FISCAL POLICY 14

MULTIPLE CHOICE

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

SHORT ANSWER QUESTIONS

Question 1

(a) Budget Outcome = Revenue – Expenditure
= 60 – 50
= $10bn surplus

(b) The fiscal stance in Year 2 is expansionary.

(c) Expansionary fiscal policy is designed to increase the level of economic activity in an economy, through lowering taxes or increasing expenditure, whereas contractionary policy aims to slow economic activity through increasing taxes or decreasing expenditure.

(d) One method of financing a deficit is to borrow from the domestic private sector. The government issues bonds at progressively higher interest rates until the deficit is met. The government may alternatively decide to borrow from overseas investors to finance the deficit or from overseas central banks. Thirdly, it may borrow from the Reserve Bank through monetary financing, which effectively means it will print money to meet the deficit.

(e) The government may choose to finance its budget deficit by borrowing from overseas. In doing so, it adds directly to foreign debt. Alternatively, if the government finances a deficit through borrowing from the domestic private sector, it will "crowd out" domestic investors from the domestic pool of savings, who will look to foreign sources of funds for their investment, increasing foreign debt. As a result, an increase in foreign debt is likely to accompany a budget deficit.

Question 2

(a) Fiscal policy is a macroeconomic policy that can influence resource allocation, redistribute income and reduce the fluctuations of the business cycle. Its instruments include government spending, and taxation and the budget outcome.

(b) The budget has been in surplus over the course of the current economic cycle. In addition, the surplus has remained relatively stable over the past few years.

(c) When the government borrows money from the private sector to finance a deficit, it draws on the small pool of domestic savings, reducing the quantity of borrowable funds. The decreased availability of funds places upward pressure on interest rates. As a result, some firms will be "crowded out" as they are unable to afford to borrow money to fund investment, reducing investment. While government spending may increase aggregate demand, the crowding out effect may reduce domestic investment, lowering growth.

(d) An expansionary fiscal policy stance will increase aggregate demand, stimulating demand for imports and worsening the balance of goods and services component of the current account deficit. An expansionary stance will also stimulate investment by firms seeking to expand production, with some of this increased supply of funds coming from overseas. The servicing costs on these increased foreign liabilities will worsen the net income component of the CAD. Should the market react negatively to the government's fiscal policy stance, it may lead to capital flight by speculators, leading to a depreciation.

Question 3

(a) Australia's highest marginal income tax rate in 2006-07 is 45%.

(b) A change in marginal income tax rates is a discretionary budget change.

(c) Cyclical components of the economic cycle are determined by the operation of the economic cycle, such as automatic stabilisers. Structural components of the budget are specific changes to government policy to achieve a particular economic objective.

(d) Two automatic stabilisers in the federal budget are transfer payments for the unemployed and income tax receipts.

(e) Automatic stabilisers counteract the economic cycle. Accordingly, when the economy is growing, the cost of unemployment benefits falls as more people find work. These new employees start paying tax, adding to government revenue, while other employees move to higher tax brackets as their incomes increase. As a result, government spending decreases and revenue increases, creating a contractionary impact on the economy, which helps maintain a sustainable rate of economic growth.