Assessment 4 - Economic Policies and Management
Vivian– Model Farms High School

FISCAL POLICY

1. Definition

Fiscal policy is a macroeconomic policy, refers to the use of the government's annual budget to affect the level of economic activity and the achievement of objectives such as internal and external balance and economic growth. Government manipulation of the level and composition of taxation and government spending has an impact on:

- Aggregate demand and level of economic activity
- The pattern of resource allocation
- Distribution of income

A **government budget** is the annual statement from the government of its income (mostly taxes) and expenditure (e.g. welfare payments, education), borrowings, plans for the next financial year.

2. Budget Outcome

The budget outcome gives an indication of the overall impact of fiscal policy on the state of economy.

There are 3 possible budget outcomes

I. *Fiscal* surplus [G < T]: A positive balance that occurs when government revenue exceeds government expenditure. This is will have a **contractionary effect** in the economy, as the contraction in government spending will lead to a multiplied decrease in consumption and investment, damping demand.

II. *Fiscal deficit* [G > T]: A negative balance that occurs when government expenditure exceeds government revenue. This is will have an **expansionary effect** in the economy as the expansion in government spending will lead to a multiplied increase in consumption and investment and stimulates aggregate demand.

III. *Fiscal balance* [G = T] *a* Zero *balance* when government expenditure equals to government revenue. This **neutral** fiscal policy should have no effect on the overall level of economic activity.

The three main reassure of the budget outcome are:

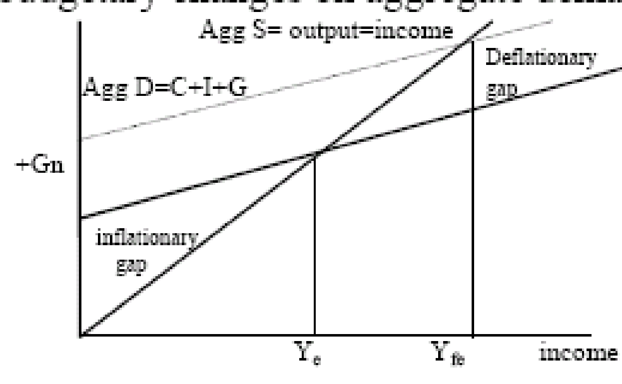
- **Headline cash balance** shows total cash outlays less total cash receipts and shows by how much government debt will be increased or decreased
- **Underlying cash outcome:** calculated as total revenue less total outlays plus net advances. This figure only measures cash item, not items which will occur in future year s It is the best indicator of the short term impact of fiscal policy on the economy.
- **Fiscal Outcome:** calculated the same way but uses a different accounting method which includes future payments that have not taken place. It is the best indicator of the long term fiscal strategy because it counts expenditure or liability from the day the transaction occurs

Both the last 2 methods' figures remove the effect of ONE OFF transaction that can distort the budget outcome.

3. Solving the Deflationary Gap using SIMPLE multiplier

Increase in government expenditure will increase aggregate demand and the equilibrium level of income, output and employment. The increase of government spending will be bigger effect (in money) due to the multiplier effect.

Effects of budgetary changes on aggregate demand



On the graph, the equilibrium level of income is at 12000, but the economy requires a level of income of 16000 to ensure full employment of resource (Ye) this shortage of demand is call the DEFLATIONARY GAP.

To fix this gap, the government could supplement private sector spend with a budget deficit. From the multiplier, we can work out such an increase in spend is requiring by the government:

$k = 1/(1\text{-}MPC)$
$= 1/0.25$
$= 4$

$\Delta Y = k \times \Delta G$

we need Y rise by 4000 (i.e. $\Delta Y = 4000$)

$4000 = 4 \times \Delta G$

$\Delta G = 1000$

Therefore, increasing aggregate demand by 1000 (G) will result in equilibrium for national y and output of 16000.

Similarly, if aggregate demand is above equilibrium level, there will be an inflationary gap. Therefore, government can run a surplus budget. In this situation a reduction in government spending (G) will have a larger initial impact in reducing aggregate demand than the same increase in taxation. A reduction in government spending will also have a larger multiplier effect than equal reduction taxation.

4. Changes in Budget Outcome

Every year, the budget outcome change reflects the changing economic condition and changes in fiscal policy.

*N*on-discretionary *(*or cyclical component*)* is changes in fiscal policy caused by changes in the level of economic activities. In recession periods, budget deficit will increase where during strong economic growth Budget deficit will contract or the budget will shit into surplus.

*D*iscretionary *(*or structural component*)* is changes in fiscal policies that are deliberate changes such as reduced spending or changing taxation rate. *D*iscretionary changes influence the structural component of the Budget outcome.

5. Automatic Stabilisers

Automatic stabilizers are those changes in the level of government revenue and expenditure that occur as a result of economic activity.

The two main automatic stabilisers are:

Unemployment benefit: when economy moves into recession, the level of economic activity falls, causing rise in unemployment, leads to greater government expenditure on unemployment benefit. Thus a decline in the level of economic activity automatically leads to an increase in government expenditure.

The Progressive Income Tax system (PAYG/PAYE) means that persons on higher incomes pay proportionately more tax than those on lower income. During economic boom, income are rising and it move worker into higher income brackets, also unemployed person start paying tax, both situation will increase government revenue.

6. Effect of Budgetary Changes

Impact on Resource Use

Fiscal policy may directly affect resource use through government spending into that particular sector or it can indirectly affect resource use through tax and spending changes. For example: imposing a tax on polluter to encourage economic activities that dose not damage the environment.

Impact on Income Distribution

Income distribution is affected by the budget through changes on taxation and welfare system. Government commitment to progressive taxation means marginal and average rate of tax rise as income rise, allowing government to use this money for social welfare or other social expenditure, leading to a redistribution of income from high to low income earners.

Budgetary change involving government spending can also influence income distribution. The social security system impacts on the distribution of income through the targeting of transfer payment because low income earners tend to be more reliant on government service.

Impact on Economic Activities

Changes in the stance on fiscal policy impact on the level of economic activity through changes in the budget outcome. The stance on fiscal policy is best measured by changes in the structural component of the budget outcome.

Expansionary fiscal policy leading to a budget deficit or reduced surplus will tend to increase the level of economic activity by increasing aggregate demand, and a contractionary stance leading to smaller deficit or larger surplus will reduce economic activity. (also see pg 2 budget outcome)

Impact on savings and CAD

A relationship exists between the size of the Budget and the size of the CAD and foreign debt. Public sector debt requires a use of national savings. If we have fiscal deficit, we add to public sector debt. The use of the pool of savings is being regarded as negative savings, or dissavings. If the pool is not big enough to provide enough money for both the public sector and the private sector, it is the private sector that misses out. They are "crowed out" of the pool by the public sector, alternatively the inflow of fund must come from overseas which lead to increases in the size of for foreign debt.

7. Methods of financing budget deficits

There are three options available for financing the shortfall to meet spending commitments:

I. It can borrow funds from the private sector by selling new Commonwealth government securities in domestic financial markets. This is known as bond financing and the government pays back the money in the future with interest. Deficit financing is undertaken by the federal government selling treasury bonds through a tender system. This means it determines the total values of bonds to be sold according to the size of the budget deficit, and tenderers put in bids to buy binds at a rate. The lowest tenders are accepted first until the bonds are sold and deficit is fully financed.

Adv:
No change in the money supply and money borrowed is again injected through government spending
No increase in net foreign debt

Disadv:
May cause rise in interest rates and crowding out of private investment, as government securities will only be successful if the interest rate offered is competitive with prevailing market rates. Higher interest rates raise the cost of borrowing for business. Therefore deficit financing may lead to extra government expenditure at the expense of private spending.

Higher interest rates may increase capital inflow, raising the exchange rate and reducing Australia's international competitiveness. This may lead to a rise in imports and crowding out.

Deficit financing leads to accumulation of national debt and sets up future obligations in interest.

II. It can borrow from the RBA by instructing them to simply print more money to cover the shortfall. This is known as monetary financing. The government sells securities to the RBA who are obliged to buy and credits the governments account with cash for the deficit.

Adv:
No change in interest rates or accumulation of public debt

Disadv:
Danger of increased inflation
May cause reduction in business and consumer confidence in govt. economic management

Not used as govt. can enter financial markets directly now and sell securities. The 'tap and tender' system means the budget outcome no longer impacts on the conduct of monetary policy

III. It can borrow funds from overseas financial markets by getting the RBA to sell government securities in return for foreign currency. The RBA holds this in its reserves and credits the Australian dollar equivalent of the loan to the Government's account.

Adv:
No increase in domestic interest rates

Disadv:
Accumulation of foreign debt, increase in CAD as interest payments increase the net income component of the CAD.

8. *Methods of using a budget surplus*

B*udget surpluses* c*an be disposed in two* w*ays*:

I. U*sing it to pa*y *off publi*c *debts* (*do*m*esti*c & *overseas* co*mponent*)

- Govt. can reduce debt incurred with the private sector by buying back CGS sold to finance the deficit from the private sector. This reduces the crowding out effect and the pressure on interest rates. Interest payments saved by the government can then be used to fund other areas of future expenditure.

- The surplus can also be used to repay the governments overseas loans reducing net external debt. A reduction in net foreign debt will decrease the size of net income payments in the current account and as a direct result the CAD.

II. The government can simply deposit with the Reserve Bank, accumulate the surplus to finance expenditure in the future or fund present tax cuts. It could increase ownership of productive assets such as infrastructure but this is unlikely with a trend towards privatisation. It is more likely public savings will be raised, which reduced the CAD.

- **Public Sector Borrowing**

The underlying stances of fiscal policy dose not represent the full impact of the public sector on the economy. The overall impact is reflected ion the **public sector cash outcome**. The public sector cash deficit or surplus shows the borrowing needs brought about by deficit experienced by the Commonwealth, Sate and local government, as well as government authorities and public trading enterprises.

9. Current stance of Fiscal Policy

Under the Howard government, rather than influencing the key economic objective of growth, the budget's main role has been to minimise the extent of public borrowing and to implement specific policy change in targeted areas of the economy.

The shift away from large surpluses was also accompanied by an explain of the public sector i.e. the government makes up a bigger % of the economy.

The government now approaches fiscal policy in the context of its three year parliamentary term.

First term – reduction in spending on government programs e.g. abolition of many labour programs, cuts in education spending.

Second term – rebound in spending and a shift in the tax mix from direct (income) tax to indirect tax through the introduction of GST expansion of government programs for health, roads and other services.

Third Term – reduction in surpluses and a commitment to balanced budgets rather than surpluses during years of economic growth.

10. The Impact of Recent Fiscal Policy

After shifting from a contractionary role between 1996 and 1999, to an expansionary role in 2000 and 2001, fiscal policy has more recently taken a neural policy stance.

Economic Growth

Despite of contractionary fiscal policies, the economy was growth in late 1990s. This is due to the fact that tighter fiscal policy can increase economic growth in the medium term if it helps to lower interest rates, make domestic fund more easily available for investment and improve business confidence. Nevertheless, fiscal policy can play an effective short term role in stimulating growth, e.g. expansionary budget in 2000-01 and 2001-02 helped to ward off a deeper slowdown, but only intent to 'support' growth in 2003-04.

Unemployment

Strong growth in the late 1009s contributed to a reduction in unemployment to its lowest level in a decade 5.6% by April 2004. The brief slowdown of 2000-01 saw unemployment rise to 7%, but expansionary fiscal policy helped to curb the rising trend.

Interest Rate and Investment

A lower deficit will reduce the public sector demand for funds and help to lower interest rate. While a higher deficit or cut in income tax such as in 2000-01 introduced strong expansionary pressures to the economy, forcing the RBA to higher interest to prevent resurgence in inflation.

National savings and the CAD

There is no direct correlation between the rising CAD and the current fiscal outcome. However, by increasing the level of public savings should help to reduce the CAD in long term.

Distribution of income

The 2004-05 budget is designed to improve the income inequality by giving tax cuts to household and a large package of family assistance. However some economists argue that the 2004-05 budget will widen income inequality, because most tax cuts are targeted at the middle income earners. The previous budget had the similar effect through rising university education fees and possible higher costs for visits to doctors

11. Budget 2004-2005

Budget Outcome

The federal government has outlined a moderately expansionary fiscal agenda in the 2004-05 budget.

BUDGET OUTCOMES 2002-2007

	Actual	Estimates		Projections		
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Underlying cash balance ($b)	**7.5**	**4.6**	**2.4**	**1.6**	**3.4**	**4.5**
Per cent of GDP	1.0	0.6	0.3	0.2	0.4	0.4
Fiscal balance ($b)	**6.0**	**3.0**	**0.7**	**0.7**	**2.3**	**2.6**
Per cent of GDP	0.8	0.4	0.1	0.1	0.2	0.3

source: 2004-05 Budget Overview p. 5

The diagram above shows this year's budget outcome measured in 2 main methods, comparing to the previous two year and 3 years of projection.

In 2004-2005 budgets, the government have outlined a underlying cash surplus of 2.4 billion dollars. It is a reduced surplus compare to a 4.6 billion surplus from the previous year, increased in spending from 0.6 % to 0.3% of GDP.

Government revenue is predicted to grow by 3.7% to $ 193.1 Billion.

Government spending will grow by $9.2 billion or 5%.

Fiscal Policy Stance

The Fiscal policy stance has shifted from neutral to moderately expansionary, providing moderate stimulus to economic growth in Australia in the coming. This is because the economy is expected to slow down a little with a growth rate of 3.5 % (below the sustainable rate of 3.75%).

A downturn in the housing sector is estimated as the major drag on economic growth in the coming year, the budget forecast of dwelling investment will contract 3 % in 2004-2005. This will reduce the "wealth effect", that the high consumer spending is because of rising asset prices.

The government expects no improvement in Australia's unemployment rate, with unemployment forecast to remain around the 5.74% level.

Australia's inflation rate is expected fall below to 1.75%. The budget paper identifies falling import prices as the main factor containing inflationary pressure.

This budget will have a mixed impact on the distribution of income, but its overall effect is likely to increases income inequality. The reduction in personal income tax will only benefit higher income earners and will make the taxation system less progressive. Many of the changes to the welfare system will reduce the means tests for family payments. Eg. The new Maternity payment will provide to all mothers, regardless of their income level.

However, the measure to encourage low income earners to contribute more savings may have a positive impact on wealth distribution over time.

The CAD is estimated to remind high around $44 billion, or 5% of GDP, the slightly improved from a $46 billion in the previous budget is due to export growth, as export revenue are expected to increase by 8%.

Budgetary Changes

The budget outcome is the result of both cyclical and structural factors which are working in opposite directions. Cyclical changes have a positive impact on the budget this year, with government revenue expected to rise 4.9 % for the last budget. Continued economic growth has underpinned strong employment and wages growth together with surging business profits are expected to see tax receipts increases.

Structural factors will more than offset the positive impact of cyclical factors on the budget outcome. Discretionary changes announced in this year's budget, such as increases transfer payments and tax cuts, are expected to cause an $ 8.3 billion or 1.3% of GDP deterioration of the fiscal balance.

Highlights of the Budget

- The underlying cash surplus will fall from $4.6bn to $2.4bn
- The fiscal surplus will fall from $3.0bn to $0.7bn
- The fiscal policy stance has shifted from neutral to moderately expansionary
- Higher income earners receive tax cuts of up $42 per week
- Spending on the government's priority areas - family benefits, aged care and defence - is increased
- Family benefits and superannuation rules have been changed to foster increased workforce participation and savings
- A major criticism of the budget is that government policy is being driven by short-term political objective with a Federal election expected later this year