stimulate household and business spending, so aggregate expenditure rises from AE_{def} to AE_{fe} . The final effect is larger than the initial stimulus because of the effect of the multiplier - a small change in government spending (i.e. a small vertical movement in AE) produces a larger increase in the level of aggregate income.

Figure 12.3 Expansionary fiscal policy



In a contraction, the government uses its budget to increase aggregate expenditure to counter the deflationary gap (the difference between Y_{def} and Y_{fe}). A deficit budget involves cutting taxes and / or increasing spending. Expansionary fiscal policy gives households more disposable income. Company taxes could also be reduced to allow firms to retain profit. As a result, the level of economic activity should rise from Y_{def} to Y_{fe} – a return to full employment levels of expenditure, output and income.

Note that the government spending multiplier applies – the final impact of the budget deficit (\$50 billion) is greater than the initial stimulus (\$25 billion), implying the government spending multiplier was 2.

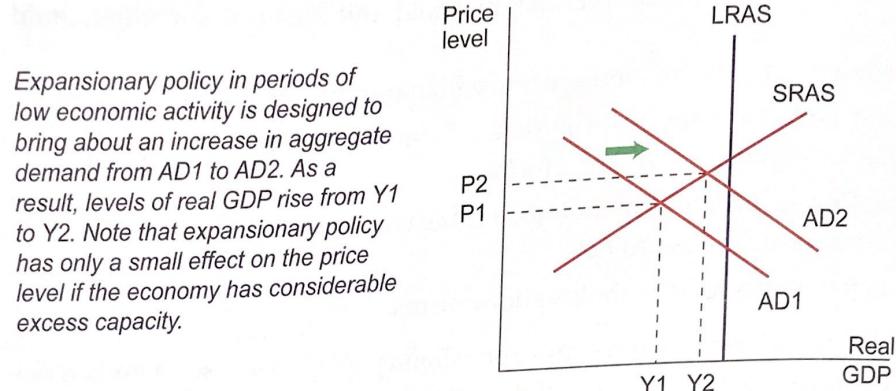


Figure 12.4 Expansionary fiscal policy – AD/AS model

The AD/AS model can also be used to model the operation of expansionary fiscal policy and its effect on the level of output. As shown in figure 12.4, increased government expenditure, and/or lower taxation will have an expansionary effect on aggregate demand, shifting the AD curve from its initial level AD₁, to AD₂. The level of real output (and thus incomes and expenditure) rises from Y₁ to Y₂. Expansionary policy has brought the economy closer to its potential (the level of output shown by the LRAS curve).

Expansionary fiscal policy should have minimal impact on inflation if the economy is in a trough. When economic output is below potential, increased aggregate demand will tend to soak up excess capacity and unemployed resources before putting much upward pressure on the price level.

A contractionary stance

In a period of higher economic growth, it would be appropriate for the government to plan a budget surplus to reduce levels of spending in the economy. Policy options to achieve this contractionary outcome might include:

- increasing personal and company tax rates;
- reducing or postponing spending on major projects; and/or
- increasing excise taxes such as those applied on sales of cars, tobacco and alcohol.

There are many components of government revenue and expenditure, so to ‘reduce spending’ means that a decision has to be made as to what component of expenditure will be reduced. It could be current or capital expenditure, and might be taken from defence, education, health or infrastructure. The actual way in which revenue is increased or expenditure is cut is usually influenced by political, as well as economic judgments. As previously mentioned, it is difficult to make large cuts in government expenditure, because most of the spending in any department (approximately 70 per cent) is spent on wages and salaries. The size and scope of the public sector creates its own inertia which makes budget

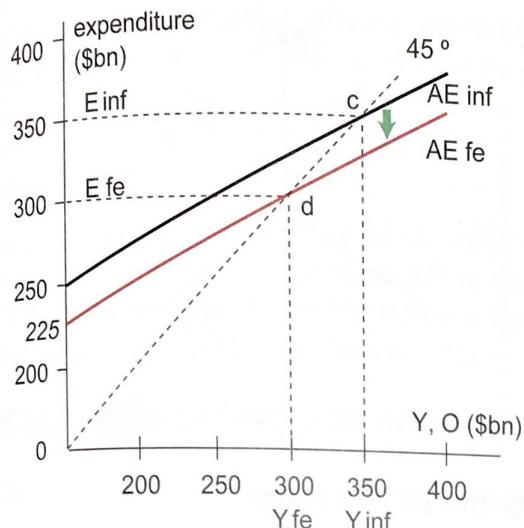


Figure 12.5 Fiscal policy in a boom

cuts hard to design and implement. Reductions tend to be made in small amounts over a period of time – pruning rather than slashing.

A budget surplus will always have a contractionary effect because there is a net withdrawal of funds from the economy. Even when the budget surplus is reduced from one year to the next, it will still have a contractionary effect.

Contractionary fiscal policy can be analysed using the Keynesian and AD/AS models. In figure 12.5, the economy is initially in equilibrium at Y_{inf} – the term ‘inflationary gap’ is used to describe the pressure on prices that occurs when levels of expenditure are close to the level of expenditure at which resources will be fully employed (Y_{fe}).

In a period of strong growth, the government could either increase taxation levels or cut its expenditure, reducing the spending power of households and

Fiscal policy and the multiplier

Will a change in government spending have the same multiplier effect as an equivalent change in taxes? For example, will an increase in government spending of \$10bn have the same effect as a tax cut of \$10bn?

The answer is no! The formula for the spending multiplier is $1/(1-mpc)$ or $1/mps$. But the formula for measuring the effect of a change in taxes is different – it is $mpc/(1-mpc)$ or mpc/mps . What is the reason for the difference? A change in tax must first change household consumption through the mpc, but a change in government spending will directly affect GDP.

The spending multiplier = $1/(1-mpc)$ or $1/mps$. Thus if the mpc = 0.6, the spending multiplier = 2.5. If government spending is increased by \$10 bn, GDP will increase by \$25bn. The tax multiplier = $mpc/(1-mpc)$, or mpc/mps . Thus if the mpc = 0.6, the tax multiplier = 1.5. If tax is cut by \$10bn, GDP will increase by \$15bn.

In a boom, the government uses its budget to reduce the inflationary gap (the difference between Y_{fe} and Y_{inf}). This can be achieved by raising taxes and / or reducing spending. Contractionary fiscal policy reduces households' disposable income, so aggregate consumption should fall. Company taxes could also be raised.

The level of economic activity should fall from Y_{inf} to Y_{fe} – a return towards full employment levels of expenditure, output and income. Note that the multiplier applies – the final reduction in AE (\$50 billion) is greater than the initial reduction in government spending (\$25 billion).

The economy is beyond its potential. Contractionary fiscal policy increases taxation, or decreases government spending (or both) to reduce aggregate demand from AD₁ to AD₂. As a result, levels of real GDP fall from Y₁ to Y₂. This will also reduce the price level (inflation rate).

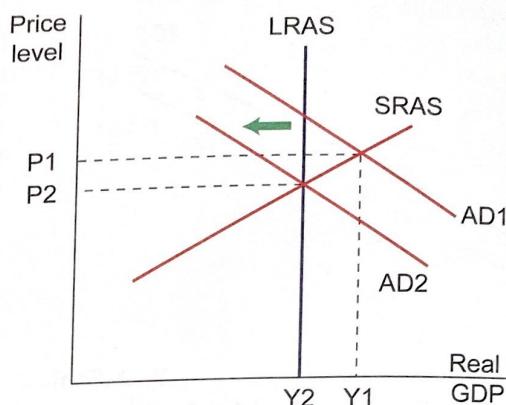


Figure 12.6 Fiscal policy in a boom - AD/AS model

businesses from AE_{inf} to AE_{fe}. The negative multiplier effect applies – reductions in spending or increases in revenue (i.e. a small downward movement in AE) produce a larger decrease in aggregate output and income. Figure 12.6 analyses the effect of contractionary fiscal policy, using the AD/AS model. Assume the initial level of aggregate demand was AD₁. The associated level of output, Y₁, is beyond the economy's full employment potential (indicated by the LRAS curve), placing upward pressure on prices (initially rising at the rate P₁). Reduced government spending and/or increased taxation will have a contractionary effect on aggregate demand, shifting the AD curve to the left (from AD₁ to AD₂). Real output will fall from Y₁ to Y₂, and the rate of change of prices (level of inflation) will fall from P₁ to P₂.

In summary, when macroeconomic activity is below potential, the government plans to boost aggregate spending by increasing expenditure and/or reducing revenue. In boom conditions, the government plans to reduce spending power in the economy by cutting its own expenditure and/or increasing its revenue.

A neutral budget stance

If the government thought economic conditions were close to the natural rate of employment with inflation in the 2–3 per cent range, it might adopt a neutral budget stance. In this case, there would be little difference between planned revenue and spending, and the budget outcome would be in balance.

Budget balance and the budget stance

The budget balance is determined by two factors – discretionary changes made by the government, and automatic changes related to the business cycle. The discretionary changes to government spending and taxation determine the structural balance, while the effect of automatic stabilisers determines the cyclical balance:

$$\text{Budget balance} = \text{structural balance} + \text{cyclical balance}$$

The real stance of fiscal policy is determined by the structural balance, not the overall balance – a structural deficit means that fiscal policy is expansionary, whereas a structural surplus implies that fiscal policy is contractionary. Ideally the structural balance should equal zero when the economy is at potential GDP (full employment).

Understanding whether the fiscal balance is driven by cyclical or structural factors is important in understanding the stance of fiscal policy. It is, however, difficult to separate the budget balance into its exact structural and cyclical parts, although the government does provide a range of estimates.

Strengths of fiscal policy

Several strengths of fiscal policy as a demand management tool can be identified.

Fiscal policy is fairly direct. Revenue and spending measures announced in the Budget can be implemented immediately, if required. For example, the Treasurer might announce an increase in the excise tax on a commodity from the day after the Budget, or a reduction in the marginal rates of taxation after a certain date. Consumers feel the impact of these decisions as soon as they come into law. Fiscal policy can be targeted to impact on specific sectors of the economy, and can also affect aggregate supply by, for example, spending on infrastructure projects.

Keynesian economists believe that a strength of fiscal policy is its positive impact on the economy in recession – the government can open a ‘spending tap’ to increase the level of aggregate demand in the community. In the Great Depression (1930s), government funds were used to build infrastructure and employ workers on government projects, providing an immediate boost to employment, spending power and consumption. In the Global Financial Crisis (GFC), many governments around the world adopted significant fiscal stimulus packages to try to avoid recession. As described later in the chapter, the COVID-19 pandemic again saw governments undertaking massive stimulus measures to keep households and businesses spending, and to save jobs and businesses.

Finally, well-timed fiscal policy measures and automatic stabilisers (refer to figure 12.2) are complementary. In a boom, both discretionary and automatic stabilisers dampen spending and economic activity. In a downturn, discretionary and automatic stabilisers act together to stimulate spending and economic activity.

Weaknesses of fiscal policy

Several weaknesses of fiscal policy can also be identified. As with all economic policy, time lags may have an impact (as discussed in chapter 11). The recognition lag occurs because economic indicators often lag the real trends, so policy may be based on out-of-date data. The decision lag refers to the time that passes whilst appropriate policy is formulated, especially when different views might need to be considered as part of the political process. The impact or effect lag is the time it takes for the policy to have an impact on the level of economic activity.

Fiscal policy is relatively inflexible. In developing the budget, Treasury cannot really make large changes to the patterns of allocation and distribution established in past years. There are social, demographic and political constraints which determine the fabric of the budget – these cannot be ignored just to get the economy into shape. It would be impossible, for example, to reduce spending in a boom by cutting all defence spending, or slashing social security payments. Similarly, it is unlikely that social security benefits could ever be increased by more than a small amount at a time, because funding larger benefits would be hugely expensive and may even encourage people to stop work! Policy makers also have to consider possible costs of compliance due to policy changes – retailers, for example, would not react well to constant changes in excise tax rates on goods they sell.

Political machinations impact on the budgetary process, because governments seek re-election. In the first year of their term, governments tend to apply tough fiscal measures, but in the year preceding an election, budgetary measures may appear easier – perhaps hoping to ‘buy’ votes from the electors. In May 2022, for example, the Treasurer delivered an expansionary Budget prior to an election. In October, the new government announced a Budget that limited expenditure growth in order to bring down the deficit. The data used to compile figures 12.1 and 12.7 refer to the October budget.

An important effect of the budgetary process is its unintended impact on decisions taken in the private sector. The crowding out hypothesis referred to earlier suggests that a budget deficit can actually make it harder for the private sector to participate in recovery because the supply and cost of loanable funds becomes tighter. This could have a negative effect on firms in the private sector because the availability of loanable money falls, and its price (the interest rate) is higher. Hence business borrowing becomes a more risky proposition, and private firms may decide not to go ahead with plans to borrow. At the extreme, crowding out could become a ‘zero-sum game’ – increased government expenditure could be canceled out by reduced private sector activity. In that case, expansionary fiscal policy would have no effect on the economy.

Fiscal policy should be part of the overall policy picture – it should not conflict with the direction taken by monetary policy. The Australian federal government

Learning activity

Critical and creative thinking - the MYEFO

The Mid-Year Economic and Fiscal Outlook (MYEFO) is prepared each year in accordance with the Charter of Budget Honesty Act 1998. The Charter requires that the Government provide a mid-year budget report which provides updated information to allow the assessment of the Government's fiscal performance against its fiscal strategy. The MYEFO is released half way through the financial year. Access the latest MYEFO from the government's Budget web site and read the Economic Outlook section which sets out the government's view of economic conditions facing the country as it prepares its Budget. If you were the Treasurer, what policy stance would you expect your advisers to recommend in the next Budget?

cut taxes for five years in a row between 2003 and 2007, despite a booming economy that saw nine increases in official interest rates over the same period! Fiscal and monetary policy stances seemed at odds, although the government explained that its intention was to return some of the surplus to taxpayers and to focus on long term structural reforms to the economy.

In the sections above, the phrase 'traditional fiscal policy' has been used deliberately. That is, how fiscal policy can be used as a demand management tool? How it can expand or contract the level of aggregate expenditure (aggregate demand) towards that associated with full employment or economic potential?

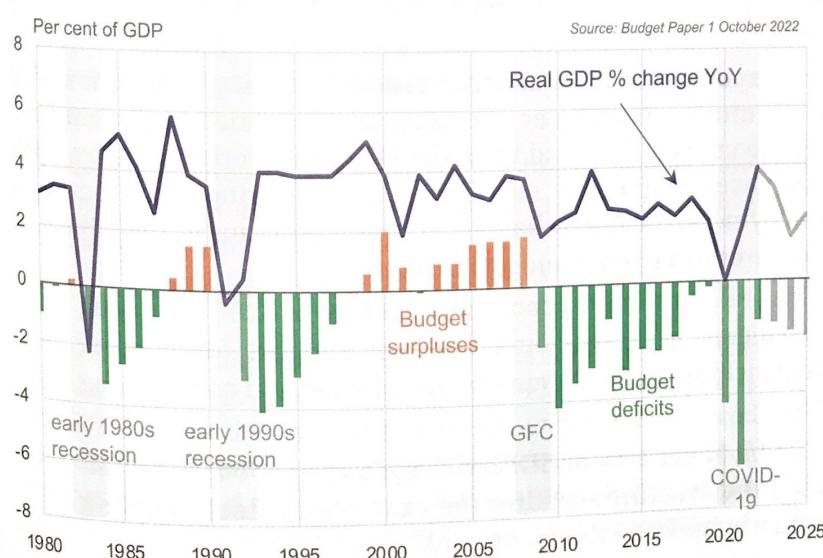
Note that whilst the focus of fiscal policy is often on shifting aggregate demand by changing government spending and taxation, fiscal policy can also affect the aggregate supply curve through

- spending on infrastructure, which adds to the capital stock, and
- the impact of income tax rates on the willingness of people to work (labour supply).

Recent fiscal policy in Australia

As illustrated in figure 12.7, there is a clear relationship between fiscal policy (budget outcomes) and economic performance since 1980. When economic growth slows, as it did in 1983, 1991, 2000, 2008 and 2020, the budget outcome quickly turns from surplus to deficit. Recovery and the economic upswing sees a gradual movement towards budget surplus, which extends through the expansion. This surplus/deficit pattern reflects both the action of automatic stabilisers and discretionary adjustments to government revenue and spending.

Figure 12.7 Budget outcomes since 1980



The line graph shows the rate of economic growth (% p.a.).

The columns show the planned budget outcome as a proportion of GDP. Orange columns indicate years in which the Budget was in surplus; green columns indicate deficits.

The 2023-25 figures are estimates from the October 2022 Budget.

As illustrated, Budget deficits decline as the economy recovers. Does this imply that the government had adopted a contractionary stance? The answer is no – the gradual reduction in the deficits was due to the operation of automatic stabilisers. The budget balance improved because the cyclical deficit was moving towards surplus, as tax revenue grew and claims on welfare fell. The structural balance was still in deficit, however because of discretionary policy announcements. In the post GFC period, for example, structural measures included reducing the tax burden for small businesses; funding transport infrastructure; amendments to education and health funding; changing income tax brackets (2017 Budget) and commitments to reduce company tax. These are classic examples of discretionary policy aimed at stimulating aggregate demand in order to increase economic activity and the rate of growth.

Over the period 1980-2023, there were 28 years of budget deficit (the green columns) and 13 years of surplus (orange columns). This section briefly reviews the government's fiscal stance (discretionary policy) in three of those years: 2008-2009 (during the Global Financial Crisis (GFC); 2014-15, and 2020-21.

2008-2009: The GFC and the need for stimulus

Australia was in excellent 'financial health' in the mid 2000s: debt-free, growing strongly, and running surplus budgets. Except for a brief lull in 2000, the world economy was also growing strongly. The expectation of rising asset prices (especially housing) encouraged excessive borrowing. In the US, housing loans are often packaged (securitised) and sold on to investors. Over time, however, some of those packages included riskier loans provided to less qualified buyers. As house prices peaked, a crisis emerged. Banks that had financed higher risk borrowers faced losses as the value of the property fell below the loan balance, triggering withdrawal of those investment funds. There was considerable panic as everyone was trying to reduce their exposure to housing mortgages at the same time. This caused credit to dry up as institutions sought to avoid risk, and business confidence plunged.

Many businesses responded to the financial crisis by slashing production and running down inventories. Consumer spending and confidence plummeted. By October 2008, the crisis had spread from the US to the world economy, with virtually every advanced economy in recession in 2009. Fearing slowing growth and rising unemployment, the Australian government announced the following discretionary measures in a special budget in October:

- an initial \$10.4 billion stimulus package (1 per cent of GDP) consisting of cash payments to low-income families; support for housing construction including a first home owners scheme; and new training places; and
- a second \$42 bn (4 per cent of GDP) package targeting consumption support and infrastructure spending (for example a schools building program and a home insulation program).

The Reserve Bank of Australia (RBA) also adopted an expansionary monetary policy stance, reducing the cash rate from 7.25 percent to 3 per cent over just nine months between August, 2008 and April, 2009.

Australia avoided recession, although growth was just 1.8 percent in 2008–09 and unemployment nearly 6 per cent (there were fears that it would rise above 10 per cent). Assisted by a favourable terms of trade and strong demand for minerals, Australia survived the crisis in better shape than many western countries.

Post GFC – a ‘soft’ economy

The economy did not, however, bounce back to its pre-GFC strength. Growth over the next decade averaged 2.5 per cent per annum, with 2011–2012 being the best at 3.9 per cent. The average rate of economic growth for ‘high income’ countries over the period 2010–2019 was just 2 percent (World Bank, 2020).

The stimulus measures undertaken in the GFC meant net government debt rose above 10 per cent of GDP, and there was great concern in Australia about how to raise revenue and/or cut expenditure to ‘get back into surplus’. In May 2014, the government announced they were undertaking ‘budget repair’ by introducing tax increases and expenditure cuts, including:

- \$80 billion cuts to education and health spending;
- review of eligibility for people under 35 receiving a disability pension;
- an extra fee for visits to a doctor;
- reduced unemployment entitlements for people under 25; and
- a ‘temporary budget repair’ increase in tax rates for high income earners.

This ‘austerity’ budget proved very unpopular, and many of the measures were abandoned by early 2015 as they proved to be electorally damaging. Economic growth and wage increases were insufficient to improve household budgets. It was apparent that using the budget to arrange a premature ‘exit’ from the deficit position was, in fact, just prolonging the soft economy, so budget repair was postponed!

The political mantra of ‘returning to surplus’ continued, however, and eventually the government forecast a small budget surplus for fiscal year 2020–2021. That forecast would prove to be short-lived.

2020 – the COVID-19 pandemic

As discussed in chapter 8, the coronavirus pandemic saw the Australian economy enter recession for the first time since 1991. The rapid spread and uncertain health impact of the coronavirus meant governments faced a trade off between the health costs and the economic impacts of the disease. Most countries chose to limit the spread of the disease and its impact on health services by closing or restricting activities where people were in close contact with others.

Box 12.1 COVID-19 stimulus measures (February – August, 2020)
Support for businesses

- From March 2020, a \$1,500 per fortnight payment known as JobKeeper was paid to all employees of eligible businesses, including full time, part-time and casuals (if employed for more than a year) and including employees who may have been stood down or retrenched because businesses were unable to open. Over 4 million workers received JobKeeper support by July;
- small businesses could claim a 100% depreciation allowance for investment in equipment (actually in place since 2011, but extended several times);
- cash payments to business based on wage and salary tax withheld and notified in business activity statements (BAS) payments); and
- wage subsidies for apprentices.

Support for households

- two \$750 payments to pensioners and other welfare recipients;
- early access to superannuation (by application);
- a temporary \$550 coronavirus supplement to JobSeeker recipients;
- a child care relief package; and
- a \$25,000 grant to home owners for new building or substantial renovations (HomeBuilder).

The cost of these measures to the end of August 2020 exceeded \$250Bn. In addition, states funded \$13Bn in measures such as payroll tax relief and support for sectors such as tourism.

Source: MYEFO, media releases.

This led to reduced trading hours, especially in the service and entertainment sectors. In early 2020, the government introduced a significant 'stimulus package' to limit the impact of the virus on businesses and employment. Some of the key

measures are shown in box 12.1. The forecast budget deficit for 2020-2021 was nearly \$200 billion – 10 per cent of GDP!

Fiscal policy outlook 2023 - 2025

Budgets tend to go into deficit during economic downturns, and usually return to balance or surplus over a period of 5-6 years. As at late 2022, however, the Budget has been in deficit for 14 years, and is forecast to remain that way for another decade. The deficits have added, year-on-year, to result in significant (by Australian standards) government debt. Net debt as a proportion of GDP stood at 22.5% of GDP in June 2022. Many other countries are, for various reasons, in a 'worse' position.

A number of events have impacted on the nation's ability to 'balance its budget' in recent years. With the onset of the pandemic, the government implemented stimulus measures larger than those applied in the GFC in 2008. The Russian invasion of Ukraine in February 2022 brought further disruption and tension around energy and food supply worldwide, quite apart from the considerable human cost of war. Finally, Australia has seen a series of severe flood events in the eastern states.

Australia - Government net debt as a % of GDP	
Year	(% to GDP)
2006	0
2007	-2.2
2008	-3.4
2009	-0.9
2010	3.7
2011	6.4
2012	10.2
2013	10.4
2014	13.1
2015	15.1
2016	18.3
2017	18.3
2018	18.6
2019	19.2
2020	24.8
2021	28.6
2022	22.5
2023 (f)	23.0
2024 (f)	25.8
2025 (f)	27.4
2026 (f)	28.5

*Source: : Budget 2022-23
Budget Paper No 1: Table 10.4.*

Each of these events has fed inflationary pressures. The October Budget forecast that inflation in Australia would peak at 7.7 per cent in late 2022. In the main, rising prices are the result of the 'supply-side' problems mentioned above. The policy responses, however, appear to have focussed on the demand side. Admittedly, policy makers have faced a dilemma. On the one hand, public debt is a threat to the economy because it must be repaid (with interest) in the future. Interest payments on debt are forecast to cost as much as the NDIS by 2026-2027! This suggests that 'budget repair' (reducing deficits by increasing revenue and cutting spending) should be a priority.

On the other hand, real wages have not increased. Household budgets have been stretched by rising electricity, gas and food costs. Workers living in outer suburban areas have seen their transport bills rise. Rents and mortgages have risen – with interest rates rising about two percent over the course of 2022, monthly repayments on a 25-year \$500,000 loan have gone up by \$650.

The 'orthodox' view of fiscal policy is that governments and the public they serve have to 'live within their means'. In other words, governments should only spend as much as they have been able to raise from taxation revenue, or the sale of government bonds (\$892bn of which were on issue at October, 2022). Contrary to the traditional view is the modern monetary theory (MMT) view that deficits are government sector 'red ink' that supports private sector 'black ink'. Used properly, deficits produce both growth in the future, and the capacity to absorb themselves (pay off debt). Properly applied, government deficits and debt can help achieve objectives currently on Australia's agenda, such as a fully-funded National Disability Insurance Scheme (NDIS); renewal of aging infrastructure; quality aged care; renewable energy; decarbonising the economy and diversifying Australia's economic base. A timely reminder of the difficulty the government faces in dealing with the economic problem!

Worksheet

1. What are the three budget outcomes? Are the outcomes the same as policy 'stances'?
2. How are government bonds used to finance a deficit?
3. In what ways could a government use funds from a budget surplus?
4. Explain how government revenue and expenditure automatically change when the economy is in a boom?
5. Suggest three specific measures the government could use to 'increase government expenditure' or 'decrease revenue' to boost spending in a sluggish economy.
6. Explain the meaning of the term 'cyclically balanced budget'.
7. Using either Keynesian (aggregate expenditure) or aggregate demand / aggregate supply models, illustrate the intended effect of the measures taken in 2014–15 Budget on the level of economic activity.

Government net debt as a % of GDP		
Country	2018	2022
Japan	156	237
Italy	118	150
US	78	107
France	87	98
Canada	28	89
UK	78	81
Germany	41	60
Netherlands	43	48
Switzerland	20	41
Sweden	5	35
Australia	19	23

Source: *Trading Economics, 2022*

8. Using the alternative type of model to the one you used in question 7, explain the intended effect of the 2020–21 Budget on the level of economic activity.
9. Distinguish between the structural and cyclical components of the budget.
10. The extent to which crowding out actually occurs has been the subject of much debate among economists for many years (and in any case it probably varies from time to time). What factors might determine the extent of any ‘crowding out’?
11. Draw up a table which summarises the strengths and weaknesses of fiscal policy.
12. Refer to figure 12.7. To what extent do budget outcomes over the period of the graph reflect business cycles in the Australian economy?
13. The 2020–21 Budget predicted medium term budgets deficits and rising debt. How might the debt be repaid?

Fiscal policy case study: 1991–92 Budget

The data in the table below shows a selection of Australian economic indicators for the period 1984-85 to 1992-93. Note all data refers to ‘percentage change on previous year’.

Economic indicators: 1984-85 to 1992-93					
Year	a	b	c	d	e
1984-85	2.1	12.2	4.3	6.5	3.0
1985-86	3.4	4.5	8.4	2.0	4.3
1986-87	-0.3	-1.0	9.3	0.1	2.8
1987-88	2.8	14.5	7.3	8.8	3.0
1988-89	2.3	13.1	7.3	5.4	3.9
1989-90	2.8	-3.0	8.0	1.4	3.8
1990-91	-0.9	-11.5	5.3	-0.3	-0.6
1991-92	2.5	-6.3	1.9	-0.7	-1.9
1992-93	0.3	9.2	1.0	1.9	0.1

Key to columns:

- [a] = Retail trade (% change on previous year)
- [b] = Private gross fixed capital formation (% change on previous year)
- [c] = CPI (annual percentage change)
- [d] = Industrial production volume (% change on previous year).
- [e] = Employment (% change on previous year)

1. Graph each column a to e, using a line graph and a single set of axes.
2. Refer to columns a and b. Which of these indicators is more volatile (features greater fluctuation)? Suggest reasons for the volatility.
3. Is there any evidence in the table that employment is a lagging indicator?
4. The 1991-92 recession was described by the then Prime Minister, Paul Keating, as “the recession we had to have”. Find evidence from the data that there was an inflationary gap/boom in the late 1980s.
5. Had you been the Treasurer in 1990-91, what budgetary stance would you have taken? Provide some examples of changes you could have made in the Budget which would have delivered your result. Model your budget stance using either a Keynesian or AD/AS framework.
6. The 1990-91 Budget forecast a small surplus. Over the course of the year, actual outlays rose by 6.8%, and revenue fell by 4.7% compared to the previous year. Use the data provided to suggest reasons for the difference between the forecast and actual figures.
7. The Treasurer at the time was John Dawkins (ALP). Dawkins announced a \$13.4 billion Budget deficit in 1992-93 - equivalent to 3.3 per cent of GDP (compared to the 1983-83

- Budget deficit of 4.1 per cent of GDP (1983-84 being the previous recession). Why is it important to look at the size of the budget result as a percentage of GDP?
8. Using the data, describe one 'beneficial result' that the recession of 1991-92 brought for the Australian economy.
 9. The budget balance as a proportion of GDP was 0.4% in 1989-90; 1.8% in 1990-91; -2.4% in 1991-92 and -3.3% in 1992-93. To what extent does this indicate a structural deficit? (Hint: distinguish between the terms 'cyclical deficit' and 'structural deficit').

Budget 2022-23

The text below is an edited excerpt from Statement 1 of Budget Paper 1, 2022-23 (October).

Economic and Fiscal Outlook

The global economic environment has sharply deteriorated. Exacerbated by a global energy price shock, inflation has risen rapidly across advanced economies and, in many countries, is at levels not seen in decades. Central banks have lifted interest rates quickly in response, constituting the fastest synchronised monetary policy tightening in the inflation targeting era. The combination of these factors is expected to slow global economic growth in 2023 to 2.75 per cent. The risk of recession across major advanced economies has risen and China's growth outlook has weakened.

While Australia has withstood the pandemic well, it is not immune to the intensifying global challenges and risks. Domestic disruptions including the recent floods will test our resilience further. While the economy is forecast to grow by 3.25 per cent in 2022-23, the weaker global outlook, high inflation, cost-of-living pressures, and higher interest rates are expected to see growth slow to 1.5 per cent in 2023-24. Annual inflation is expected to peak at 7.75 per cent in late 2022, before moderating gradually to 3.5 per cent by June 2024 and returning to the Reserve Bank's inflation target by 2024-25.

In line with the weaker outlook for growth, the current tightness in the labour market is forecast to gradually ease over the coming years. While labour demand is expected to soften alongside slower growth in 2023-24, employment growth is forecast to remain positive. The unemployment rate is forecast to rise to 4.5 per cent by the June quarter of 2024 but remain below pre-pandemic levels. Workforce participation is expected to ease from recent record highs but remain structurally higher than projected, expanding the supply capacity of the economy.

While some household groups have built up savings buffers over recent years, others are expected to come under greater pressure. Many indebted households will be more significantly impacted by higher interest rates. Low-income households are also expected to be more heavily affected as essentials such as housing costs and energy make up a larger share of their household expenses, and these are expected to rise. The Government's targeted cost-of-living relief, indexation of government allowances and pensions and the larger than usual minimum wage increase provided by the Fair Work Commission will help to provide relief for many households.

1. From figures 10.2, 11.1, 12.7 and 13.8 of this book, determine the rate of economic growth, unemployment rate, inflation rate, and cash rate at June 2022. Alternatively, use ABS and RBA web sites.
2. List the factors in the economic environment that have 'deteriorated'. Choose one of them and explain how this would be expected to effect government revenue or expenses.
3. The first paragraph mentions the term 'budget repair'. Given the information in later paragraphs, suggest what the 'repair' involves.
4. Draw an AD/AS model that shows how the series of deficit budgets over the period 2020-2023 would be expected to impact on real GDP, employment and income.
5. What factors were driving the cost of living upwards? What budgetary (fiscal) measures could the government use help low-income households overcome cost of living increases emerging during the recovery from the pandemic.

6. Fiscal Policy Case Study - current year

Major newspapers such as *The Australian Financial Review* and *The Australian* publish Budget supplements in the days after the Budget is handed down in Federal Parliament. Obtain a copy to help answer the following questions. Also access the government's Budget web site.

1. Write the latest revenue and expenditure totals alongside figure 12.1, and use the data to construct a new column/s for the current year/s on figure 12.7. Is the budget in deficit or surplus? Is the Budget contractionary, neutral or expansionary, in your opinion?
2. At Budget time, what are the current rates of growth, inflation and unemployment? Has the Australian economy expanded or contracted in the period since the last Budget. Provide two pieces of evidence.
3. Give three examples of discretionary measures announced by the Treasurer to affect the current level of aggregate demand (i.e. short term demand management measures).
4. Give three examples of discretionary measures announced by the Treasurer which support longer term, 'supply side' initiatives (perhaps related to the workforce, productivity, environment or climate change).
5. There may be an article in the supplement about budget 'winners and losers'. Provide two examples of households, businesses or sectors classified under either title.
6. From reading about the Budget, describe the economic challenges faced by the current government.

Multiple choice questions

Choose the best alternative in the following questions.

1. In an economy where the level of aggregate expenditure was falling, the following automatic stabiliser would come into operation.
 - a. Taxation revenue would rise, cutting household spending.
 - b. Welfare payments would rise, increasing household spending.
 - c. Taxation revenue would fall, causing reduced government spending.
 - d. Discretionary government spending would be expected to rise.
2. Budget outcomes are affected by cyclical and structural factors. Cyclical factors refer to:
 - a. the impact of the business cycle on government revenue and expenditure.
 - b. deliberate policy decisions which allocate funds to areas of government responsibility.
 - c. the need to redistribute income from rich to poor in periods of unemployment.
 - d. changes in the demand for labour in the economy.
3. Balanced budgets:
 - a. are effective stabilising tools at all phases of the business cycle.
 - b. have a stabilising effect on economic activity because expenditure is always governed by revenue received.
 - c. may have a destabilising effect on the economy because they have no impact on aggregate expenditure.
 - d. may have a destabilising effect on the economy if they make booms higher and troughs deeper.
4. If the actual budget surplus is greater than the forecast budget surplus, this would suggest that:
 - a. the government has made policy changes to reduce spending since the budget.
 - b. the actual level of economic activity is lower than that forecast at budget time.
 - c. tax receipts have fallen during the year.
 - d. the actual level of economic activity is higher than that forecast at budget time.

5. Which combination of factors best explains why the actual budget surplus may be larger than the planned surplus?
 - i An unexpected increase in the terms of trade.
 - ii An unexpected decrease in unemployment.
 - iii An unexpected increase in tax avoidance.
 - iv An unexpected natural disaster.
 - a. i and ii.
 - b. i and iii.
 - c. ii and iii.
 - d. ii and iv.
6. If a government budgets for a surplus and there is an unexpected increase in the level of economic activity, which of the following is likely to occur?
 - a. There will be an increase in tax revenues and a decrease in the budget surplus.
 - b. There will be a decrease in tax revenues and an increase in the budget surplus.
 - c. There will be an increase in tax revenues and an increase in the budget surplus.
 - d. There will be a decrease in tax revenues and a decrease in the budget surplus.
7. A contractionary Budget is:
 - a. one in which revenue exceeds expenditure.
 - b. expected to reduce the level of aggregate expenditure in the private sector, as well as moving the government budget more towards surplus.
 - c. one in which the net surplus is smaller than that recorded for the previous year.
 - d. one in which more revenue is raised from taxation measures.
8. Which of the following is the best example of discretionary fiscal policy?
 - a. An increase in personal tax revenue due to wage growth.
 - b. An increase in Jobsearch payments due to higher unemployment levels.
 - c. An increase in spending on infrastructure during an economic contraction.
 - d. A fall in company tax receipts in a recession.
9. The forecast Budget deficit in Year 1 was \$10 million. Over the course of the year, economic activity improved. Actual revenue increased by \$10 million, and actual expenditure fell by \$2 million. The Budget for Year 2 forecasts a surplus of \$5 million. On this information, the Year 2 Budget is:
 - a. in deficit.
 - b. expansionary.
 - c. contractionary.
 - d. balanced.
10. 'Crowding out' may occur when:
 - a. the government borrows from overseas sources to finance its budget deficit, thus causing depreciation of the exchange rate.
 - b. the budget is in surplus, so the government is out of the market for private sector funds.
 - c. interest rates fall in line with a government deficit.
 - d. the government borrows to finance its budget deficit, thus increasing the competition for loanable funds throughout the economy .

Data interpretation

The table below shows economic indicators for a hypothetical economy.

Year	CPI	Unemployment rate	Interest rates (cash rate % p.a.)	Index of manufacturing activity
1	105.0	7.6	5.50	108
2	108.3	7.4	6.25	112
3	112.5	7.0	6.75	115
4	117.2	6.2	7.50	125

- Calculate the inflation rate, and the percentage change in manufacturing activity between Years 3 and 4. [2 marks]
- Use the information in the table to draw conclusions about the state of the economy over the four year period. [4 marks].
- Describe the fiscal policy measures that would be appropriate for Year 4. Explain how you expect they will impact on the level of economic activity? [4 marks].

Extended responses

Each of the following questions should be answered in 2-3 pages of writing. Include diagrams and examples where appropriate. Pay attention to the allocation of marks when writing your answer. Some questions refer to concepts developed in other chapters.

- a. Distinguish between automatic and discretionary stabilisers. [8 marks]
 - Explain, using examples, how automatic stabilisers operate in an economic expansion. [12 marks]
- a. Identify reasons why the actual budget outcome at the end of the year could show a greater surplus than had been forecast. [10 marks]
 - Explain how a Budget deficit can increase the level of economic activity in a recession? Is it certain that the deficit will boost economic activity? [10 marks]
- In an economic boom, the government would traditionally announce contractionary policy measures such as increased taxation and reduced government expenditure. Describe these measures and explain their effect on aggregate levels of consumption and investment. [20 marks]
- Discuss the merits and weaknesses of the traditional fiscal policy measures which would be applied in the contraction phase of the business cycle. [20 marks]