

Fiscal policy - use of government spending & taxation to influence the level & nature of economic activity

Federal government budgets, & the budget outcome

è **Federal Budget:** sets out government's expenditures, revenues & borrowing over financial year

è **Budget outcomes:** nature & size of relationship between expenditures & tax receipts.

- balanced budget; Surplus - first for 35 years in 1987/88; Deficit - common feature post-war.

è **Budget Outcome = Structural** (decision making) + **Cyclical components**(automatic stabilisers)

- **Discretionary fiscal policy:** deliberate alteration of government spending through the Budget bill

- It is the best single indicator of fiscal stance - product of government's explicit decisions.
- recent fiscal stance regarding the structural outcome - Liberals promise to maintain a structural surplus over cycle - in line with Dr Vince Fitzgerald, author of government's national savings report.

- **Non-discretionary fiscal policy:** changes which occur automatically over course of business cycle

- **Automatic stabilisers:** arrangements built into spending & taxation programs which automatically reduce the size of fluctuations in the general level of economic activity.

- Personal income taxes & Unemployment benefits
- Limitations of **automatic stabilisers**
 - cannot eliminate fluctuations in the level of economic activity completely.
 - fiscal drag - part of progressive tax system - bracket creep - stifles growth

è **Underlying budget deficit:** officially announced Budget deficit adjusted for the effect on it of asset sales.

- Asset sales are a one-off transaction, & a burden on nation's savings, because the private sector has to use its savings to pay for the asset its bought - effectively a form of deficit financing.

è **Total Budget Outcome = Domestic Outcome + Overseas Outcome**

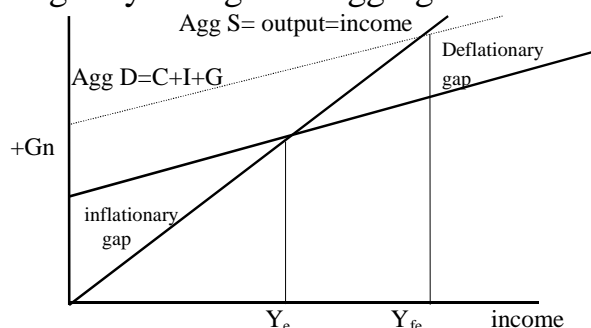
- **domestic outcome:** expenditures made within Australia minus revenues raised within Australia.

- a much better indicator of fiscal stance than either overseas or the total budget outcome itself.

- **overseas outcome:** Commonwealth spending overseas minus Commonwealth revenue raised overseas.

- Overseas transactions have very little impact on demand for G&S produced within Australia.

Effects of budgetary changes on aggregate demand



è **Budget deficits, budget surpluses & economic activity - Keynesian view**

- increase in government expenditure will increase aggregate demand & the equilibrium level of income, output & employment. Increase larger than expenditure due to multiplier effect...

Financing deficits & disposing of surpluses - neo-classicalists view

- Higher government borrowing & spending will not stimulate the economy with more activity through the multiplier, but will replace private sector activity with public sector activity.

è **Financing the deficit:** effect on domestic money supply depends on source of Commonwealth borrowing

- **Borrowing from the reserve bank:** injecting new money into money supply - printing money.

- **Borrowing from overseas** - effect on money supply depends on the exchange rate system.

- under floating exchange rates, overseas borrowing will not alter the domestic money supply.

- **Borrowing from the Australian private sector** - main method of financing budget deficit

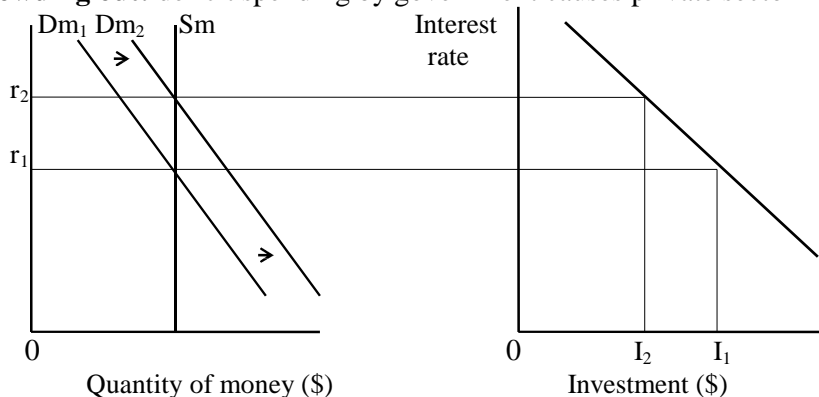
- Federal government exchanges private sector cash for government securities or bonds.

- firms withdraw from their accounts in banking system - an initial drop in money supply.

- When the government spends these funds, the money supply returns to original level.

è **public sector borrowing requirement** - total borrowing sought by all government bodies in one year

è **crowding out:** deficit spending by government causes private sector investment to contract.



- Government enters financial markets as a borrower & The money demand shifts from Dm_1 to Dm_2 .
- Given the fixed money supply, the general level of interest rate rises from r_1 to r_2 .
- Rise in rates means increase in cost of borrowing - volume of private sector investment falls I_1 to I_2 .

è Disposing of the surplus - Impounding the surplus versus retiring the debt

- **impounding the surplus:** holding surplus in Reserve Bank - economy feels the full contractionary effect.
- **retiring the debt:** pay off a portion of the national debt - reducing the contractionary effect

Present fiscal stance - The budget 96/97

Outcome	1995/96 actual	96/97 estimate	change on 95/96	% GDP
revenue	\$ 121.6 billion	\$ 130.2 billion	7% in money terms	25.3%
outlays	\$ 126.7 billion	\$ 129.7 billion	2.4% money terms	25.2%
headline	-\$5 billion	\$ 0.5 billion		0.1%
underlying	-\$10.3 billion	-\$5.6 billion		-1.1%

fiscal stance - contractionary - New government making an attempt to eliminate deficit in three years

è Deficit to fall by \$4.7 billion this year & a further \$4.1 billion in 1997/98.

- In 1996-97, \$0.8 billion is due to 'growth dividend' & \$3.9 billion to spending cuts & tax changes.
 - (Net spending cuts remain 3/4 of the total, leaving 1/4 explained by net tax changes.
- Of \$4.1 billion in 97/98, \$0.9 billion explained by economic growth changes.

è The size of the Budget's contractionary effect is, relative to the size of the economy, quite small.

- Contractionary effect equivalent to 0.8% of GDP & next years it's equivalent to a further 0.6%.
- Treasury acknowledges 'fiscal consolidation' likely to have 'a slight moderating influence' on growth
 - Budget's contractionary effect offset by other factors:
 - Overseas growth at trade weighted average rate of 4.5%. 14% growth in business investment
- Treasury expects the economy (real GDP) will grow by 3.5% this year & 3.25% next year.
 - Insufficient to reduce unemployment - more to improve structural CAD in medium term

Outlook for 1996/97	1995/96	1996/97	Comment
Economic growth	4.1%	3.5%	volatility with 0.1% in June quarter & % in March quarter
Underlying inflation	3.2%	2.75%	pressure from wages growth
Unemployment rate	8.5%	8.5%	8.25% at end of year (attacked by government's IR policy)
Employment growth	2.6%	1.5%	not enough to reduce unemployment in short term
Household savings ratio	2.5%	2.5%	historically low levels - fall may offset public saving
Private consumption	4.3%	3.0%	lower economic growth lowering inflationary pressure
Average earnings	4.4%	5.0%	wages growth high
Business investment	9.7%	14.0%	improved business confidence & lower interest rates
Current Account (\$bn)	-\$20.5	-\$20.0	little impact in the short term
CAD as % of GDP	-4.2%	-4.0%	same as the average of the 1980s. 2% in 1960s & 1970s

Broad strategy is one of deficit reduction without resort to increased taxation

- Increasing National savings & reducing level of public dis-saving to give structural reduction in CAD.
 - Over the years to the end of the '70s, our CAD averaged 2.5% of GDP.
 - But since the early 1980s its averaged 4.5% of GDP & hit cyclical peaks of about 6%.
 - Biggest reason for structural rise in CAD: Government's transformation to a dis-saver in mid-1970s.
 - We need to bring the average structural CAD down to between 2 & 3%.
 - Also need structural increase in national investment, particularly business investment.
 - The increase in national saving we need is well over 2% of GDP.
- Reducing the size of public debt to reduce the growth of debt servicing costs
- Achieving the low inflation objective - reduced public spending dampens consumer demand
- Microeconomic reform objectives - reform of the public sector
 - Need structural reduction in public sector dis-saving & thus a structural increase in national saving.
- Reducing unemployment over the medium to longer term
 - tightening tests for the dole; improve job placement through competition for CES.
- Increasing chance of a reduction in interest rates by not crowding out investment

Effect of the contractionary fiscal stance:

- Conventional Keynesian theory: Cut in government spending → fall in private spending & investment
 - Fall in private sector spending sets Budget's "automatic stabilisers" into reverse, adding to deficit.
- rival theories - the German view
 - fiscal policy actions also have indirect effects via expectations - act as signal about future fiscal policy.
 - Empirical evidence supporting the German view is building.
 - Professor Alberto Alesina of Harvard & two reserve bank economists, Dr David Gruen & Matthew Jones examined performance of 6 OECD economies between 1984 & 1988 which reduced general government Budget deficits by between 2.5% & 5.9% of GDP.
 - average economic growth rate: 3.3% compared to OECD average of 3.7.
 - 4 of 6 countries averaged growth in business investment exceeding OECD average of 7.4%/year
 - Australia was one of those countries: reduced PSBR by 4.3% of GDP
 - Still experienced growth averaging 4.4% & business investment averaged 10.2%/year.
 - Francesco Giavazzi & Marco Pagano, for America's National Bureau of Economic Research:
 - performances of 19 OECD economies from early 1970s to 1992
 - When change in government consumption or deficit becomes large or persistent, correlation with private demand switches sign - severe contraction → increase in private demand.
 - Causes related to German view - changes in expectations of business & consumers.
 - In Australia: fiscal tightening unlikely to end in severe economic downturn
 - many people convinced B deficit reduction needed to reduce CAD & the foreign debt
 - Such decisive action could lead to business optimism about economic future.
 - Vito Tanzi & Ludger Schuknecht, two IMF economists: The Growth of Government & the reform of the state in Industrialised Countries:
 - Public spending may be subject to diminishing marginal returns: beyond a certain level, it stops delivering measurable social benefits - study of public spending over last 125 years.
 - Dispel claim of the welfare lobby that spending cuts result in a decline in social welfare.
 - Those economies with the lowest rise in public spending since 1960 seem to be more efficient & more innovative - boasting lower unemployment & higher level of registered patents
 - Because they do not need to levy high taxes, they have the smallest "black" economies
 - authors suggest average public spending should be smaller than 30% of GDP (Aus 25.2%)