ECONOMICS

Topic 4 – Economic Policies & Management – Fiscal Policy

Fiscal policy refers to the use of federal government's annual budget (an estimate of government income and expenditure) to affect the level of economic activity and to achieve objectives of internal and external balance and economic growth. In involves adjusting government income and expenditure to impact on the variables; aggregate demand, resource allocation and income distribution. The Mid-Year Economic Outlook (MYEO) is also used to revise the original budget.

The budget outcome is the net government budgetary position in terms of government spending and income. There are 3 types; balanced, deficit, surplus, which are when government spending finances, exceeds, and is less than revenue, respectively. It can also be measured in three ways. Firstly, the headline cash balance which equals to total cash outlays less total cash receipts. Secondly, the underlying cash balance, which excludes one-off amounts related to events. And finally, the fiscal balance, which is the accrual accounting counterpart of underlying cash balance, and was adopted in 1999. It also measures the government's net call on other sectors, which corresponds to the government's direct contribution to the current account balance.

The stance of fiscal policy is the overall effect of the budget outcome on economic activity. There are three types: neutral, expansionary, contractionary. An expansionary fiscal policy occurs when income is lowered or government expenditure is increased resulting in a smaller surplus or a larger deficit than previous year's outcome. A contractionary fiscal policy occurs when income from taxation is increased or when expenditure decreases, thus leading to a greater surplus or a smaller deficit. The outcome of 08-09 budget is an expected accrual surplus of $23.1b and the stance adopted is mildly contractionary in response to increased inflationary pressures, mainly through a decrease in expenditure as a component of aggregate demand. At the same time, spending on infrastructure and skills formation in the labour force has been increased, which are expected to increase capacity and hence increase aggregate supply.

A budget deficit can be financed in two ways: by printing money, which is risky, because the Reserve Bank of Australia (RBA) issues more money which may accelerate inflation, or by deficit financing, where government borrows money from households and firms, which does not add to the money supply, however can lead to the crowding out effect, which will increase interest rates.

The two main components of the budget outcome are structural/discretionary, which are the deliberate changes to government income and expenditure, and cyclical, the changes in income and expenditure caused by changes in business cycle. Included in the cyclical component are automatic stabilisers which are countercyclical. These are the progressive tax system and unemployment benefits. The progressive tax system operates with an increasing proportion of income paid in tax as income rises in a cyclical boom, hence government revenue would increase as economic activity expands. It also contains the growth in aggregate demand and possible inflation.

In a bust, a decreasing proportion of income is paid in tax hence reducing tax revenue, but this also maintains aggregate demand, economic activity and employment. Unemployment benefits monitor aggregate demand which in turn influences inflation. In an upswing, a fall in unemployment reduces government expenditure on welfare payments, thus containing aggregate demand. Conversely in a downswing, increased unemployment leads to a raised government-spending component of aggregate demand. These are the ways in which fiscal policy affects income distribution.

The current growth in government revenue to 25.9% of the Gross Domestic Product (GDP; 08-09) is due to cyclical factors, such as higher collections from income tax, company tax and petrol resource rent, and the Goods and Services Tax. Strong employment growth has pushed up tax collections from wages and salaries. A rise in national income has also led to increased consumption, adding to revenue from the GST, and the rise in commodity prices have added to company profits.

All these have contributed to increasing government revenue. Hence, fiscal policy can influence economic activity in the above ways.

In this year's budget, the structural component of revenue has been increased by policy decisions. This was through the deference of tax cuts to high-income earners, the increased tax in luxury cars, and the raised excise on alcoholic beverages. However, this surplus was used to give tax cuts to low-income earners who have higher marginal propensities to consume, which will raise aggregate demand.

This year's mid-term fiscal strategy uses the surplus to firstly, lower inflation by decreasing the growth of public demand. This can be achieved by leaving the surplus in the account with RBA to decrease government spending. Secondly, it provides funding for future capital investment in infrastructure, education and health. Taxes are kept below last year's level to ensure surpluses are delivered through disciplined spending not an increase in revenue. Thirdly, it ensures strong net financial position (by achieving fiscal sustainability). For example, the liabilities in future superannuation payments to public servants have been decreased, and holdings in the Future Fund which earns interest will increase. It should be noted that the government has had zero net deficit since 05/06, which is where $60b of gross debt that is more than offset by building funds. The intergenerational reports (02 and 07) show that long-term fiscal sustainability had improved but the aging population still places pressure on government expenditure, which is addressed by measure to enhance productivity and Labour Force Participation Rate (LFPR). Finally, this year's fiscal strategy uses the surplus to maximise growth, by achieving fiscal balance to raise national savings, raising funds available, thereby facilitating a lower interest rate environment. This increase in savings will also decrease the current account deficit by lowering public debt, allowing the crowding-in effect to occur, so more domestic investment will be financed by domestic savings. These will lead to higher rates of sustainable economic growth and improvements in the long-term standard of living.

The main components of government spending this year are social security and welfare (to cater for the aging population), health (due to sustained growth in use of medical services), defence (to maintain an annual 3% real growth in its commitments) and education.

One of the key priorities of this year's budget attempts to improve resource allocation and increase Australia's productive capacity. These are achieved through reforms in education and skills, infrastructure, health, ESD and the introduction of the Working Families Support Package. This Package includes tax cuts in the form of raising 30%, 40% and 45% thresholds to firstly, increase disposable income to offset bracket creep due to inflation, and secondly to strengthen incentives to work, thus raising LFPR. This is a build on previous budget policies where for example, tax relief was given thru the super co-contribution scheme for low and middle-income earners (06-07). Other ways of helping this group are the increase in the LITO (Low Income Tax Offset) over next three years, the increase in the Child Care Tax Rebate and the Education Tax Refund, making housing more affordable and ensuring grocery and petrol prices are competitive.

Reform in Australia's education and skills features the Education Investment Fund and the Education Revolution, which focused on higher, vocational education and training. In the area of infrastructure, the Building Australia Fund was established to enhancing productive capacity, which finances support and communications. In health, the Health and Hospitals Fund was set up and ESD was addressed in the form of climate change, by lowering greenhouse gas emissions, and introducing renewable energy target (20% of electricity sourced from renewable energy by 2020). Furthermore, Prime Minister Kevin Rudd had signed the Kyoto Protocol in Bali in Dec 07. He proposed a 60% reduction in carbon dioxide emissions from 1990 levels by 2050.

The government has been criticised for not having decreased government spending enough to contain inflationary pressures and tax cuts will offset spending cuts. Also, these tax cuts raise disposable incomes which add to aggregate demand, leading to demand-pull inflation, which is procyclical, conflicting with monetary policy's aim to reduce aggregate demand and inflation.

However, it has addressed supply constraints to counter for the growth in aggregate demand, for example, in infrastructure and skills shortage.

The outlook for the Australian economy is being influenced by countervailing forces. On one hand, the factors of slower global growth, tighter credit conditions, and higher domestic interest rates are expected to slow down economic growth. On the other hand, robust growth in emerging economies e.g. China and India is supporting large rises in Australia's Terms of Trade, which will raise national income and economic growth.