

Fiscal Policy

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Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) Automatic stabilisers refer to inbuilt mechanisms in the Commonwealth Government budget which react to changes in the business cycle. The stabilisers are the progressive income tax system, which takes away proportionately more tax as income increases; and the unemployment benefits system which gives more income to those who lose their jobs in an economic downturn.
- b) In 2000-01 there was a downturn in the business cycle. As national income fell, the progressive tax system would have taken proportionately less in tax which means that the fall in income would be less than without the stabilisers. This would lower government revenue. At the same time, the unemployment benefits system would pay an income to the unemployed, who would have otherwise had no income. Government spending would also increase, which combined with the fall in tax revenues would push the budget into an expansionary stance.
- c) During a recession, the economy has a shortage of aggregate demand which causes a decrease in production levels across the economy. Fiscal policy can operate in an expansionary stance, which would involve lowering a budget surplus or raising a budget deficit. This would increase net government spending, increasing aggregate demand. According to the multiplier theory, this would then raise income levels across the economy, increasing consumption by the value of the marginal propensity to consume, further raising income and consumption. The final increase in GDP would be greater than the initial increase in government spending. When the government budgets a deficit, it must finance the deficit by borrowing from the private sector. This soaks up borrowable private savings, potentially crowding out private investment as there are less savings available. However, in a recession it is likely that there is little private investment occurring in the economy. In this circumstance, the crowding out effect is unlikely to be significant. In fact, since government spending is a large input into aggregate demand, the government would be able to “crowd in” investors and restore investor confidence in the economy by increasing government spending. Overall, although the crowding out effect has the potential to undermine the expansionary effects of increasing a budget deficit, in a recession the lack of investment means that the impact of government spending is more likely to raise investment rather than crowd it out.

Question 2

- a) \$125 million surplus.
- b) Expansionary (the surplus has decreased).
- c) The most common way of financing a budget deficit is to borrow from the private sector. The government would issue bonds to the private sector for which it would receive money. The government would be required to pay interest on the bond and to repay the bond upon its maturity. The government would also be able to borrow from overseas, which would increase Australia's foreign debt. The government could borrow from the Reserve Bank, known as monetary financing, which involves the Reserve Bank printing money, which causes inflation. Finally, the government may finance a budget deficit by selling public assets.
- d) Fiscal policy can be used to improve external stability by aiming to improve the level of national savings in Australia. When the government budgets a deficit, it must borrow from the private sector, which reduces the supply of borrowable savings available to fund investment. This means that investors are forced to use overseas sources of funding, which increases Australia's level of foreign liabilities and raises the net income deficit on the current account. The policy of fiscal consolidation involves running balanced or surplus budgets over the economic cycle to minimise the government's drain on private savings and avoid the crowding out effect. The surplus can then be used to repay government debt. The government eliminated its net debt in 2006 and since then has directly saved the surplus into accounts such as the Future Fund, which directly raises the supply of savings available to fund investment. The government can also implement measures to increase domestic savings in its budget. The policy of fiscal consolidation requires that all employers pay 9 per cent of an employee's wage into a superannuation account, directly raising the level of national savings. In addition, the superannuation co-contribution scheme encourages private savings into superannuation. Under this policy, the government will match a person dollar for dollar when they voluntarily contribute to their superannuation.

Question 3

- a) Progressive taxation is a tax system where higher income earners pay proportionately more tax than lower income earners – as income increases, so does the average rate of taxation.
- b) The government may experience an increase in taxation as a result of an increase in national income levels. As income levels rise, individuals pay proportionately more income tax which raises government revenue and would raise the surplus. The government may also have made a discretionary change to increase taxes by raising the marginal rates of taxation. This would increase revenue and raise the budget surplus. Finally, the government may have made a discretionary decision to lower government spending, which would raise the budget surplus.
- c) Fiscal policy can improve environmental management through its use of indirect taxes. The government may levy an indirect tax on products with environmentally harmful negative externalities, such as the fuel excise. This would increase the price of the product to approximate the social cost and decrease the equilibrium quantity. As a result, there would be a lower level of environmental degradation due to the decrease in quantity produced.
- d) Fiscal policy can affect the distribution of income and wealth through its use of taxation and welfare. The government uses a progressive income tax system which takes proportionately more from higher income earners than lower income earners, which improves the distribution of income. However, if the government were to grant tax cuts to higher income earners, this would make the tax system less progressive and worsen the distribution of income. On the other hand, if the government were to grant tax cuts to lower income earners, or raise taxes for higher income earners, this would make the tax system more progressive and improve the distribution of income. The welfare system improves the distribution of income by providing a minimum level of income to those who are disadvantaged financially in society, which raises the income level of lower income earners. The more strictly the welfare system is means tested and adapted to the needs of lower income earners, the greater the improvement in the distribution of income. Fiscal policy can also harm the distribution of income through the use of indirect taxes. Indirect taxes, such as the GST, are regressive forms of taxation since the amount of tax on a product is a higher proportion of income to a lower income earner than a higher income earner. However, the effect is lessened due to the fact that the GST does not apply to essential items such as food.

Skills Revision

Table 1:

- \$10 surplus
- \$10 deficit
- Expansionary

Table 2:

- \$60 surplus
- \$40 surplus
- Expansionary