

# FISCAL POLICY



## Multiple choice

- |      |       |       |       |
|------|-------|-------|-------|
| 1. C | 6. A  | 11. A | 16. D |
| 2. C | 7. B  | 12. A | 17. C |
| 3. B | 8. A  | 13. C | 18. A |
| 4. D | 9. D  | 14. B | 19. C |
| 5. D | 10. B | 15. D | 20. D |

## Short answer questions

### Question 1

- (a) Automatic stabilisers are the non-discretionary components of fiscal policy that seek to curb the level of economic growth in a boom period, and stabilise economic growth during recessions. The two main automatic stabilisers are progressive income tax and welfare payments. In a recession, there will be less revenue from income tax and more expenditure in the form of welfare payments, increasing the Budget deficit and helping to stimulate growth by affecting aggregate demand. In a boom on the other hand, growth would be curbed by increased tax receipts from progressive income tax.
- (b) The Budget can influence income distribution in two ways - through taxation or government spending. Changes to the taxes impact on income distribution by either making the overall tax system more progressive or making it more regressive. For example, the introduction of the GST made overall tax arrangements more regressive and resulted in lower income earners paying a relatively higher proportion of their income in tax – worsening income equality. Budget expenditure programs such as labour market programs for the unemployed and welfare payments are aimed directly at improving the distribution of income by benefiting those on lower incomes. Indirectly, government fiscal initiatives to influence the level of economic growth will have an impact on income distribution, with economic growth often leading to a widening of the income gap.
- (c) Fiscal policy has played somewhat of a mixed role in demand management in recent years. The late 1990s were characterised by a string of contractionary Budgets which aimed to restore fiscal consolidations and improve national savings. Fiscal policy was thus not aimed at demand management and the stabilisation of economic growth. However, following slow domestic growth, fiscal policy returned to the forefront of economic policy in 2000 and demand management in an attempt to counteract the

negative effects of the GST on growth, with the fiscal balance hurtling down to a \$5.0bn surplus from \$13.5bn. Again in 2001 fiscal policy aimed at expanding the level of domestic growth in the face of a weak global economy by introducing a range of new spending measures that blew the Budget into deficit of \$3.8bn. Despite removing itself from demand management in 2001-02 with a neutral Budget, the 2003-04 Budget was mildly expansionary in the face of continuing weak global factors. The fiscal balance fell of \$1.5bn to \$0.7bn as recent tax windfalls for the Government were returned to tax payers.

## Question 2

- (a) There are two main measures of the Budget outcome, which are the results of different methods of accounting: the underlying cash outcome and the fiscal balance. The underlying cash outcome is the difference between the Budget's outlays and its revenues, but excludes any one-off items such as asset sales. Additionally, it is important to note that this figure only measures cash items, not items which will occur in future years. The fiscal outcome similarly calculates the difference between Budget expenditure and revenues and excludes asset sales, however it is calculated using the accrual accounting method, which includes future payments that have not taken place. This measure is regarded as the most accurate long-term indicator of fiscal policy. The headline budget outcome is a third, but not particularly useful measure as it analyses the Budget's cash outcome but includes the one-off transactions which are otherwise excluded from the other measures.
- (b) The main form of deficit financing is borrowing from the domestic private sector. This involves selling treasury bonds under a tender system, where the government sets the value of the bonds to be sold and purchasers tender to buy a certain quantity at a particular rate of interest. Another financing method is to borrow from overseas, which has the disadvantage of increasing foreign debt, but has the advantage of having no negative impact on the pool of domestic savings (ie it avoids the 'crowding out effect'). The third, and least likely method of financing is borrowing from the RBA, or monetary financing. This amounts to the government printing money in order to finance its expenditures. In effect this would increase the money supply and add to inflation.
- (c) Fiscal policy, since the election of the Howard Government, has focused very heavily on improving Australia's low level of domestic savings. Australia's low level of domestic savings is the major cause of our external imbalance, due to the national reliance on overseas borrowing. Fiscal consolidation, or returning the Budget to surplus, as occurred in the late 1990s, increases the level of national savings. This allows the Government to gradually eliminate public sector debt and also increases the longer term size of domestic savings. By increasing national savings, the Government hopes to avoid forcing private sector investment overseas – which increases foreign debt but more importantly increases the net income deficit and widens the current account deficit, destabilising the economy. Budgetary items such as changes to superannuation schemes can also attempt to increase private savings and reducing the level of private overseas borrowing, although this has recent history has shown this to be fairly ineffectual

**Question 3**

- (a) **Cyclical unemployment has increased in year two. This type of unemployment occurs due to a downturn in economic activity, which is illustrated in the table (falling from 3.0% to 0.8%) and confirmed through the decrease in the inflation rate – a direct result of low growth levels.**
- (b) **There may have been an increase the participation rate. Often following an upturn, the hidden unemployment will again actively seek work which will increase the reported level unemployment, offsetting the employment growth associated with the upturn in economic activity.**
- (c) i) **Achieving a simultaneous reduction in unemployment and inflation is a major historical conflict for the government in the short to medium term. Increases in aggregate demand not only fuel job growth but also put an upward pressure on prices. Lower levels of aggregate demand relieve price pressures, yet tend to contribute to cyclical unemployment. This outcome forces the government to implement macroeconomic policies with caution, as to maintain a balance between these two objectives.**
- ii) **The government also faces the traditional economic conflict between growth and inflation. Higher levels of aggregate demand and thus growth create jobs and raise the level of incomes in the economy. Unfortunately, this can lead to increased demand for goods and cause demand-pull inflation.**
- (d) **Fiscal policy can often be an effective tool for providing short term stimulus to an economy. In the economy above, growth took a serious downturn in Year 2 falling from 3% to 0.8%. To combat this, discretionary changes could be made to the Budget in an attempt to stimulate economic activity. This could increase additional spending measures or tax cuts which would stimulate aggregate demand. Additionally, non-discretionary Budget measures such as welfare payments will help to stabilise the extent of the drop in economic activity. Unemployment will be influenced indirectly by the measures to increase growth mentioned above. Increased economic activity will lead to increased investment and demand for labour, reducing the level of unemployment. Unemployment could also be targeted with specific measures announced in the Budget such as employment programs like apprenticeship funding.**