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HSC Economics

Topic 4: Economics Policies and Management

Lesson 1

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HSC Economics Topic 4: Economic Policies and Management
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Syllabus Dot-points covered:

Macroeconomic Policies

- Rationale for macroeconomic policies - stabilisation and shifts in aggregate demand

Fiscal policy

- Federal Government budgets and budget outcomes
- Effects of budgetary changes on resource use, income distribution and economic activity

Macroeconomic policies

- Macro policies include the use of the government budget (fiscal policy) and changes in the level of interest rates (monetary policy) to impact the overall level of economic activity. These policies tend to influence the level of aggregate demand in the economy
- The main role of macro-policies is to manage the **business cycle** - they are designed to minimise the fluctuations of the business cycles so that economies experience low rates of inflation and unemployment and relatively stable economic growth
- As such, they are often known as **counter-cyclical policies**
- For example, methods to reduce the level of economic activity may include:
    - Higher tax rates - reduce consumers' disposable income and reduce the level of spending and aggregate demand, also reducing pressures on inflation and the CAD
    - Reduced government (budget) spending - lower the level of AD by lowering the level of aggregate expenditure in the economy
    - High interest rates- make borrowing less attracting and will discourage borrowing and spending by both consumers and businesses. Also encourages saving rather than spending

- **Methods to increase the level of economic activity:**
    - Tax cuts, increased government spending and reductions in the level of interest rates
    - Cash payments to families - increase consumer disposable income and overall consumption in the economy

- **HOWEVER:** The main limitation of macroeconomic policies is that it does not address longer-term problems such as a lack of international competitiveness, lower productivity growth, a low level of national savings or the need to reduce carbon emissions

Fiscal policy

Fiscal policy involves the use of the Commonwealth Government's Budget in order to achieve the government's economic objectives. By varying the amount of government spending and revenue, the government can alter the level of economic activity, which in turn will influence economic growth, inflation, unemployment and the external indicators in the economy.

- **Reallocation of resources** i.e. structural change in what the economy produces
- **Redistributing income** e.g. from high income earners to low income earners
- **Reduce fluctuations of the business cycle**

Features of government revenue (2019 Federal Budget):

- Direct tax (personal and company) - personal income tax provides 46% of total revenue while company tax provides 19%
- Indirect tax (such as customs and excise duties and the Goods and Services Tax) provides 24% of total revenue
- Other revenues (such as dividends from public trading enterprises) make up 11% of total revenue

Features of government expenditure (2019 Federal Budget):

- Social welfare - 36%
- Health - 16%
- Education - 7%
- Defence - 6%
- Public administration - 5%

<u>Federal government budgets and budget outcomes</u>

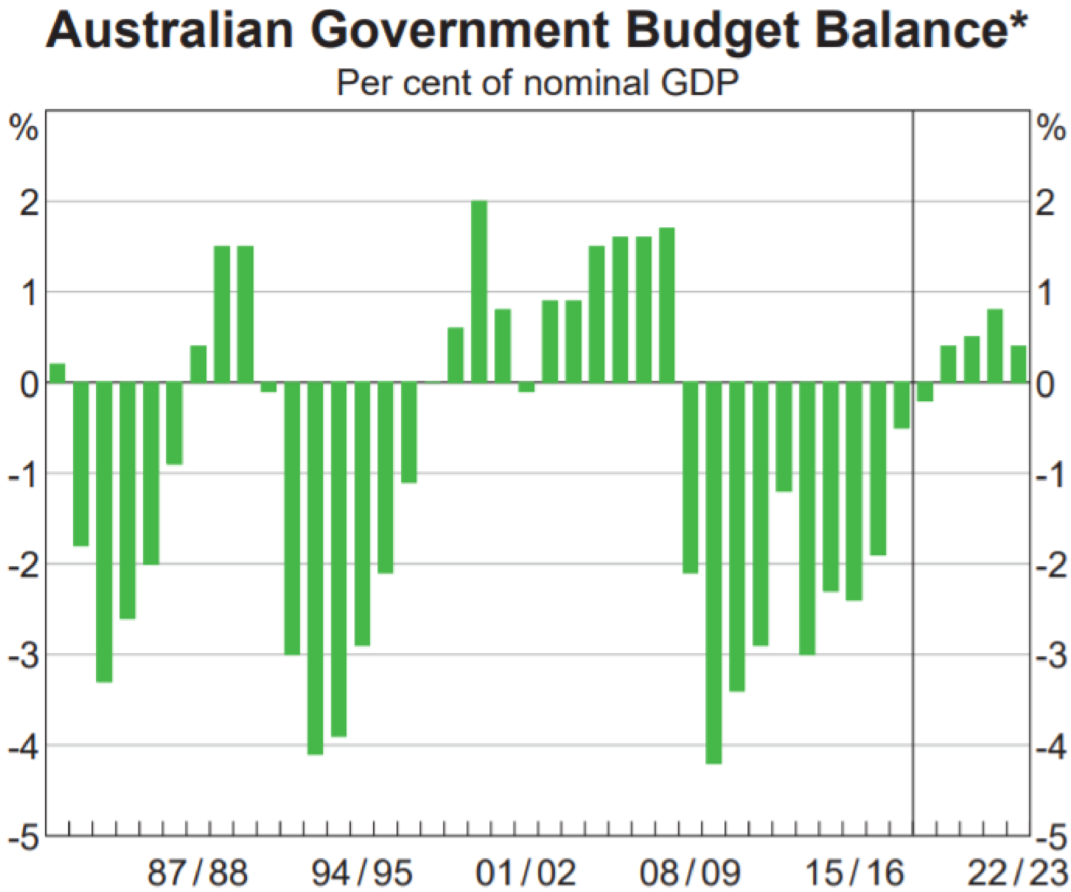
The fiscal or budget outcome gives an indication of the overall impact of fiscal policy on the state of the economy

The Budget outcome:

- **Fiscal surplus** (or budget surplus)- Revenue > Expenditure
- **Fiscal deficit** (or budget deficit) - Expenditure > Revenue
- **Fiscal balance** (or balanced budget) - Revenue = Expenditure

The 2019/20 Federal Budget marked the **first return to a surplus** position in almost a decade with a surplus of **$7.1 billion.** Total receipts were expected to be $505.5 billion and total payments were $493.3 billion.

Historical Budget Outcomes



* Underlying cash balance; 2019/20 Budget
Source: Australian Treasury

NB: the Treasury predictions of the future budget balance have proven untrue due to the COVID-19 crisis.

Measuring the budget outcome

The Fiscal outcome

Calculated as total revenue less total expenses let net capital investment (excludes one-off items such as privatisation of previous government-owned businesses - e.g. Telstra, which are recorded in the State of Other Economic Flows)

- Calculated using the accrual account method - e.g. includes superannuation owed by the government to public servants even it is not paid out until retirement
- Regarded as most accurate long-term indicator of fiscal policy

The underlying cash outcome

- Calculated similarly to the fiscal outcome except using the cash accounting method
- In this method, receipts are recorded during the period they are received, and expenses are recorded in the period in which they are actually paid
- Also removes the effect of one-off transactions that can distort the Budget outcome (e.g. sale of government assets/loans to state government)
- Gives the best indicator of the impact of fiscal policy on the level of economic activity this year

The headline budget outcome

- Like fiscal outcome, except it includes one-off transactions
- Not regarded as a useful indicator of fiscal policy as economists agree such revenue should be removed when assessing the effect of the Budget on the economy
- Selling of government assets to the private sector is merely a transfer of assets and will not necessarily generate extra economic activity, at least in the short run

A main goal of fiscal policy aim is to achieve fiscal balance, on average, over the course of the economic cycle.

Budget outcome drivers

- Changes in the budget outcome reflects the impact of two key drivers: changing economic conditions (cyclical or non-discretionary changes) and changes in fiscal policy (known as structural or discretionary factors)
- **Discretionary changes** in fiscal policy
  - Deliberate changes to fiscal policy, such as reduced spending or changing taxation rates
  - Influences the structural component of the budget outcome

- **Non-discretionary changes** in fiscal policy
    - Caused by changes in the level of economic activity and not the introduction of new policy
    - The budget deficit tends to increase during recessionary periods and vice versa during periods of economic booms
    - Influences the cyclical component of the budget outcome
    - Includes automatic stabilisers (see below)

- **Automatic stabilisers**
    - Changes in the level of government revenue and expenditure that "automatically" occur as a result of changes in the level of economic activity
    - These automatically counterbalance economic activity - in boom they decrease economic activity and, in a recession,, they increase economic activity
    - **Unemployment benefits** - in a recession, economic activity falls causing a rise in unemployment. A rise in unemployment leads to greater government expenditure on unemployment benefits. Thus a decrease in the level of economic activity leads to an increase in government expenditure. Vice versa.
    - **The progressive income tax system** - During boom, employment opportunities rise and incomes rise. Rising incomes move workers into higher tax brackets and previously unemployed persons start paying income tax. This leads to an increase in taxation revenue. Vice Versa
    - These play a **counter-cyclical role** (designed to smooth fluctuations in the business cycle)
    - However, automatic stabilisers are not powerful enough, as they merely reduce the severity of the problem. The government still relies on discretionary policy measures to curb the economic cycle.

Effects of budgetary changes on resource use, income distribution and economic activity

Impact on economic activity

- An **expansionary stance** is one where the government is planning to increase the level of economic activity in an economy. This occurs either through a reduction in taxation revenue and/or an increase in government expenditure, creating either a smaller surplus or a larger deficit than in the previous year. This expansion leads to multiplied increase in consumption and investment and stimulates aggregate demand, which will increase the level of economic activity. Note: A budget outcome can still be in surplus and expansionary
- A **contractionary stance** is one where the government is planning to decrease the level of economic activity in the economy. This is through an increase in taxation revenue or a decrease in government expenditure, either creating a smaller deficit or a bigger surplus. This leads to a multiplied decrease in consumption and investment, dampening aggregate demand, which will decrease economic activity
- A **neutral** fiscal policy stance occurs when the government plans to maintain the gap between revenue and spending at around the same level as the previous year. A neutral fiscal policy should have no effect on the overall level of economic activity.

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Impact on resource use

- Fiscal policy can change the allocation of resources directly or indirectly
- Direct influence can occur through **government spending** in a particular area of the economy
    - Indirect influence can occur through **tax** and **spending *decisions*** that make it more or less attractive for resources to be used in a particular way
- e.g. removing taxes from ethanol production might encourage farmers to use more of their wheat, sugar and other crops to produce ethanol
    - e.g. high tax rates in tobacco products to discourage its use, which in the long term may reduce the costs of the healthcare system that arise from treating tobacco-related diseases
- Direct influence can also occur through provision of **public goods** e.g. national defence and environmental protection

Impact on income distribution

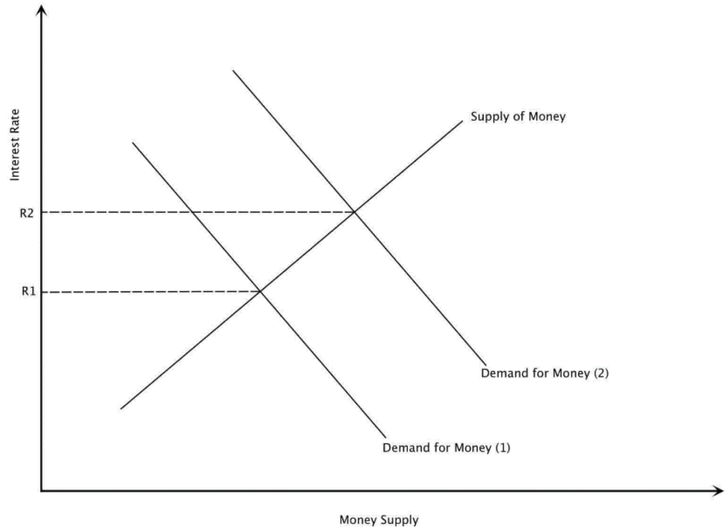
- People on higher income pay higher rates of income tax, allowing the government to use this money for transfer payments, community services and other types of social expenditure, which in particular assist people on lower incomes
- A reduction in tax at the upper end would make the tax system less progressive and may create a less equal distribution of income
- An increase in the rate of Goods and Services Tax would make the tax system less progressive and would result in lower-income earners paying a relatively higher proportion of their incomes in tax, increasing inequality
- Spending on civic amenities - an increase in spending on community services such as health care and labour market programs will reduce income inequality as they have greater proportional benefit for low income earners

Impact on savings and the current account deficit

- A budget deficit decreases national savings (since the Government must finance is budget deficits by borrowing from private sector savings). When the budget deficit increases, so too does the size of the public sector deficit. Public sector deficit is regarded as **negative savings** or **dis-savings**, which reduces the level of national savings.
    - The Twin Deficits Theorem states that reducing the public sector underlying deficit (PSUD) can help to reduce the current account deficit. In reality, this does not work as the level of savings and investment are not kept fixed.
- A depleted national savings pool will then place an upward pressure on interest rates due to the competition for a limited amount of savings to finance domestic consumption and investment, making private sector investment more expensive (higher lending rates) and difficult (**crowding out effect)**
- This means the inflow of funds to finance domestic investment and consumption must come from overseas, which shows up as an inflow on the capital and financial account. This will increase the size of Australia's foreign liabilities and associated future servicing costs.
- Alternatively, if the government borrows from overseas, the inflow of funds will directly lead to an increase in Australia's foreign liabilities.
- This will raise the net primary income deficit as the higher level of foreign liabilities is serviced with higher interest repayments.
- Thus, consistently large fiscal deficits will increase the size of the current account deficit as well.
- Recently, negative savings in the private sector rather than the public sector has been the main contributor to CAD. However, with the budget in deficit, some economists argue that the crowding out effect from public sector borrowing may contribute to higher CADs in the future

The crowding out effect

Phase I



- The initial phase of the crowding out effect relates to the increase in interest rates as the government competes with the private sector for a limited supply of loanable funds (savings)
- The increase in demand shown in the graph above, causes the equilibrium price of loanable funds (interest rate) to increase from R1 to R2
- The higher interest rate may be perceived as too costly for domestic investors who may either seek to borrow overseas in international capital markets, at perhaps lower rates, or cease their investment projects overall

Phase II

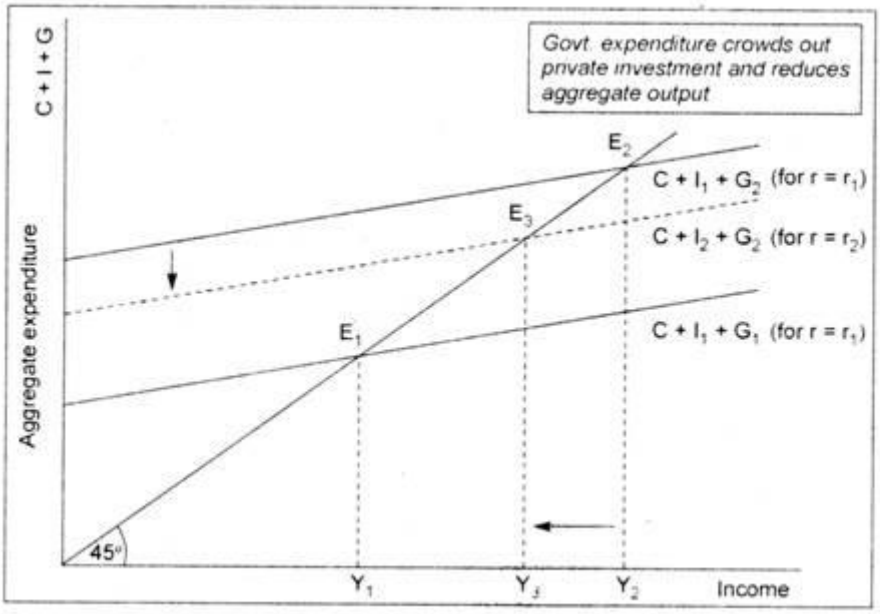


Fig. 3.37: Crowding-out Effect

- In phase II, the Keynesian Cross graph above highlights what would happen if domestic investors chose to cease their investments altogether.
- While initially, increased government expenditure (G2) would lead to a rightwards shift in the AD curve and a higher equilibrium point (E2) and higher national income (Y2), the crowding out effect would simultaneously result in an increase in interest rates from R1 to R2.
- At the higher R2 interest rate, the level of private investment in the economy would fall from I1 to I2, resulting in a fall (leftward shift) in the Aggregate Demand curve until a new lower equilibrium (E3) is achieved.
- **Key Takeaway:** *The crowding out effect can undermine the government's ability to stimulate economic growth in an economy that is constrained by a limited level of loanable funds.*

Practice Exam Questions:

1. Explain why a government might want to pursue a budget surplus. (3)

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2. Analyse the limitations of using fiscal policy to improve the distribution of income. (4)

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3. Explain how the crowding out effect can constrain the government's ability to stimulate economic growth. Use a diagram in your response. (6)

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Answers

<u>*Question 1.*</u>

A budget surplus occurs when the government's expected taxation revenue exceeds its proposed expenditures. A budget surplus can increase the level of public savings held by the government and can then be drawn upon when the government enters a necessary deficit. For example, during the 2008/09 GFC, the Rudd government implemented a $50 bn stimulus package to support the economy. However, a significant amount of foreign debt was required to fund this expenditure. This worsened Australia's external stability by increasing the level of net foreign liabilities. A budget surplus can also add to the overall level of national savings, which can reduce the savings investment gap and improve Australia's persistent CAD.

<u>*Question 2.*</u>

Fiscal policy has been used to improve income distribution through the combination of a progressive taxation system and transfer payments for the disadvantaged. While effective to a certain degree, fiscal policy is constrained by political factors. For example, it may be difficult for the government to increase taxes on the rich without upsetting a significant amount of their voters. More recently, the Turnbull government implemented a series of tax cuts, mostly benefitting high income earners, to appease voters ahead of election season. Moreover, fiscal policy may be constrained by the pursuit of fiscal consolidation. Government funding to civic amenities such as health and education may be cut to reduce the budget deficit. As these public services are primarily used by low to middle income households, it can worsen the distribution of income.

Question 3.

Refer to the Diagram in the notes provided.

Under Keynesian economic theory, the government can stimulate economic growth through greater government expenditure (G). This will result in a shift in the AD curve to the right (AD = C + I + G + X – M) on the Keynesian cross. Theoretically, the new equilibrium point corresponds to a higher level of national income (Y2). In practice, the government will need to borrow enough funds to undertake its expenditure projects. To do so, it may have to compete with the private sector for a limited pool of domestic savings, thus driving up the price of loanable funds i.e. the interest rate in a phenomenon known as the "crowding out effect". The higher interest rate could deter investors in the private sector from undertaking proposed investment projects as some projects which were previously profitable, under lower interest rates, may no longer appear attractive. This reduces the private sector investment component of the Aggregate Demand equation, causing overall AD to fall. As a result, the economic benefits of the government's AD injection are partly offset by the fall in private sector investments. This results in a lower than anticipated improvement in economic growth.