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 keep future budgets in surplus. If achieved, this will allow it to commence a process of ‘fiscal consolidation’ – i.e. moving the budget back into surplus and using surplus funds to reduce the level of debt that has been accumulated as a result of previous deficit budgets.

Monetary policy still has its focus on inflation targeting and has been more accommodating with lower interest rates due to the low levels of inflation and to support the economy as it seems to have finally transitioned from the mining investment ‘boom’ phase which ended in 2014-15.

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

This 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.

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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 17.1 - Commonwealth Budget Aggregates

<table>
<thead>
<tr>
<th>Year</th>
<th>Receipts $b</th>
<th>% of GDP</th>
<th>Outlays $b</th>
<th>% of GDP</th>
<th>Budget Outcome $b</th>
<th>% of GDP</th>
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</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>294.9</td>
<td>24.9</td>
<td>271.8</td>
<td>22.9</td>
<td>19.7</td>
<td>1.7</td>
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<tr>
<td>2008-09</td>
<td>292.6</td>
<td>23.3</td>
<td>316.0</td>
<td>25.2</td>
<td>-27.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>2009-10</td>
<td>284.6</td>
<td>22.2</td>
<td>336.9</td>
<td>26.2</td>
<td>-54.7</td>
<td>-4.3</td>
</tr>
<tr>
<td>2010-11</td>
<td>302.0</td>
<td>21.6</td>
<td>346.1</td>
<td>24.7</td>
<td>-47.7</td>
<td>-3.4</td>
</tr>
<tr>
<td>2011-12</td>
<td>529.9</td>
<td>22.2</td>
<td>371.3</td>
<td>25.1</td>
<td>-44.4</td>
<td>-3.0</td>
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<tr>
<td>2012-13</td>
<td>351.0</td>
<td>23.1</td>
<td>367.2</td>
<td>24.1</td>
<td>-18.3</td>
<td>-1.2</td>
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<td>2013-14</td>
<td>360.3</td>
<td>22.7</td>
<td>406.4</td>
<td>25.6</td>
<td>-48.5</td>
<td>-3.0</td>
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<tr>
<td>2014-15</td>
<td>378.3</td>
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<td>412.0</td>
<td>25.5</td>
<td>-37.8</td>
<td>-2.3</td>
</tr>
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<td>2015-16</td>
<td>386.9</td>
<td>23.4</td>
<td>423.3</td>
<td>25.5</td>
<td>-59.6</td>
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<tr>
<td>2016-17</td>
<td>409.9</td>
<td>23.8</td>
<td>439.7</td>
<td>25.0</td>
<td>-83.1</td>
<td>-1.9</td>
</tr>
<tr>
<td>2017-18</td>
<td>446.9</td>
<td>24.2</td>
<td>452.7</td>
<td>24.5</td>
<td>-10.1</td>
<td>-0.5</td>
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<tr>
<td>2018-19</td>
<td>493.2</td>
<td>25.0</td>
<td>482.7</td>
<td>24.9</td>
<td>-4.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>2019-20</td>
<td>505.3</td>
<td>25.2</td>
<td>493.3</td>
<td>24.6</td>
<td>7.1</td>
<td>0.4</td>
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<tr>
<td>2020-21</td>
<td>522.3</td>
<td>25.1</td>
<td>511.3</td>
<td>24.6</td>
<td>11.0</td>
<td>0.5</td>
</tr>
<tr>
<td>2021-22</td>
<td>551.0</td>
<td>25.4</td>
<td>533.2</td>
<td>24.5</td>
<td>17.8</td>
<td>0.8</td>
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<tr>
<td>2022-23</td>
<td>566.9</td>
<td>25.0</td>
<td>557.7</td>
<td>24.5</td>
<td>9.2</td>
<td>0.4</td>
</tr>
</tbody>
</table>

* includes Net Future Funds earnings

Source: 2019-20 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) hovered just above or below 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.
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.

A similar pattern occurred with the budgets of 2015-16 and 2016-17. Forecast deficits ended up being different to their actual outcomes. The 2015-16 deficit was $39.6 billion (forecast $35.1 billion) while the 2016-17 budget deficit was $33.1 billion (forecast $37.1 billion).

The 2017-18 budget was expected to be a deficit of $29.4 billion or 1.6 per cent of GDP. However the actual outcome for the year was a deficit of $10.1 billion (0.5 per cent of GDP).

The improvement in the budget outcome was mostly due to higher levels of receipts. Automatic stabilisers such as income and company tax payments rose due to increased numbers of Australians being employed and strong growth which increased company profitability. This allowed the receipts share of GDP to rise at a faster rate than outlays. (Refer to Table 17.1).

The 2018-19 and 2019-20 Budgets

When the May 2018-19 budget was released, the budget was forecast to end the upcoming financial year with a deficit of $14.6 billion. (-0.7 per cent of GDP). According to the recently released budget it will be a deficit of $4.2 billion. (-0.2 per cent of GDP).

This improvement in the budget outcome is mostly due to increased receipts from automatic stabilisers such as income and company tax and reduced government outlays on welfare benefits and the NDIS. The improvement in receipts saw its size relative to GDP increase from 24.2 per cent in 2017-18 to 25.0 per cent in 2018-19. Outlays over the two year period also rose but not as fast as the rate of increase in receipts. (Refer to Table 17.1).

The 2019-20 budget outcome is forecast to be a surplus of $7.1 billion or 0.4 per cent of GDP. Receipts for the year are expected to increase to be equal to 25.2 per cent of GDP while outlays will fall from 24.9 per cent of GDP to 24.6 per cent. This trend of higher receipts relative to outlays is forecast to continue over the next three years and will allow the government to achieve ongoing surpluses during those years.

The above implies that the budget stance over the next four years will be contractionary. The government’s level of net debt is expected to start falling during 2019-20 and continue to do so as long as future budgets remain in surplus and funds are used to repay debt. (Refer to Table 17.2). This will also bring about a fall in the level of net interest payments over time. The government projects that if the above occurs and debt is repaid that government net debt should be eliminated by 2030.

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:

- following the upcoming federal election that there are no significant changes to government policy settings;
- 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.
5. A federal budget is in surplus when:
   a. current government expenditure is greater than government capital expenditure;
   b. outlays are greater than revenues;
   c. revenues are greater than outlays;
   d. direct tax receipts are greater than indirect tax receipts.

6. The underlying budget balance refers to:
   a. the budget outcome adjusted for inflation;
   b. the budget outcome adjusted for changes in interest rates;
   c. the budget outcome adjusted for the effects of asset sales;
   d. the budget outcome less spending on imports.

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

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 2019-20 (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?
18. THE 2019–20 COMMONWEALTH BUDGET

The 2019-20 Budget is forecast to be a surplus with an underlying cash balance of $7.1 billion. If achieved, it will be the first budget surplus after twelve consecutive deficits since 2007-08. The government’s aim with this budget is to keep the budget in surplus over the coming years in order to start a program of fiscal consolidation.

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 2018-19 budget forecasts, with revised forecasts as announced in the recent budget, shown in brackets for that year.

### Table 18.1 - Detailed Budget Economic Forecasts

<table>
<thead>
<tr>
<th></th>
<th>Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018-19</td>
</tr>
<tr>
<td>Real GDP</td>
<td>3.0 (2.25)</td>
</tr>
<tr>
<td>GNE</td>
<td>3.0 (3.5)</td>
</tr>
<tr>
<td>Household Consumption</td>
<td>2.75 (2.25)</td>
</tr>
<tr>
<td>Business Investment</td>
<td>3.0 (1.0)</td>
</tr>
<tr>
<td>Employment</td>
<td>1.5 (2.0)</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.25 (5.6)</td>
</tr>
<tr>
<td>Participation rate</td>
<td>65.5 (65.5)</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.25 (1.5)</td>
</tr>
<tr>
<td>CAD per GDP</td>
<td>-2.3 (-1.75)</td>
</tr>
<tr>
<td>Terms of Trade</td>
<td>-5.25 (4.0)</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>4.0 (3.5)</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>2.0 (1.5)</td>
</tr>
<tr>
<td>Net Exports (% contribution to GDP)</td>
<td>0.25 (0.5)</td>
</tr>
</tbody>
</table>

*2018-19 figures in brackets show the adjusted 2018-19 forecast figures following the release of the 2019-20 Budget. Source: Budget Papers 2019–20 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 2018, it forecast that real GDP growth for 2018-19 would be 3.0 per cent. The expected figure has been adjusted down to 2.25 per cent. However, GNE grew at 3.5 per cent compared with the Budget forecast of 3.0 per cent. Business Investment was only 1.0 per cent compared with the original forecast figure of 3.0 per cent.

The unemployment figure was below the figure released in May last year. The terms of trade improved (4.0 per cent) which boosted the economy during the year. As a result of better than expected employment growth and higher levels of company profits (partly due to the unexpected terms of trade improvement) 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.

Lower than anticipated growth can quickly alter the originally forecast outlays and revenue figures, which will impact the overall budget outcome.

However slower growth (affecting receipts) can be offset by an improvement in the terms of trade which will result in higher export earnings, increased company profits and therefore extra revenue flowing to the government as companies pay more tax. Similarly an improved labour market will bring about higher levels of income tax payments and lower welfare payments being made.

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

The 2019-20 Budget Economic Forecasts

The most significant figure when looking at the forecasts for 2019-20 and 2020-21 is Real GDP.

Treasury and the government anticipate that growth will increase to 2.75 per cent in 2019-20 and stay the same in 2020-21. This is well below the nation’s long term trend rate (3.0 - 3.25 per cent).

Internal demand as measured by GNE (2.5 per cent and 2.75 per cent for the next two years) will be a key driver of growth. If this occurs employment will grow (1.75 per cent in each year). The unemployment rate will stay at its current level of 5.0 per cent and the participation rate is expected to stay at its current level of 65.5 per cent. Inflation will remain within the Reserve Bank’s target range.

Net exports will make a positive contribution to GDP (0.25 per cent) during 2019-20 but will act as a drag on the economy (-0.25 per cent) in 2020-21. Significantly for the economy (and future government revenue) the terms of trade will weaken over the next two years which will also impact the size of the current account deficit.

Some key initiatives announced in the 2019-20 Budget included:

Tax

- Cuts to personal income tax rates (announced in the 2018-19 budget) for middle income earners will double and be passed on to 10 million taxpayers when they lodge this year’s tax return. Single income families will get up to $1080 and dual income families up to $2160;
- All taxpayers earning between $45 000 and $200 000 by 2024 will see their tax rates drop to 30 per cent that year. This will affect 94 per cent of workers;
- The total value of the tax cuts to individuals over the next decade will amount to $302 billion;
- The instant asset write off for businesses will be lifted to $30 000 (currently $20 000) and extended to medium sized businesses;
- Businesses with a turnover of less than $50 million a year will have their tax rate lowered to 25 per cent by 2020-21;
- The Australian Taxation office will receive an extra $1 billion to extend its crackdown on multinational companies, large companies and wealthy individuals;
Welfare Recipients

- 4 million welfare recipients will receive a one-off payment of $75 for singles or $125 for couples to help reduce electricity costs and reduce cost of living pressures. The cost to the budget will be $350 million.

Infrastructure

- A $3 billion increase to the Urban Congestion Infrastructure Fund which aims to cut travel times and increase rail parking;
- The government’s previously announced 10 year infrastructure package will be increased from $75 billion to $100 billion;
- Congestion-Busting projects have been announced for each state and territory and include $3.5 billion for the Western Sydney North-South Rail Link and $1.6 billion for the M1 Pacific Motorway and $2.6 billion for Queensland key road and transport projects;
- $2 billion will go towards a fast train service from Melbourne to Geelong;
- $2.2 billion for road safety improvements;
- Funding for improved water infrastructure;

Health

- $1.3 billion over seven years to upgrade the nation’s healthcare and hospital systems;
- $331 million so more medicines can be added to the pharmaceuticals benefits scheme;
- $737 million over seven years will be spent on improving community mental health services;

Environment

- $100 million for a new Environment Restoration Fund for large projects to restore animal habitats, protect coastlines and recycle waste;
- A $25 million national center for coasts, climate research and education at Point Nepean in Victoria;

Education

- $525 million for 80 000 apprenticeships targeting skills shortages;
- $453 million to expand pre-school education;
- $30 million to expand school upgrades;
- 4720 scholarships to encourage students to enroll at rural universities and vocational educational education and training providers;

Research and Development

- $9 billion will be invested in science, research and technology;
- $20 billion will go towards a Medical Research Future Fund for clinical trials into areas such as tuberculosis and traumatic brain injuries;
- $400 million towards genomic research;
- $56 million for research into type 1 diabetes;
The impact that the above and other measures will have on the budget over the next four years can be seen in Charts 18.1 and 18.2.

**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 move towards ongoing surpluses 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 budget surpluses. Also, less ‘crowding out’ (because the budget will be in 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.

### Chart 18.1

<table>
<thead>
<tr>
<th>Initiatives</th>
<th>2018-19 $m</th>
<th>2019-20 $m</th>
<th>2020-21 $m</th>
<th>2021-22 $m</th>
<th>2022-23 $m</th>
<th>Total $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower taxes for hard-working Australians: Building on the Personal Income Tax Plan (a)</td>
<td>0.0</td>
<td>-750.0</td>
<td>-700.0</td>
<td>250.0</td>
<td>-4540.0</td>
<td>-5740.0</td>
</tr>
<tr>
<td>Tax Integrity - extension and expansion of the ATO Tax Avoidance Taskforce on Large Corporates, Multinationals and High Wealth Individuals</td>
<td>0.0</td>
<td>114.6</td>
<td>910.9</td>
<td>1236.0</td>
<td>1351.1</td>
<td>3612.5</td>
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<td>Increasing and expanding access to the instant asset write-off</td>
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<td>-200.0</td>
<td>-500.0</td>
<td>50.0</td>
<td>250.0</td>
<td>-400.0</td>
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<tr>
<td>Personal Income Tax - increasing the Medicare levy low-income thresholds</td>
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<td>-100.0</td>
<td>-50.0</td>
<td>-50.0</td>
<td>-50.0</td>
<td>-250.0</td>
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<tr>
<td>Protecting Your Super Package - amendment</td>
<td>0.0</td>
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<td>59.1</td>
<td>-14.5</td>
<td>-7.3</td>
<td>-119.8</td>
</tr>
<tr>
<td>Tax Integrity - increasing engagement and on-time payment of tax and superannuation liabilities</td>
<td>0.0</td>
<td>-15.9</td>
<td>-21.6</td>
<td>-23.0</td>
<td>-23.3</td>
<td>-83.9</td>
</tr>
<tr>
<td>Superannuation - improving flexibility for older Australians</td>
<td>0.0</td>
<td>0.0</td>
<td>-10.0</td>
<td>-25.0</td>
<td>-40.0</td>
<td>-75.0</td>
</tr>
<tr>
<td>Protecting Your Super Package - putting members’ interests first</td>
<td>0.0</td>
<td>-35.7</td>
<td>-2.1</td>
<td>-2.0</td>
<td>-2.0</td>
<td>-41.8</td>
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<tr>
<td>Increasing Work and Holiday Visa Cap for Indonesia</td>
<td>0.0</td>
<td>3.0</td>
<td>8.8</td>
<td>13.1</td>
<td>15.4</td>
<td>40.4</td>
</tr>
<tr>
<td>Australia-Hong Kong Free Trade Agreement</td>
<td>0.0</td>
<td>-10.0</td>
<td>-10.0</td>
<td>-10.0</td>
<td>-10.0</td>
<td>-40.0</td>
</tr>
</tbody>
</table>

(a) This measure, which will reduce revenue by $19.5 billion over the forward estimates period, reduces tax receipts by $3.7 billion owing to the inclusion of a provision in the 2018-19 MYEFO.

All figures are in net fiscal impact terms. Totals may not sum due to rounding.
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 and the one-off electricity payment to welfare recipients will help to close the gap between them and those on higher incomes. However, once the tax changes are fully implemented in 2024 high income earners will be better off relative to those on lower incomes due to them gaining the most from the changes to marginal tax rates.

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 increase to 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.

<table>
<thead>
<tr>
<th>Initiatives</th>
<th>2018-19 $m</th>
<th>2019-20 $m</th>
<th>2020-21 $m</th>
<th>2021-22 $m</th>
<th>2022-23 $m</th>
<th>Total $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure Investment Program - Urban Congestion Fund - next priorities</td>
<td>0.0</td>
<td>-400.0</td>
<td>-400.0</td>
<td>-400.0</td>
<td>-400.0</td>
<td>-1,600.0</td>
</tr>
<tr>
<td>Infrastructure Investment Program - Victorian infrastructure investments</td>
<td>0.0</td>
<td>-98.4</td>
<td>-107.4</td>
<td>-358.4</td>
<td>-636.5</td>
<td>-1,200.7</td>
</tr>
<tr>
<td>Guaranteeing Medicare - strengthening primary care</td>
<td>-46.7</td>
<td>-147.1</td>
<td>-142.0</td>
<td>-268.8</td>
<td>-449.5</td>
<td>-1,054.1</td>
</tr>
<tr>
<td>Infrastructure Investment Program - Road Safety and Upgrade Package</td>
<td>0.0</td>
<td>-200.0</td>
<td>-200.0</td>
<td>-200.0</td>
<td>-200.0</td>
<td>-800.0</td>
</tr>
<tr>
<td>More Choices for a Longer Life - improving the quality, safety and accessibility of aged care services</td>
<td>-332.9</td>
<td>-148.4</td>
<td>-138.8</td>
<td>-36.9</td>
<td>-21.4</td>
<td>-679.4</td>
</tr>
<tr>
<td>National Security Agencies - additional resourcing</td>
<td>-33.0</td>
<td>-80.3</td>
<td>-75.5</td>
<td>-171.5</td>
<td>-194.2</td>
<td>-554.5</td>
</tr>
<tr>
<td>Royal Commission into Violence, Abuse, Neglect and Exploitation of People with Disability</td>
<td>-7.3</td>
<td>-191.2</td>
<td>-179.0</td>
<td>-149.6</td>
<td>-0.9</td>
<td>-527.9</td>
</tr>
<tr>
<td>National Partnership Agreement on Universal Access to Early Childhood Education - further extension</td>
<td>0.0</td>
<td>-136.2</td>
<td>-318.3</td>
<td>0.0</td>
<td>0.0</td>
<td>-454.5</td>
</tr>
<tr>
<td>Infrastructure Investment Program - Roads of Strategic importance — next priorities</td>
<td>0.0</td>
<td>0.0</td>
<td>-100.0</td>
<td>-150.0</td>
<td>-200.0</td>
<td>-450.0</td>
</tr>
<tr>
<td>Infrastructure Investment Program - Western Australian infrastructure investments</td>
<td>0.0</td>
<td>-17.5</td>
<td>-60.0</td>
<td>-233.5</td>
<td>-132.0</td>
<td>-443.0</td>
</tr>
</tbody>
</table>

All figures are in net fiscal impact terms. Totals may not sum due to rounding.
Concluding Comments

As previously stated, the Government’s intention is to get the budget into surplus and keep it there so it can commence a program of fiscal consolidation. If budgets are kept in surplus 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 these adjustments it will be easier to achieve continued surpluses and by 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 it 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 future governments to maintain budget surpluses will be jeopardised.

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.

The above plus the possibility that the upcoming federal election result could bring about a change of government may also mean that a second budget in the third quarter of this year may result in many changes to the April budget taking place.

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. new tax arrangements;
- 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 2019-20 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 2019-20 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 2019-20 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 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.
19. INTEREST RATES AND ECONOMIC ACTIVITY

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 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.

<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>3.00</td>
<td>5.30</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>3.0</td>
<td>2011-12</td>
</tr>
<tr>
<td>2013</td>
<td>2.75</td>
<td>5.25</td>
<td>9.25</td>
<td>1.2</td>
<td>2012-13</td>
</tr>
<tr>
<td>2014</td>
<td>2.50</td>
<td>5.00</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>2018</td>
<td>1.50</td>
<td>5.00</td>
<td>8.00</td>
<td>3.4</td>
<td>2017-18</td>
</tr>
<tr>
<td>April 2019</td>
<td>1.50</td>
<td>5.00</td>
<td>8.00</td>
<td>2.25</td>
<td>2018-19</td>
</tr>
</tbody>
</table>

Source: ABS National Accounts S006.0, RBA Bulletin, Budget 2019-20
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 up to 2017. 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

During 2017 and the first half of 2018 the international outlook showed signs of improved world growth. Domestic inflation was below the Reserve Bank’s target range and economic growth reached a high of 3.4 per cent during 2018.

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

The rebalancing process which took place was not uniform across the nation. Western Australia and Queensland which previously were drivers of growth experienced a significant slowdown. New South Wales and Victoria once again resumed their traditional roles as the engines of the economy (partly driven by migration growth).
As 2019 commenced, it became apparent that the economy was experiencing a slowdown. The housing and construction sectors and household spending levels showed signs of weakness. Tighter lending restrictions by the major financial institutions coupled with falling housing prices impacted the sector. Household spending was also slowing due to high levels of mortgage debt and weak wages growth.

The Reserve Bank is mindful of the changes taking place and has kept official rates on hold. Many economists believe that continued weakness in the housing sector may force the Reserve Bank to lower rates later in the year.

A complication for the Reserve Bank has been the sharp increase in property values in Sydney, Melbourne and Brisbane over recent years (although a significant correction is currently taking place. Refer to Chart 19.1 (Graph 2).

![Chart 19.1](image)

Since 2013, record low interest rates and population growth have been responsible for high levels of demand for housing and a subsequent rise in mortgage levels, which has left many households with ‘mortgage-stress’.

As Chart 19.1 (Graph 1) indicates, Household Debt levels as a percentage of household disposable incomes are now at an historical high (above 180 per cent). Borrowing levels to finance property purchases rose sharply during the 2013–2018 period. Now with falling property values comes an added problem for many in that they have loans based on previous high valuations, which still need to be repaid despite the fall in the value of their properties.

Household consumption has been affected as consumers still need to repay mortgages and meet other expenses at a time when average real wages have been stagnant. Much will depend on the economy maintaining its current level of employment. If the unemployment rate increases significantly, mortgage defaults could rise, which could have a significant impact on the property market, the finance sector and the economy in general.

Due to the above, the Reserve Bank is adopting a ‘watch and wait’ approach in terms of how it will use interest rate policy to manage the economy over the coming year.

‘Assisting’ the Reserve Bank over the last eighteen months has been the decision by the US Federal Reserve to raise official US interest rates which has widened 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.
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.

This has allowed 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 contractionary. As long as inflation remains at current levels the Reserve Bank will be able to maintain its current stance.

However, if the trend of weaker growth continues then the Reserve Bank may be forced to lower official rates. While this may make borrowing costs cheaper the concern for the Reserve Bank may be that it could increase demand for housing loans and bring about another period of rising property prices.
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, his 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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