

# Government in Action

# 17

## Multiple Choice

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|--------|---------|---------|
| 1. (B) | 6. (D)  | 11. (B) |
| 2. (C) | 7. (D)  | 12. (D) |
| 3. (B) | 8. (A)  | 13. (C) |
| 4. (C) | 9. (D)  | 14. (C) |
| 5. (A) | 10. (D) | 15. (B) |

## Short Answers

### Question 1

- Fiscal Policy refers to government action to vary taxation and spending through its annual Budget in order to influence economic activity and achieve its economic objectives.
- The *fiscal outcome* refers to the monetary position of the budget that provides an indication of the overall spending and taxation patterns in a given year. The budget can be in surplus, deficit or balance. The *fiscal stance* refers to the budget's intended impact on economic activity, and can be expressed as being expansionary, contractionary or neutral.
- Automatic stabilisers are policies built into the budget and trigger automatically in response to changes in economic conditions. There are two main components – the progressive taxation system and welfare payments, which act to counter fluctuations in the business cycle. For example during an upturn in economic activity, the progressive taxation system will mean that individuals pay proportionately higher taxes as their income levels rise, leaving them with relatively less disposable income for consumption. Also, as unemployment falls and incomes rise, less people become eligible for welfare benefits and this too decreases available household disposable income for consumption. The automatic stabilisers therefore result in lower aggregate demand compared to a situation without these policies, dampening the extent of the initial upturn. The government's budget position will automatically move into a larger surplus or a smaller deficit as a result of rising taxation revenue and falling welfare payments. The opposite will occur during an economic downturn.
- There are two dimensions to fiscal policy that enable it to promote growth and reduce unemployment during a downturn. The first are the built in automatic stabilisers, such as the progressive taxation system and welfare benefits, which will automatically trigger an increase in household disposable income during a downturn as income levels fall and unemployment rises. Secondly, fiscal policy also works through the channel of greater discretionary spending where the government can consciously announce new spending initiatives to either directly inject expenditure into the economy itself, or through initiatives to encourage more private consumption and investment. An expansionary fiscal policy stance will see the budget outcome move into a smaller surplus or larger deficit as taxation revenue falls and government expenditure increases.

## Question 2

- (a). Two non-tax sources of government revenue include:
- Sale of government business enterprises
  - Interest, dividends and royalties paid to the government
- (b). The answer may include any one of the following:
- Increase in discretionary government spending during an economic downturn
  - An increase in non-discretionary spending on welfare benefits
  - A fall in taxation revenue due to an economic downturn and the progressive taxation system

Ways in which the government could move the budget towards a surplus:

- Increasing income tax rates of individuals, companies, superannuation funds, fringe benefits and petroleum resources
  - Levying other taxes or increasing the rate of existing non-income taxes such as excise duty, customs duty and sales tax
  - Cutting future planned discretionary and non-discretionary expenditure
  - Sale of government business enterprises
- (c). An interest group that might lobby for an increase in excise duty is the Australian Council for Social Services. They are the peak body for community services and social welfare and are naturally concerned about the negative social impact of producing and consuming demerit goods such as cigarettes, alcohol, drugs, petroleum, as well as other anti-social activities such as gambling. They would therefore support an increase in excise duty to discourage the provision and consumption of these goods and services that incur significant negative externalities.
- (d). Expansionary fiscal policy is intended to stimulate economic activity. Its impact on the economy will be higher levels of aggregate demand. If conducted during a recession, expansionary fiscal policy will moderate the extent of the downturn, and if conducted during a boom, it will further increase the rate of economic growth. However, a negative impact of expansionary fiscal policy is an increase in public debt levels as the government increases spending and/or receives less taxation revenue. As public debt levels rise, the government may be forced to increase taxation in the future in order to pay off the debt. The sustainability of public debt levels may also affect investor confidence in financial markets, as seen in the aftermath of the global financial crisis after 2008.

## Question 3

- (a). Global financial markets may constrain the government's ability to conduct economic policy, particularly in open economies like Australia that operate under a floating dollar. This means that the Australian economy and government are under constant scrutiny from overseas investors. The government must always be mindful that its policy decisions do not affect international investor confidence in our economy. If the government pursues policies that are unpopular with global financial markets, it could potentially trigger a collapse in overseas confidence, resulting in a withdrawal of foreign funds from the Australian economy and a severe depreciation of the Australian dollar.

Developments in global financial markets may also force the government to change its domestic policies. This often occurs when there is financial market turmoil in other parts of the world, which have the potential to spread to Australia and affect its economic performance. For example during the global financial crisis in 2008, the risk of a severe contagion effect from worldwide financial markets saw the Australian government respond with initiatives such as guaranteeing bank deposits and injecting funds into financial institutions in order to maintain the stability of Australia's financial markets.

- (b). The political process in Australia constrains economic policy making because major policy changes such as the federal budget, taxation reform and industrial relations reforms must be passed as an Act of Parliament. Often, the political party in control of government does not possess that majority of seats in the Senate, and will only control the House of Representatives. Without control of the Senate, the government cannot simply undertake policy changes without also obtaining the support of other political parties that occupy the Senate. This slows down the legislation process, although it does provide greater transparency and scrutiny of proposed changes in economic policy.

Governments may also need to be mindful of electoral support for its policies, and this may often constrain the government from undertaking economic policy that is politically unpopular in the short term, but is economically beneficial in the long term.

- (c). A government that sustains persistent budget deficits may cause foreign investors to lose confidence in the Australian economy. This is because budget deficits can imply several things.

Firstly, it suggests that the fundamentals of the Australian economy are not particularly strong if it has to constantly rely upon ongoing government expenditure to sustain aggregate demand. If foreign investors believe that the Australian economy is performing poorly, they will choose to invest their funds elsewhere. This will constrain Australia's economic growth.

Secondly, persistent budget deficits increase the level of public debt and are often financed through overseas borrowing. This incurs progressively higher interest repayments. If foreigners believe that the level of government debt is unsustainable, they may seek to withdraw their funds from the Australian economy, causing a collapse in Australia's financial markets and a sharp depreciation of the Australian dollar. Foreign investors may then be reluctant to lend to, or invest in Australia in the future. This is precisely what occurred in Greece in early 2010, where persistent budget deficits saw a sudden decline in investor confidence in Greece, which resulted in its collapse.

- (d). Different lobby groups represent a wide range of divergent interests in the economy and each year, many of them petition the government for both small-scale and large-scale economic reforms that will best further the interests of the individuals and groups of people that they represent. When the government attempts to legislate in response to the wishes of one particular lobby group, this may conflict with the desires of another group and the other group is likely to voice significant opposition to the particular government policy.

The government is always conscious of the need to maintain widespread electoral support, but it cannot please all lobby groups at once. This is especially the case for contentious issues like industrial relations policies, environmental policies and taxation reform, where there will invariably be a wide range of interest groups lobbying for mutually incompatible policy directions. Often, the most vocal and well resourced lobby group will be the most influential, and this can potentially constrain the scope of effective policy making.