ADVANCED SERIES

POLICY AT WORK

The recently delivered Commonwealth budget continues the Government’s course of changing the direction and role that fiscal policy plays in the Australian economy. The desire for change follows a period where fiscal policy had been used to stimulate aggregate demand in order to assist economic growth in the wake of the 2008-09 Global Financial Crisis (GFC).

The Government is attempting to curb future levels of government spending. At the same time it is looking to increase revenue sources in order to bring the budget back into surplus. This process of ‘fiscal consolidation’ — i.e. moving the budget back into surplus and using surplus funds to reduce the levels of debt that have been accumulated as a result of previous deficit budgets — has been driving economic planning. Many of the Government’s attempts to increase revenue and decrease spending have been thwarted due to its inability to get Senate approval for some of its proposals.

Monetary policy still has its focus on inflation targeting and has been more accommodating with lower interest rates due to the lower levels of inflation and the need to help the economy rebalance as it transitions from the mining investment ‘boom’ phase.

Policy settings have been further complicated due to uncertainties associated with the international economy. The US and Europe are showing signs of recovery and China is still growing but at a slightly lower rate than in previous years.

This May edition of the Advanced Series focuses on the recent Commonwealth budget and monetary policy. It will keep you up to date and provide a context for your continued analysis of factors which affect the Australian economy.

Issue 2 — May 2018

Section 17
The Fiscal Policy Stance..................................................Page 94

Section 18
The 2018–19 Commonwealth Budget......................Page 101

Section 19
Interest Rates and Economic Activity.....................Page 109

Issue 3 — September 2018

Year 12 Exam Primer — Statistical Update and commentary on the current policy mix
17. THE FISCAL POLICY STANCE

Budgetary or fiscal policy involves changes that the government makes to the size and composition of its receipts/revenues and outlays/spending in order to achieve economic objectives.

The government uses its spending and outlays in an anti-cyclical way in order to support the economy and manage economic fluctuations. The budget outcome (the balance between revenue and outlays) gives a guide to the government’s fiscal stance.

The government manipulates its budget outcome through the changes that occur with the discretionary and automatic stabilisers which are built into each budget.

Discretionary stabilisers are those actions announced by the Treasurer in the budget which bring about some change to the level and composition of its revenues and expenses. Examples include a change to income and company tax rates or increasing education and health spending levels to achieve certain objectives.

Automatic stabilisers are also built into a budget and change according to the economic cycle. Income and company tax receipts, as well as welfare payments, are examples of automatic stabilisers. During periods of strong economic growth, revenue from tax collections increases and outlays on unemployment benefits are reduced. The government does not need to make any adjustments to its budget in order for these revenue and expenditure flows to take effect.

These automatic stabilisers act to increase budget surpluses when the economy is strong. They have the opposite effect when economic growth is slow and move the budget towards either a smaller surplus or into deficit.

<table>
<thead>
<tr>
<th>Table 17.1 - Commonwealth Budget Aggregates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts</td>
</tr>
<tr>
<td>$b</td>
</tr>
<tr>
<td>2007-08</td>
</tr>
<tr>
<td>2008-09</td>
</tr>
<tr>
<td>2009-10</td>
</tr>
<tr>
<td>2010-11</td>
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<tr>
<td>2011-12</td>
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<td>2012-13</td>
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<td>2013-14</td>
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<tr>
<td>2014-15</td>
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<tr>
<td>2015-16</td>
</tr>
<tr>
<td>2016-17</td>
</tr>
<tr>
<td>2017-18e</td>
</tr>
<tr>
<td>2018-19e</td>
</tr>
<tr>
<td>2019-20e</td>
</tr>
<tr>
<td>2020-21p</td>
</tr>
<tr>
<td>2021-22p</td>
</tr>
</tbody>
</table>

e - estimate; p - projection * includes Net Future Funds earnings

Source: 2018-19 Budget Paper 1 Statement 10 Table 1

Table 17.1 shows past and projected changes to the key budget aggregates and the budget stances taken by governments over the period shown.
COMMENTARY—RECENT TRENDS

The Fiscal Policy Stance

A major influence on the fiscal stance undertaken by governments over the last decade has been the Global Financial Crisis (GFC) which impacted the Australian economy in the latter months of 2009.

Pre-GFC Fiscal Stance (counter-cyclical)

The years up to 2008-09 coincided with Australia recording large budget surpluses (Refer to Table 17.1). The first phase of the mining boom and investment phase was taking place as China had started its initial expansion phase from 2004-05 which greatly increased its demand for mineral resources. This brought about high rates of economic growth within Australia and allowed automatic stabilisers to improve the budget outcome. Revenue windfalls in the form of increased company tax payments (partly due to the profits being made by the mining sector) and higher income tax payments due to the strength of the labour market also allowed the government to make discretionary changes to welfare and tax rates during this period.

The budget stance up to 2009 was very much counter-cyclical. The aim of the government was to use the surpluses to repay previously accumulated government debt and become an actual net lender (which it did during 2007-08 and 2008-09 - refer to Table 17.2) while at the same time, not allowing high levels of overseas demand to bring about excessive growth in the economy.
GFC Recovery Years (pro-cyclical)

The severity of the global economic downturn, which originated in the US economy in late 2009 and quickly spread to Europe, brought fears that Australia would also face a severe downturn to its economy. To counteract this, the government adopted a pro-cyclical expansionary stance and moved the budget into deficit. This trend of using large budget deficits to support growth started in 2008-09 and continued through until 2013-14. (Refer to Chart 17.1)

During these years, discretionary spending was used to support the economy. Receipts from automatic stabilisers were not as strong as during the pre-GFC period. As a share of GDP, receipts remained weak, falling to a low of 21.6 per cent in 2010-11. At the same time, outlays increased to be above 25 per cent of GDP. Budget outcomes (deficits) were consistently around 3.0 per cent.

During this period, the Commonwealth’s level of net debt grew steadily as governments used borrowing to finance budget deficits. From being a net lender in 2008-09, as a consequence of their deficits, governments accumulated debt which saw interest repayments required to service the debt rise (refer to Table 17.2). The increasing level of interest repayments also imposed a further burden on future budgets as funds each year needed to be allocated within the budget to finance interest repayments.

Deficit Reduction Period (neutral to mildly contractionary)

The 2014-15 budget marked a significant shift in the budget stance when compared with previous years.

Significant cuts to spending and increases to revenue were announced in order to change the structural components of the budget with the aim being to reduce the size of the deficit and have it close to surplus by the end of the 2017-18 financial year. (Refer to Chart 17.1).

The government’s aim was to start a process of fiscal consolidation.

This involved a strategy of moving budgets from deficits to surplus and using the surplus funds to pay back previously accumulated debt (as was the case prior to the GFC). This was to occur from 2018-19 onwards assuming that the budget returned to surplus.

### Table 17.2 - Commonwealth Net Debt and interest levels

<table>
<thead>
<tr>
<th></th>
<th>Net Debt</th>
<th>% of GDP</th>
<th>Net interest payments</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$b</td>
<td></td>
<td>$m</td>
<td></td>
</tr>
<tr>
<td>2007-08</td>
<td>-44.8</td>
<td>-3.8</td>
<td>-1015</td>
<td>-0.1</td>
</tr>
<tr>
<td>2008-09</td>
<td>-16.1</td>
<td>-1.3</td>
<td>-1195</td>
<td>-0.1</td>
</tr>
<tr>
<td>2009-10</td>
<td>42.3</td>
<td>3.3</td>
<td>2386</td>
<td>0.2</td>
</tr>
<tr>
<td>2010-11</td>
<td>90.7</td>
<td>6.4</td>
<td>4608</td>
<td>0.3</td>
</tr>
<tr>
<td>2011-12</td>
<td>153.4</td>
<td>10.3</td>
<td>6609</td>
<td>0.4</td>
</tr>
<tr>
<td>2012-13</td>
<td>159.6</td>
<td>10.4</td>
<td>8285</td>
<td>0.5</td>
</tr>
<tr>
<td>2013-14</td>
<td>209.9</td>
<td>13.1</td>
<td>10848</td>
<td>0.7</td>
</tr>
<tr>
<td>2014-15</td>
<td>245.8</td>
<td>15.2</td>
<td>10868</td>
<td>0.7</td>
</tr>
<tr>
<td>2015-16</td>
<td>303.5</td>
<td>18.3</td>
<td>12040</td>
<td>0.7</td>
</tr>
<tr>
<td>2016-17</td>
<td>322.3</td>
<td>18.3</td>
<td>12365</td>
<td>0.7</td>
</tr>
<tr>
<td>2017-18e</td>
<td>341.0</td>
<td>18.6</td>
<td>13128</td>
<td>0.7</td>
</tr>
<tr>
<td>2018-19e</td>
<td>349.8</td>
<td>18.4</td>
<td>14492</td>
<td>0.8</td>
</tr>
<tr>
<td>2019-20e</td>
<td>344.0</td>
<td>17.3</td>
<td>12226</td>
<td>0.6</td>
</tr>
<tr>
<td>2020-21p</td>
<td>334.3</td>
<td>16.1</td>
<td>12401</td>
<td>0.6</td>
</tr>
<tr>
<td>2021-22b</td>
<td>319.3</td>
<td>14.7</td>
<td>12175</td>
<td>0.6</td>
</tr>
</tbody>
</table>

e - estimate; p - projection

*Source: 2018-19 Budget Paper 1 Statement 10 Table 4*
Despite the government’s intentions for its 2014-15 budget it was unable to reduce the size of its deficit as first projected.

It ended the year with a deficit of $37.8 billion well above what was originally forecast ($29.7 billion).

This was due to declining revenue from automatic stabilisers and its inability to get key legislation through the Senate.

The 2015-16 Budget was projected to be in deficit by $35.1 billion but due to similar reasons as for the 2014-15 budget, its outcome for the year blew out to be $39.6 billion.

The 2016-17 Budget was forecast to be a deficit of $37.1 billion. Its final outcome for the year was a deficit of $33.1 billion (1.9 per cent of GDP).

The 2017-18 and 2018-19 Budgets

When delivering the 2017-18 budget, the Treasurer based the government’s fiscal policy stance on re-stating its aim to have the budget back in surplus by 2020-21 in order to restart the process of fiscal consolidation.

The estimated deficit for the 2017-18 year was expected to be $29.4 billion (1.6 per cent of GDP) and $21.4 billion (1.1 per cent of GDP) in 2018-19. A deficit of $2.5 billion (0.1 per cent of GDP) was projected in 2019-20 with a surplus of $7.4 billion (0.4 per cent of GDP) to occur in 2020-21.

When the May 2018-19 budget was released, the figures and projections for the period up to 2021-22 showed that the 2017-18 estimates and projections had altered significantly.

Table 17.1 shows that:

- the final budget outcome for 2017-18 is now estimated to be a deficit of $18.2 billion (1.0 per cent of GDP)
- the 2018-19 budget outcome is expected to be a deficit of $14.8 billion (0.8 per cent of GDP).
- the government expects that the budget will return to a surplus of $2.2 billion (0.1 per cent of GDP) in 2019-20.
- in 2020-21, a surplus of $10.9 billion (0.5 per cent of GDP) is projected and an even larger surplus of $16.6 billion (0.8 per cent of GDP) is projected to occur in 2021-22.

This improvement in the budget outcome is mostly due to increased receipts from income, company tax and superannuation payments and reduced government outlays on welfare benefits. This has resulted in a $35 billion improvement in the overall budget position over the next four years. However, about half of this gain will be returned to taxpayers through proposed tax cuts over the coming years.

The Treasurer has stated that the government’s goal is to eventually keep the receipts/revenue share as a proportion of GDP at 23.9 per cent.

The outlays/spending share is expected over the coming years to also fall. If the above is achieved, then the budget will remain in surplus.

The above implies that the budget stance over the next four years will be contractionary/less expansionary as the budget’s outcome (and its impact on the economy) as a proportion of GDP gets smaller. The government’s level of net debt will continue to increase until 2018-19 before falling once the budget moves into surplus in 2019-20. (Refer to Table 17.2). This will also bring about a fall in the level of net interest payments over time.

A problem with this budget (as with all budgets) is that for the desired outcomes to occur all forecasts that are built into the budget — in terms of revenue and outlays — must turn out as predicted.
It also assumes that:

- the government is able to get all its planned changes through the Senate
- there will not be any unforeseen variations in the economic cycle which will impact the automatic stabilisers built into the budget and cause a need for discretionary changes to take place

If the government does achieve its desired stance over the coming years, a consequence will be that fiscal policy will have a limited role in helping to regulate changes in the economic cycle. This will place a greater reliance on monetary policy to manage short-medium term adjustments which may occur.

EXAM SKILL BUILDER TIP — APPLYING THEORY TO A REAL WORLD CONTEXT

Policy-based questions often require students to explain an economic theory and then apply it in a real world context.

For example:

How can fiscal policy be used by the government to avoid an economic downturn?

A successful approach to the above question would be to:

- Firstly explain in theory how fiscal policy can be used in an expansionary way to avoid an economic downturn (running a budget deficit)
- Use your knowledge of recent budget outcomes to illustrate your point.

It is important that you have developed a good level of understanding of recent budget outcomes or the stances associated with them. If you have been provided with some stimulus material, use it to support your answer.

This is a skill that needs to be practiced throughout the year!
MULTIPLE CHOICE

(Circle the alternative that most fully and correctly answers the following questions)

1. Two signs that the Commonwealth Government is adopting an expansionary fiscal/budgetary stance would be:
   a. higher tax rates and lowered levels of government spending;
   b. lower tax rates and increased levels of government spending;
   c. higher interest rates and lower levels of government spending;
   d. lower interest rates and increased levels of government spending;

2. At the bottom of the business cycle the government's budget is most likely to be in:
   a. surplus because of increased levels of revenue received through automatic stabilisers and a reduced need to spend on discretionary stabilisers;
   b. surplus because of increased levels of revenue received through automatic stabilisers and an increased need to spend on discretionary stabilisers;
   c. deficit because of reduced levels of revenue received through automatic stabilisers and an increased need to spend on discretionary stabilisers;
   d. deficit because of reduced levels of revenue received through automatic stabilisers and a decreased need to spend on discretionary stabilisers.

3. During the expansion phase of the business cycle which of the following should increase automatically?
   a. personal income tax rates;
   b. government consumption expenditure;
   c. the size of the budget deficit;
   d. the amount of company tax receipts.

4. Which of the following will move the budget outcome towards a surplus?
   a. a rise in the level of unemployment in Australia;
   b. the indexation of fuel excise taxes;
   c. an increase in child-care rebates;
   d. a rise in interest rates.
EXTENDED RESPONSE QUESTIONS

1. Use your text to find a definition of budgetary policy?

2. Explain the meaning of the terms:
   - underlying cash balance
   - budget surplus
   - budget deficit
   - counter-cyclical policy
   - automatic and discretionary stabilisers
   - budget stance

3. What is meant by the term ‘fiscal consolidation’?

4. Explain the strategy that the government is adopting in order to be in a position to start repaying debt in 2020-21 (include data from the Tables and Chart in this section to support your answer).

5. How will the government’s fiscal policy stance over the next four years impact its ability to use the policy as a counter cyclical demand management tool?

Answers: 1b 2c 3d 4b 5c 6c
18. THE 2018—19 COMMONWEALTH BUDGET

The 2018-19 Budget is forecast to be in deficit with an underlying cash balance of −$14.6 billion. This will make it the eleventh consecutive deficit since the budget was last in surplus in 2007-08. The government’s aim with this budget is to reduce the size of the deficit over the coming years and move back into surplus in order to start a program of fiscal consolidation from 2020-21.

Budget Forecasts and Forecasting Errors

When framing a budget, the Treasurer relies on the economic forecasts that are made by Treasury. These forecasts underpin the revenue estimations and outlay commitments which the treasurer makes when delivering the budget. Also they form the basis of the projections for the years following the current budget. Forecasting accuracy is required if the actual outcome announced in the budget is to be achieved. Amendments to forecasts greatly affect the final budget outcome.

Table 18.1 summarises the changes that have been made to the original 2017-18 budget forecasts, with revised forecasts as announced in the recent budget, shown in brackets for that year.

<table>
<thead>
<tr>
<th>Table 18.1 - Detailed Budget Economic Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Real GDP</td>
</tr>
<tr>
<td>GNE</td>
</tr>
<tr>
<td>Household Consumption</td>
</tr>
<tr>
<td>Business Investment</td>
</tr>
<tr>
<td>Employment</td>
</tr>
<tr>
<td>Unemployment rate</td>
</tr>
<tr>
<td>Participation rate</td>
</tr>
<tr>
<td>Inflation</td>
</tr>
<tr>
<td>CAD per of GDP</td>
</tr>
<tr>
<td>Terms of Trade</td>
</tr>
<tr>
<td>Exports of goods and services</td>
</tr>
<tr>
<td>Imports of goods and services</td>
</tr>
<tr>
<td>Net Exports (% contribution to GDP)</td>
</tr>
</tbody>
</table>

*2017-18 figures in brackets show the adjusted 2017-18 forecast figures following the release of the 2018-19 budget. Source: Budget Papers 2018-19 Budget Overview - Appendix H: Detailed Economic Forecasts

As the table shows, some significant revisions have occurred. For example, when the budget was released in May 2017, it forecast that real GDP growth for 2017-18 would be 2.8 per cent which as the Table shows was accurate. However, GNE grew at 3.0 per cent compared with the Budget forecast of 2.5 per cent. Business Investment grew strongly (4.5 per cent), unemployment fell (5.5 per cent), the participation rate was higher than expected and the terms of trade had a positive impact rather than a negative impact on the economy. As result of the above both income and company tax receipts were higher than originally forecast and outlays on welfare benefits were lower.

Why does this happen?

As has been shown above, during the course of a financial year many of the original forecasts can be altered as a result of changed economic circumstances.

Unforeseen events such as natural disasters can add to government spending. Also the inability of the government to get key changes to legislation through the Senate will also impact forecast receipts.
Lower than expected inflation will impact on wages growth, which can affect income tax receipts as well as other receipts that are linked closely to inflation. Furthermore, extra grants to the States for health and education, the expansion of pharmaceutical benefits and extra defence spending can also add to budget outlays during the course of a year.

Alternatively better than anticipated growth can quickly alter the originally forecast outlays and revenue figures which will impact the overall outcome as was the case during 2017-18.

The combination of these revenue and spending changes can cause the final expected budget outcome figure to change when compared with the original forecast made when the budget was released in May of the preceding year.

The 2018-19 Budget Economic Forecasts

The most significant figure when looking at the forecasts for 2018-19 and 2019-20 are those for Real GDP.

Treasury and the government anticipate that growth will increase to 3.0 per cent in 2018-19 and 3.0 per cent in 2019-20) and therefore will be closer to trend (3.0 – 3.25 per cent) over the next two years. Internal demand as measured by GNE (3.0 per cent and 3.0 per cent) will be a key driver of growth. If this occurs employment will grow (1.5 per cent in each year). The unemployment rate will drop from its current level to be around 5.25 per cent. Inflation will remain subdued. Net exports will continue to make a positive contribution to GDP with exports growing at a faster rate than imports despite a weakening in the terms of trade.

Some key initiatives announced in the 2018-19 Budget included:

Tax

- Cuts to personal income tax rates via a seven-year tax plan. This will in the short run provide lower tax rates for low and middle income earners and over time address problems associated with bracket creep by abolishing the 37 per cent tax bracket.
  - Australians earning up to $90 000 will get a tax cut worth up to $530 next year although it will be paid as a lump sum when tax returns are submitted.
  - The threshold for workers to pay 37 cents in the dollar to rise from $87 000 to $90 000 next year before rising again to $120 000 in 2022-23
  - The 37 per cent tax rate to be abolished entirely in 2024-25, when all Australians earning up to $200 000 will only pay 32.5 cents in the dollar
- Multinational companies will be stopped from shifting profits to lower taxing countries
- Extending the $20 000 instant asset write-off provisions for small businesses
- Better targeting the Research and Development Tax Incentive
- Targeting organised crime and tax evasion by establishing a Black Economy Task Force

Infrastructure

- Implementation of a $75 billion, 10-year national infrastructure plan which will improve road safety, tackle congestion and deliver essential rail links both within the major cities and across regional Australia.
- Improving water infrastructure and the accuracy of GPS for regional Australians
- $200 million for a third round of the Building Better Regions Fund, which supports regional infrastructure and community investments.

Health

- The More Choices for a Longer Life Package includes online interactive 45 and 65 year checks across key areas of skills, finances and health, which will allow Australians to plan ahead to get the most out of their longer lives, while having the flexibility to remain in the workforce if they choose.
- 14 000 additional home-care packages for older people with high level needs. This will include support for the mental health of older Australians and will help them to remain in their homes and connected to the community.
- A new public hospital agreement will deliver more than $30 billion in additional funding between 2020-21 and 2024-25.
Funding for the Medicare Benefits Schedule (MBS) and the Pharmaceutical Benefits Scheme (PBS) is guaranteed through the Government legislated Medicare Guarantee Fund with $34.4 billion being credited to the Fund for the current year and a further credit of $35.3 billion will be made to meet estimated MBS and PBS expenditure for 2018-19.

Environment

- New funding for biosecurity and better management of pests and weeds
- Investing more than $500 million to secure the future of the Great Barrier Reef and the jobs it supports, including through improving water quality, combating crown-of-thorns starfish and conducting scientific research.

Education

- Skills Checkpoint for Older Australians — support for older workers to maintain and upgrade skill levels to allow them to stay in the workforce longer
- Increased levels of needs-based school funding to achieve better results for Australian students and to provide more support. This will be achieved through the $24.5 billion Quality Schools package.

Research and Development

- Supporting medical research through the establishment of a 21st Century Medical Industry Growth Plan which will deliver $1.3 billion to support Australia as a global health industry leader in medical technology, biotechnology and pharmaceuticals while improving health outcomes for all Australians through investments in medical innovation.

The impact that the above and other measures will have on the budget over the next four years can be seen below.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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<th></th>
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<tbody>
<tr>
<td>Personal Income Tax Plan</td>
<td>0.0</td>
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<td>-400.0</td>
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<td>Black Economy Package – Combatting Illicit Tobacco</td>
<td>0.0</td>
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<td>Better targeting the Research and Development Tax Incentive</td>
<td>0.0</td>
<td>314.2</td>
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<tr>
<td>Black Economy Package — New and enhanced ATO enforcement against the Black Economy</td>
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<td>0.0</td>
<td>180.0</td>
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<td>276.5</td>
<td>276.8</td>
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<tr>
<td>Protecting Your Super Package — changes to insurance in superannuation</td>
<td>0.0</td>
<td>0.0</td>
<td>223.8</td>
<td>228.0</td>
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<td>A firm stance on tax and superannuation debts</td>
<td>0.0</td>
<td>-149.3</td>
<td>-152.2</td>
<td>-156.0</td>
<td>-159.8</td>
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<td>Black Economy Package — further expansion of taxable payments reporting</td>
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<td>Superannuation — better integrity over deductions for personal contributions</td>
<td>-0.4</td>
<td>89.1</td>
<td>109.2</td>
<td>109.5</td>
<td>119.5</td>
<td>426.9</td>
</tr>
</tbody>
</table>
The intent of the above changes is to reduce the size of the deficit over the coming year and allow the budget to move into surplus in 2019-20.

Impact on the Economy

The budget by its nature and stance should theoretically have a less expansionary/contractionary impact on the economy over the coming years. The smaller deficits and move into surplus will mean that fiscal policy may not play as big a part as a demand management tool as it did in the years following the GFC and up to 2014-15.

However, the funding for major infrastructure spending and proposed tax cuts will act to provide stimulus to the economy and will somewhat offset the dampening effects which are normally associated with smaller budget deficits and surpluses. Also, less ‘crowding out’ (when the budget returns to surplus) will occur as the government will not be competing for funds to finance its spending. This should reduce interest rate pressures in finance markets.

Impact on Income Distribution

The announced changes are not expected to significantly impact income distribution. In the short term, the tax cuts for low to middle income earners will help to close the gap between them and those on higher incomes. However, the full impact of the changes will not take effect for another seven years and, when they are fully implemented, will favour higher income earners more than those on lower to middle incomes.

The decision by the government to no longer increase the Medicare levy (as proposed in last year’s budget) will be of benefit to low income households.

Other initiatives such as cheaper pharmaceuticals and higher levels of support for elderly Australians will help some of the more vulnerable members of our community.

Impact on Employment

The effect of giving tax cuts to low and middle income earners — who tend to have a higher marginal propensity to consume any increase in their income — should result in higher levels of consumption spending, which will support growth and demand for workers.

Combined with the continued support for small business (through the small business asset write-off provision) and the high levels of spending on infrastructure, these initiatives should be beneficial to employment and continued jobs growth.

Major infrastructure spending will also have linkage effects to other sectors of the economy, further adding to jobs growth as a result of productivity improvements and efficiencies, which will result from the projects once they are completed. However, the unemployment figure, as projected by Treasury in its forecasts, is not expected to fall significantly mostly due to higher participation rates.
Concluding Comments

As previously stated, the Government’s intention is to reduce the size of the budget deficit and to commence a program of fiscal consolidation when the budget returns to surplus in 2019-20. By bringing about budget surpluses, there will be less need for government borrowing, which will take pressure off credit markets.

The budget is designed to alter some of the structural components associated with spending and revenue. The argument presented by the Government is that by making adjustments now, it will be easier to move the budget into a sustainable surplus in the future and in doing so, avoid imposing an unnecessary burden on future generations.

The main uncertainty associated with the current budget is the reliability of the forecasts on which the budget is based. Should GDP growth targets not be reached then the impact on automatic stabilisers, such as income and company taxation receipts, will see the budget situation deteriorate and the ability of governments to return the budget to surplus in 2019-20 will be once more delayed.

Added to this is the international outlook as well as the political uncertainty of having a minority government in the Senate. If the international economy were to enter a period of instability as a result of ongoing problems, then this could also result in lower than expected world growth, which would affect Australia’s growth rate.

EXAM SKILL BUILDER TIP – KNOW WHAT HAS BEEN RECENTLY ANNOUNCED

Questions relating to the budget assume that students are aware of any key changes or initiatives that have been announced in the latest budget.

You are not expected to know all the details of the budget, but you should have knowledge about:

- the budget outcome and the government’s stance;
- any major announcements e.g. a new tax;
- any significant changes e.g. a change to income tax rates or welfare eligibility, the impact that the budget will have on such things as the distribution of income, resource allocation, business and consumer confidence levels;
- be aware of some of the budget’s projections for the coming year(s) such as GDP growth, the inflation rate, the size of the current account deficit, unemployment levels and future budget outcomes.

Remember to focus on the big picture and not on the fine detail contained within the budget.
MULTIPLE CHOICE

(Circle the alternative that most fully and correctly answers the following questions)

1. The largest percentage of Commonwealth Government budget revenue comes from:
   a. the Goods and Services Tax (GST);
   b. Pay As You Go (PAYG) tax receipts;
   c. company taxes;
   d. fuel excise taxes.

2. Which of the following budget actions will help to expand the supply side of the economy:
   a. a reduction in government spending on infrastructure;
   b. a lowering of company tax rates;
   c. a reduction in interest rates;
   d. the abolition of export subsidies.

3. Fuel excise is an example of:
   a. a direct and progressive tax;
   b. a direct and regressive tax;
   c. an indirect and regressive tax;
   d. an indirect and progressive tax.

4. A weakness of fiscal policy is that it:
   a. can only operate indirectly to affect household incomes;
   b. cannot be used to target specific areas of the economy;
   c. is subject to political influence;
   d. relies on discretionary changes to affect economic activity.
5. Refer to the following data for Country A:

<table>
<thead>
<tr>
<th>Year</th>
<th>Government revenue</th>
<th>Government outlays</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$900b</td>
<td>$890b</td>
</tr>
<tr>
<td>2</td>
<td>$910b</td>
<td>$930b</td>
</tr>
<tr>
<td>3</td>
<td>$950b</td>
<td>$980b</td>
</tr>
</tbody>
</table>

Which of the following statements about Country A is true?

a. a deficit occurred in Years 2 and 3 but not in Year 1;

b. the surplus got bigger each year;

c. the budget was always in surplus;

d. Country A was able to achieve an overall surplus.

6. The 2018-19 budget stance could be described as being:

a. expansionary;

b. contractionary;

c. neutral;

d. deflationary.

Answers: 1b 2b 3c 4c 5a 6b
EXTENDED RESPONSE QUESTIONS

1. Check the meaning of the following by referring to your textbook:
   - budget revenue;
   - budget outlays;
   - budget outcome
   - underlying cash balance.

2. Provide examples of automatic stabilisers/cyclical factors and discretionary measures from the 2018-19 Budget.

3. What role do Treasury forecasts play in the setting of the budget?

4. How could a change in economic conditions affect the Treasury forecasts and the budget outcome?

5. Outline how the 2018-19 Budget will affect the following: (You may wish to visit the budget website to assist in your research at www.budget.gov.au)
   - equity in the distribution of personal income;
   - price stability;
   - employment and labour productivity;
   - the rate of economic growth;
   - resource allocation.

6. Explain how the moves towards smaller deficits and eventually to budget surpluses and fiscal consolidation could affect:
   - government debt levels;
   - interest rates.

7. ‘Increasing the nation’s productive capacity is necessary if Australia is to maintain growth without threatening inflation.’
   Outline how the recent budget will affect the nation’s productive capacity.
The Reserve Bank of Australia (RBA) has as its primary function the implementation of monetary policy.

The RBA assists the government to achieve its economic objectives by influencing the cost and availability of credit in finance markets and monitoring the value of the Australian dollar. It affects the cost and availability of funds through changes to the interest rate for cash in the overnight money market. By altering the cash rate (through the process of buying and selling government securities) the RBA influences the cost of funds and consequently the demand for credit, which results in changes to levels of spending, investment and economic activity.

Since the RBA has set inflation targets as part of its management of the economy, it uses changes to interest rates as a pre-emptive tool and as a short-term instrument of policy. This is achieved by minimising factors, which could bring about rises in the inflation rate such as excessive demand pressures. By raising interest rates in advance of demand pressures becoming excessive, future problems for the economy may be avoided or their harmful effects can be minimised. On the other hand the easing of interest rates by the RBA seeks to support economic growth and jobs in times when economic activity is weak.

Table 19.1 - Key Interest Rates and GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Target Rate</th>
<th>Home Loan Rate</th>
<th>Large Business Loan Rate</th>
<th>GDP</th>
<th>Financial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>As at June</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>7.25</td>
<td>9.45</td>
<td>8.10</td>
<td>3.6</td>
<td>2007-08</td>
</tr>
<tr>
<td>2009</td>
<td>5.00</td>
<td>7.30</td>
<td>8.80</td>
<td>1.3</td>
<td>2008-09</td>
</tr>
<tr>
<td>2010</td>
<td>4.50</td>
<td>6.45</td>
<td>10.30</td>
<td>2.0</td>
<td>2009-10</td>
</tr>
<tr>
<td>2011</td>
<td>4.50</td>
<td>7.80</td>
<td>10.65</td>
<td>2.0</td>
<td>2010-11</td>
</tr>
<tr>
<td>2012</td>
<td>3.75</td>
<td>7.00</td>
<td>10.00</td>
<td>5.0</td>
<td>2011-12</td>
</tr>
<tr>
<td>2013</td>
<td>2.75</td>
<td>6.25</td>
<td>9.25</td>
<td>1.2</td>
<td>2012-13</td>
</tr>
<tr>
<td>2014</td>
<td>2.50</td>
<td>6.00</td>
<td>9.00</td>
<td>3.1</td>
<td>2013-14</td>
</tr>
<tr>
<td>2015</td>
<td>2.00</td>
<td>5.50</td>
<td>8.50</td>
<td>2.2</td>
<td>2014-15</td>
</tr>
<tr>
<td>2016</td>
<td>1.75</td>
<td>5.25</td>
<td>8.25</td>
<td>2.5</td>
<td>2015-16</td>
</tr>
<tr>
<td>2017</td>
<td>1.50</td>
<td>5.00</td>
<td>8.00</td>
<td>1.8</td>
<td>2016-17</td>
</tr>
<tr>
<td>May 2018</td>
<td>1.50</td>
<td>5.00</td>
<td>8.00</td>
<td>2.8</td>
<td>2017-18</td>
</tr>
</tbody>
</table>


Table 19.1 shows that changes to interest rates have been a major factor influencing economic growth over the period shown.

The economy experienced generally prosperous economic times up to 2008 and on a small number of occasions, inflation even exceeded the RBA target range. During this period the cash interest rate was increased frequently in order to pre-empt inflationary pressures and keep the inflation rate within its target zone of 2–3 per cent.

The global financial crisis meant that both the world and domestic economies experienced a marked contraction in late 2008 and early 2009, with large declines in industrial production and international trade. In Australia’s case, this downturn was largely accounted for by substantial falls in consumer and business confidence.
The RBA responded to the domestic and worldwide deterioration by easing monetary policy significantly. The cash rate fell from 7.25 per cent in March 2008 to 3.0 per cent by April 2009 (a level not seen since the 1960s). The cuts in interest rates together with the substantial fiscal initiatives undertaken by the government of the day provided significant support to domestic demand by boosting both consumer and business confidence.

By late 2009 and throughout 2010 the Reserve Bank started to raise cash rates back to ‘normal’ levels (between 4 and 5 per cent) as it became evident that the economy had entered a recovery phase.

This stance altered in the second half of 2012 as the economy showed signs of a slowdown. This was partly due to uncertainties associated with the weak US recovery and European debt and signs that the Chinese economy had ‘slowed’ which affected demand for Australian resources.

As a response, the Reserve Bank started a series of interest rate cuts which by the end of 2012 brought about a target cash rate figure of 3.0 per cent.

**COMMENTARY**

**GFC Recovery Years**

Between 2013 and 2015, the economy was undergoing a period of adjustment following the impact of the GFC. Unemployment reached a high of around 5.5 per cent during 2013 which encouraged the Reserve Bank to cut rates to 2.5 per cent. Continued weakness in the economy during 2014 brought about further cuts with the cash rate reaching a low of 2.0 per cent by May 2015.

The justification used by the Reserve Bank was to provide the economy with stimulus at a time when the economy was transitioning/rebalancing from the ending of the mining/investment phase that it had experienced until 2013. Its aim was to allow the more traditional drivers of growth such as housing, construction and retail spending to become the main supporters of growth in the economy.

The RBA hoped that the lower cash rate would bring about a fall in the value of the Australian dollar which would provide assistance to the tourism, education and manufacturing sectors of the economy. Of significance was the fact that the economy was also experiencing low inflation rates, which gave the RBA greater flexibility in using interest rates as a pro-cyclical tool for economic management.

This approach was effective with the value of the dollar falling to around US$0.70 by the end of 2015.

Despite record low interest rates, the economy continued to experience below trend growth during 2015 and 2016. Unemployment steadily rose. A combination of weaker demand for labour in the mining sector and continued high numbers of migrants entering the country and needing to be absorbed into the labour force, affected labour demand and the nature of employment. Part-time jobs numbers were growing at a faster rate than those for full-time during this period. The level of underemployment rose as a result. At the same time, inflation fell below the RBA’s target zone.

The Reserve Bank responded during the year by making further cuts to interest rates in May (−0.25 per cent) and August (−0.25 per cent). The result was that the official rate was set at an historic low of 1.5 per cent and is still at this level.

**Current Stance**

Since the start of 2017 the international outlook has showed signs of improved world growth. Domestic inflation has been just below the Reserve Bank’s target range and economic growth has been moving closer to trend 3.2 per cent.

It is also becoming evident that the aim of rebalancing the economy away from depending on mining investment to other sectors has been relatively successful. The housing, construction and retail sectors have responded to consumers and investors taking advantage of the record low rates on offer. Business (non-mining) investment is also recovering.

The rebalancing process has not been uniform across the nation. Western Australia and Queensland, which previously were drivers of growth have seen a significant slowdown. New South Wales and Victoria have once again resumed their traditional roles as the engines of the economy (partly driven by migration growth).
A complication for the RBA has been the sharp increase in property values in Sydney, Melbourne and Brisbane over recent years (although some signs of moderation in house price growth is starting to emerge). Record low interest rates and population growth have brought about high levels of demand for housing and a subsequent rise in mortgage levels which has brought about ‘mortgage-stress’ for many borrowers. This has created a problem for the RBA and shows one of the weaknesses of monetary policy as a tool for economic management because interest rate changes are broad in nature in terms of their impact.

Some economists have argued that the currently better performing economy should be used by the Reserve Bank to raise official interest rates in order to give it greater capacity to use them should economic circumstances change. However a downside of such a move would be that it would impact the exchange rate causing it to appreciate in value at a time when rate sensitive sectors such as tourism and education (and related employment) are benefitting from the fall in the value of the currency which has occurred since 2016.

‘Assisting’ the Reserve Bank over the last twelve months has been the decision by the US Federal Reserve to raise official US interest rates, which has narrowed the gap between Australian and US rates. This has caused the US dollar to appreciate in value against the Australian dollar so that the current exchange rate is at a level which makes local producers and exporters more competitive in world markets.

It therefore allows the Reserve Bank to maintain its low official interest rate level and provide stimulus to the economy at a time when the fiscal stance is becoming less expansionary. As long as inflation remains at current levels and wage growth remains subdued, the Reserve Bank will be able to maintain its current stance.

EXAM SKILL BUILDER TIP – EVALUATING STRENGTHS AND WEAKNESSES

The evaluation of the strengths and weaknesses of two policies is a common examination question in Economics. When making an evaluation, the examiner is asking you to make a comparison and come up with some kind of conclusion.

For example:

*Evaluate the strengths and weaknesses of monetary and fiscal policy when tackling the problem of rising unemployment.*

A properly structured response would:

- provide a brief definition of each policy;
- briefly outline the main causes and types of unemployment;
- outline one or two strengths of each policy as a way of tackling each type of unemployment;
- provide some sort of conclusion about which policy may be more effective at tackling each type.
MULTIPLE CHOICE

(Circle the alternative that most fully and correctly answers the following questions)

1. The main tool of monetary policy used by the Reserve Bank to bring about changes to the level of economic activity is:
   a. the discretionary stabilisers it adjusts through the budget;
   b. changes to the exchange rate;
   c. variations it makes to the target cash rate;
   d. persuasion — talking to the financial community about the state of the economy.

2. Higher domestic interest rates will:
   a. reduce the household savings ratio;
   b. reduce household disposable incomes and increase spending levels;
   c. discourage foreign investment and weaken the value of the Australian dollar;
   d. slow economic activity and bring about higher levels of unemployment.

3. Monetary policy in Australia is primarily focused on:
   a. the rate of economic growth;
   b. external stability;
   c. full employment;
   d. price stability (stability of the currency).

4. The Reserve Bank adopts a tighter monetary policy stance when:
   a. unemployment rises significantly;
   b. the rate of inflation moves above its target range;
   c. the exchange rate appreciates;
   d. the size of the budget surplus increases.
5. If the Reserve Bank undertakes sales of securities in the overnight cash money market, this will tend to:
   a. increase market liquidity and bring about lower interest rates;
   b. increase market liquidity and bring about higher interest rates;
   c. decrease market liquidity and bring about higher interest rates;
   d. decrease market liquidity and bring about lower interest rates.

6. A strength of monetary policy when used to tackle demand inflation is that it is:
   a. quick to enact and broad;
   b. quick to enact and can be targeted;
   c. slow to enact but broad;
   d. slow to enact but can be targeted.

Answers: 1c 2d 3d 4b 5c 6a

EXTENDED RESPONSE QUESTIONS

1. Explain the economic relationship between interest rates and the level of economic activity.

2. Use your textbook to explain how the Reserve Bank of Australia alters its target cash rate.

3. Evaluate the effectiveness of using changes in interest rates to raise the level of economic activity.

4. Outline the Reserve Bank’s current stance on interest rates. Why has it adopted this approach?

5. Evaluate the strengths and weaknesses of monetary policy and fiscal policy when tackling the problem of rising unemployment.
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