THE CPAP STUDY GUIDE TO VCE ECONOMICS

PART 2 (Unit 4)
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ABOUT THE AUTHORS

Romeo Salla holds Honours and Masters degrees in Commerce (Economics Major) from the University of Melbourne, Victoria. In the early 1990's, he worked as an economist with both the Commonwealth Department of Treasury in Canberra, as well as the Industry Commission (now Productivity Commission) in Melbourne. From 1995, he completed his Diploma of Education at Monash University and then commenced teaching VCE Economics. Since his move to the education sector, Mr Salla has been prominent in advancing the interests of the economics discipline and he has continued to undertake professional development to ensure that he can provide the best possible quality of education to students. He has taught VCE Economics for 18 years, is an experienced assessor of VCE Economics exams and presents at student lectures on an annual basis.   He is the founder of both www.economicstutor.com.au and the popular smartphone App 'Economics Tutor'. He also provides professional development seminars to teachers, was longstanding Editor of the Economics section of ComNet, the official VCTA website, and is the co-author of the Year 12 economics text 'Economic Fundamentals in Australia' (CPAP), 'Humanities Alive 3' (Cambridge University Press) and the year 11 text 'Economics: from the ground up'.

Toby Robertson was born in Switzerland and has lived in England, America, France and Australia. Toby completed a degree in Economics at the Australian National University in 1986. He then worked for CRA (Rio Tinto) in Melbourne as a client advisor to various business units on economics and Foreign Exchange. He moved to State Bank Victoria to work as a Foreign Exchange and Options advisor to large Corporations and was posted to London in 1990 as a Foreign Exchange Trader, speculating in the Foreign Exchange markets. In 1992 he began work with Chase Manhattan Bank in London (one of the largest US banks) as a Vice President and ran their USDYEN Foreign Exchange Desk. In 1995 he moved back to Australia to become Chief Dealer of Chase Sydney. In 1999 he accepted voluntary redundancy and then ran his own proprietary trading business before entering the teaching profession in 2005. He has since contributed to a number of educational publications, presents to teachers across Victoria on behalf of the Victorian Commercial Teachers' Association and is an experienced assessor of VCE Economics exams.

TABLE OF CONTENTS

The website supporting students of Economics

Economicstutor.com.au has been created by Romeo Salla, an Australian economics educator and former federal treasury economist. It offers support to students of economics, particularly those undertaking a secondary economics course in Australia.

How can **www.economicstutor.com.au** help students?

Economicstutor.com.au is primarily designed to provide students with a series of **challenging activities/tests** that will take the form of **interactive multiple choice question sets** of 10 (complete with explanations) and **short answer questions** requiring students to 'fill the gaps' to reveal model answers for a typical test/exam questions. Crosswords, video links and other interactive activities feature throughout the site and **compact course notes** are included to support texts and other teacher resources. In addition, the '**Contemporary activities**' section of the site includes new and contemporary exercises and/or tasks that are designed to both challenge students and keep them 'up to date'. The completion of the exercises and activities contained will help to enhance student performance in assessment tasks and examinations.

All of the activities and core notes are categorised into each of the topic areas listed below. Note that most areas of the site are **password protected** with the exception of Introductory concepts. Students and teachers are **free to access** the **Course Notes** and **Test Yourself activities** within the 'Introductory concepts' pages of the site. Access to other areas of the site requires a password (provided with the purchase of a membership).

Throughout the year, **tutorials and lecture programs** will also be offered to students. These programs will be advertised on this Home page of the site (see below).

The Unit 4 Outline: Economic Management

The focus of this unit is the study of the management of the Australian economy, which concentrates on Budgetary/fiscal, monetary and microeconomic reform policies.

AREA OF STUDY 1: Aggregate demand policies and domestic economic stability

In this area of study students examine how the Australian Government and its statutory authority, the RBA, can utilise budgetary and monetary policy respectively to influence the level of aggregate demand in the economy. They evaluate the relative effectiveness of each policy by focusing on their strengths and weaknesses and explain how each policy has been utilised by the Australian Government in the past two years.

Outcome 1

On completion of this unit the student should be able to discuss the nature and operation of aggregate demand policies and analyse how the policies may influence the Australian Government's domestic macroeconomic goals and living standards.

Key knowledge

- the need for aggregate demand policies in terms of stabilising the business cycle.

Budgetary policy

- sources of government revenue including direct and indirect taxation, revenue from government businesses and the sale of government assets
- types of government expenses including government current and capital expenditure and transfer payments
- the budget outcome: balanced, deficit or surplus
- the ways government may finance a deficit or utilise a surplus
- the relationship between the budget outcome and the level of government (public) debt
- the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle
- the role of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle
- the effect of automatic and discretionary changes in the budget on the budget outcome and government (public) debt
- the stance of budgetary policy: expansionary or contractionary
- the effect of budgetary initiatives from the past two years on the Australian Government's domestic macroeconomic goals of strong and sustainable growth, full employment and low inflation
- the strengths and weaknesses of using budgetary policy to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards

Monetary policy

- the role of the RBA with respect to monetary policy as outlined in its charter
- the role of open market operations in altering interest rates
- transmission mechanisms of monetary policy and their influence on the level of aggregate demand including savings and investment, cash flow, availability of credit, exchange rate movements and asset prices
- the stance of monetary policy: expansionary or contractionary
- the focus of monetary policy from the past two years on the levels of aggregate demand and the Australian Government's domestic macroeconomic goals of strong and sustainable economic growth, full employment and low inflation
- the strengths and weaknesses of using monetary policy to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards.

Key skills

- define and use key economic concepts and terms relating to the Australian Government's aggregate demand policies
- gather relevant data and information about the nature and operation of aggregate demand policies in Australia
- discuss and analyse the effect of contemporary factors on the setting of aggregate demand policies
- evaluate the strengths and weaknesses of aggregate demand policies in achieving the Australian Government's domestic macroeconomic goals.

For the purposes of VCE Economics, budgetary policy refers to the federal government's use of its **budget** to achieve specified outcomes in the country, where the **budget** contains details of all income (or revenue) and expenditure (outlays) of the federal government for the <u>next</u> financial year plus the following three or more years. Budgetary policy is, therefore, the manipulation of federal government receipts and outlays in order to assist in the achievement of its economic and social objectives for Australia. As with all policies, the overriding objective is to improve the welfare or living standards of all Australians, and/or to achieve the most efficient allocation of the nation's resources.

The budget is the government's major fiscal document and is typically updated and released annually in May. However, the government can (and does) attempt to change the level (or composition) of income or expenditure at any time, with 2020 providing the perfect illustration. Due to the economic effects of the coronavirus, the government announced a number of measures in March/April that were designed to stimulate the economy and which fall under budgetary policy. In addition, it postponed the delivery of the 2020-21 Budget from early May 2020 to the 6th of October 2020.

> **Exam Tip:** It is worth remembering that there are two general types of budget figures or statistics: Budget figures that look ahead (i.e. <u>estimates</u> or <u>forecasts</u> of income and expenditure) and budget figures that look backward (i.e. <u>actual</u> income and expenditure that has taken place).

Objectives of Budgetary Policy

Budgetary policy is used to assist in the achievement of the following economic goals:

- Internal Stability (Economic Growth, Low inflation and Full Employment)
- External Stability
- Greater equity in the distribution and wealth
- Improvement in overall living standards

> **Exam Tip:** The budget plays a major role promoting a more equitable distribution of income, primarily via the implementation of a progressive tax system combined with welfare spending designed to minimise poverty and promote a more dignified standard of living for Australians. However, in the current VCE Economics study design, students are no longer required to demonstrate an understanding how the budget can, or has, been used to achieve a more equitable distribution of income (or external stability). Despite this, any budgetary policy initiative that is designed to achieve greater equity can easily be linked to living standards. Accordingly, , in the event that a question asks for how the budget can be used to lift living standards, it is feasible to refer to initiatives that are designed with 'equity' in mind (e.g. tax breaks for lower and middle income earners announced in the recent budget). But it is important to link the initiative to material and or non-material living standards rather than remain focused on measures of equality (e.g. the gini-coefficient).

The achievement of these economic goals will help to boost **living standards** and welfare for all Australians – which of course is the overriding objective of governments. In addition to these economic goals, the federal government also details its *medium term fiscal objectives* in the budget each May. We will review this shortly, but first we need to focus on the structure and nature of the budget itself.

Budget outcomes

With every budget there can be three possible outcomes. To simplify, assume that the government raised exactly $300B in taxes in order to fund the provision of the services which cost $300B. This would result in a 'balanced budget'.

budget balance

Receipts (revenue) = outlays (expenses)

However, if the government raised $290B from taxes, but still wanted to spend $300B on government services, then it would result in a 'budget deficit'.

budget deficit

Receipts (revenue) < outlays (expenses)

Alternatively, if the government raised $310B from taxes, and only spent $300B on government services, then it would result in a 'budget surplus'.

Receipts (revenue) > outlays (expenses)

Sources of Government receipts (revenue) and expenditure (expenses)

The most recent budget documents from the 2019-20 Budget reveal that the federal government expected to collect approximately $514B (2019-20), with the vast majority of this revenue coming in the form of taxation (93% or $477B). The three major sources of taxation revenue are individuals income tax ($234B), company tax ($102B) and sales taxes (primarily the GST) of approximately $71B. In addition, total excise (on goods like fuel, tobacco and alcohol) and customs duties amount to a total of $45B. Non-taxation revenue of $37B (7%) includes dividends from the RBA, earnings from the Future Fund as well as the sale of goods and services.

Where revenue comes from (2019-20)
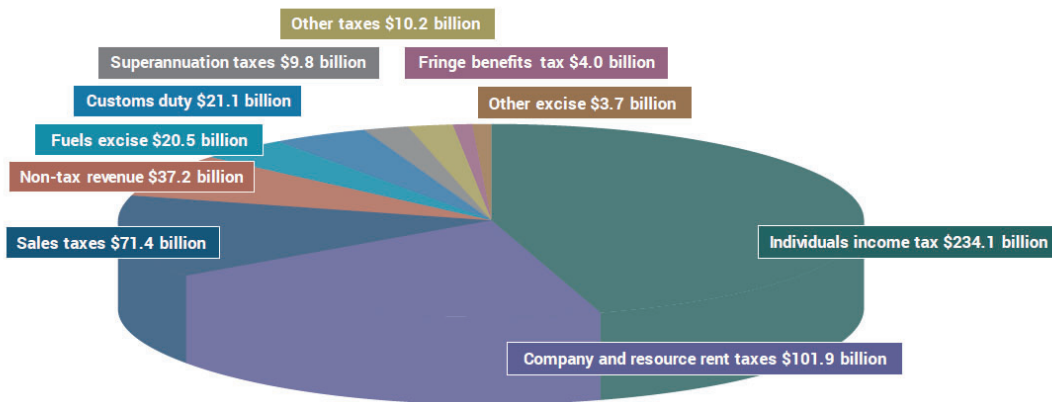
As shown in the chart below, the government also expected to spend a total of $501B. The major 'identifiable' expenses category is the $180B spent on Social Security/Welfare, accounting for more 36% of total expenses. This spending is designed to provide support for the aged; families with children; those with disabilities; veterans; carers and unemployed persons. Approximately, $82B (16%) of all expenses occur in health, including Medicare Benefits Schedule (MBS) and Pharmaceutical Benefits Scheme (PBS) payments. The next major identifiable expenses item is the $36B (7%) spent on education, which includes funding support for government and non-government schools, as well as higher education and vocational education and training. The transfer of revenue to the States and Territories, which also includes further spending on education and health, is included in the 'Other purposes' category. This latter category ($98B) also includes the payment of interest on government debt as well as spending for natural disaster relief.

Where taxpayers' money is spent (2019-20) [a]
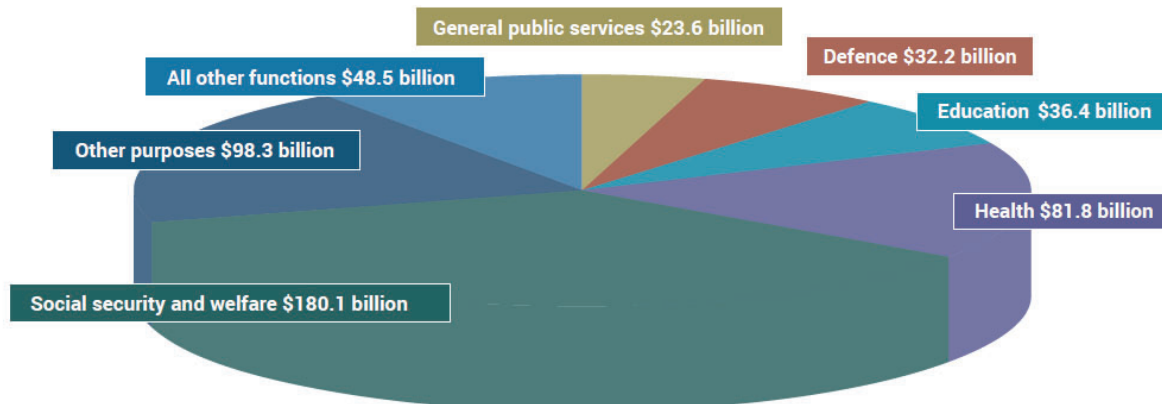
Recent budget outcomes

The latest budget figures appear in Table 1 below:

Table 1
Australian Government general government sector budget aggregates
Budget estimates and forecasts as at December 2019

	Estimates		Forecasts	
	2019-20 $b	2020-21 $b	2021-22 $b	2022-23 $b
Receipts	502.5	516.6	539.2	554.8
Per cent of GDP	25.0	25.1	25.0	24.6
Payments(a)	492.0	510.5	530.9	550.8
Per cent of GDP	24.5	24.8	24.6	24.4
Net Future Fund earnings(b)	5.5	na	na	na
Underlying cash balance(c)	5.0	6.1	8.4	4.0
Per cent of GDP	0.3	0.3	0.4	0.2
Revenue	511.1	527.3	551.7	567.2
Per cent of GDP	25.4	25.6	25.6	25.1
Expenses(d)	503.2	515.1	533.8	555.6
Per cent of GDP	25.0	25.0	24.8	24.6
Net operating balance(d)	8.0	12.1	17.8	11.6
Per cent of GDP	0.4	0.6	0.8	0.5
Net capital investment(d)	4.2	6.3	8.2	8.7
Fiscal balance(d)	3.8	5.8	9.7	2.9
Per cent of GDP	0.2	0.3	0.4	0.1
Memorandum:				
Net Future Fund earnings(b)	5.5	5.5	5.5	5.9
Headline cash balance	-2.8	-2.5	-1.4	-6.6

Source: Mid-Year Economic and Fiscal Outlook, 2019-20, DECEMBER 2019

The table reveals that the receipts (revenue) and payments (expenses) can be calculated and reported in a number of different ways to result in a range of possible budget outcomes/balances:

- **The headline cash balance**
- **The underlying cash balance**
- **The fiscal balance**
- **The net operating balance**

The **headline cash balance**: in very simplified terms is the total cash received by the federal government less the total cash paid. For 2019-20 this was estimated to be a deficit of $2.8B.

The **underlying cash balance** is the Headline cash balance, but excluding future fund earnings ($5.5B for 2019-20) and net asset purchases ($13.3B for 2019-20 and referred to as 'net cash flows from investments in financial assets for policy purposes', but not specifically identified in the previous table).

> **Exam Tip:** Table 1 can be confusing. In recognition of this fact, the examination setting panel is extremely unlikely to ask students to interpret or 'unpack' the detail. Ensure, however, that you know the difference between a surplus, deficit or balanced budget. In addition, be prepared to demonstrate an understanding of the three different ways a budget outcome can be calculated (i.e. the difference between the Headline, Underlying and Fiscal outcomes).

> **Exam Tip:** The budget figures provided in Table 1 were originally devised in April 2019, but were revised at the Mid-Year Economic and Fiscal Outlook (MYEFO) in December 2019. Ordinarily, these figures would be superseded by the those released in the 2020-21 Budget. However, due to the postponement of the 2020-21 Budget from May 2020 to October 2020, the figures contained in the table are the latest publicly available figures as at early May 2020.

For 2019-20, you should recognise that once 'net asset sales' (which is actually net asset purchases of $13.3B) and future fund earnings of $5.5B are extracted from the Headline cash balance (-$2.8B), we arrive at a figure for the underlying cash balance (surplus) of $5.0B (-0.3% of GDP). This is summarised below:

Reconciliation of underlying and headline cash balance estimates	$B
Headline Cash Balance	-2.8
Less Future fund earnings	5.5
	-8.3
Add Net cash flow from investment in financial assets for policy purposes	13.3
Underlying cash balance	5.0

Source: www.budget.gov.au (2018-19 Budget) Statement 3 table 7

This basically means that the estimated headline deficit of $2.8B would have been larger by $5.5B (i.e. a deficit $8.3B) were it not for the expected inflow of receipts in the form of future fund earnings. But it would have been smaller by $13.3B (i.e. we would have had a surplus of $5.0B) were it not for the large expected net outflow of cash used to purchase non-financial assets. Of the two cash outcomes or balances, the **Underlying cash balance** provides a better indicator of the position and impact of budgetary policy. This is primarily because:

(a) The Future Fund earnings are mandated to be reinvested into the Future Fund and not to be used for general government expenditures. This should worsen the deficit because 'theoretically' these funds are unavailable for use by the government until well into the future (when the ageing public sector workforce retires).

Net proceeds from asset sales or purchases are 'one off', non-recurring, transactions that simply represent a transfer of ownership between the public and private sectors. Accordingly, any proceeds from asset sales make any budget outcome look better than it really is in 'core' or 'underlying' terms. Similarly, any asset purchases (such as the equity investment in the National Broadband Company or the government's equity investment in the Australian Rail Track Corporation) make the budget outcome look worse than it is in 'underlying' terms.

> **Exam Tip:** The Underlying cash balance was the outcome most often referred to in budget documents and the Financial Press. However, since the release of the 2017-18 Budget, there has been increasing focus on the net operating balance (see below).

The **net operating balance** is an accrual measure (as distinct from the <u>cash</u> headline and <u>cash</u> underlying measures) which focuses on revenue (e.g. tax income) that has been earned over the relevant period minus the expenses that have been incurred over the period (i.e. expenses). It is different to the headline and underlying cash outcomes in that these outcomes record receipts and payments when the money is actually received or paid rather than when the money was earned or incurred. Importantly, the net operating balance <u>excludes</u> the actual spending on the purchase of capital assets (e.g. new stock of public housing or defence assets) and instead <u>includes</u> the depreciation (i.e. the using up or consumption of capital). It is regarded as the best measure of the sustainability of the government's financial position over time and therefore provides an indication of the ability of the government to sustain the existing level of government services into the future.

> **Exam Tip:** The most important thing to remember is that a focus on the net operating balance helps the government to get a better handle on whether any given deficit truly reflects a situation where the government is 'spending beyond its means'. For if the government experiences an underlying cash deficit in tandem with a net operating surplus it suggests that the deficit for that year is unproblematic given that it has essentially been caused by spending on capital rather than recurrent items.

The **fiscal balance** is essentially the same as the operating balance (i.e. revenue earned less expenses incurred) but it <u>includes</u> the actual spending on the purchase of capital assets (e.g. new stock of public housing or defence assets) and <u>excludes</u> the depreciation of those assets (i.e. the using up or consumption of this capital). The fiscal balance surplus for any year will, therefore, be lower than the operating surplus when there has been net new capital investment by the government (ignoring any changes in depreciation). For example, for the 2019-20 Budget, net capital investment of $4749M ($4.7B) is subtracted from the operating surplus of $12891M (i.e. $12.9B) to arrive at a fiscal surplus of $8142M (i.e. $8.1B).

Both the operating balance and the fiscal balance are like 'profit and loss statements' for the federal government and are the most accurate outcomes in terms of measuring the financial performance of the federal government or the longer term consequences of budget decisions for sustainable spending and balance of payments considerations.

Current versus capital expenditure of the federal government

Table 1 (Australian Government general government sector budget aggregates) provided detail on the major expenditure (or expense) categories for the federal government. However, of the estimated $492B in expenditure, there is no detail provided on the type of expenditure taking place within each category. For example, of the $31B (approx) to be spent on Defence over the course of 2019-20, there is no indication of how much (or what proportion) of this money will be spent on physical assets (such as tanks and planes) compared to the proportion spent on consumables (such as the day to day running expenses of the relevant government department, such as wages, advertising, energy costs, etc.). The money spent on physical assets that will continue to provide benefits for Australia well into the future is referred to as capital spending, whereas the money spent on consumables is referred to as current or recurrent expenditure.

While the Budget papers have always included information on the split between current expenditure and capital expenditure, the situation changed somewhat in the 2017-18 Budget. The government decided to focus on its budget outcome in a way that more clearly distinguished the relationship between budget deficits and what has become known as **'good debt'** versus **'bad debt'**. In simple terms, the government now focuses on a type of budget outcome (referred to as the 'operating budget outcome) that excludes capital expenditure from its calculations. This means that the 'operating' budget deficit for any given year will be lower than the headline/underlying deficit by the amount of net capital expenditure made during that year. It therefore means that the government is freer to invest in 'nation building' capital (such as buildings, roads, rail, or infrastructure more generally - all of which have the potential to contribute to social and economic benefits well into the future) without being criticised for increasing the (operating) deficit and generating an increase in 'bad debt'.

This change in the way the budget outcome is now reported followed pressure from economists and other government agencies, including the RBA, on the need for the federal government to switch its preoccupation with deficit reduction (or fiscal consolidation) and to embrace the need for much needed investment in national infrastructure assets, particularly transportation infrastructure. The consensus of opinion is that it is okay for the government's budget deficit to increase provided that any additional spending was put to good use, such as investing in assets (capital spending) as opposed to spending on the 'day to day' running of the government (recurrent spending). These thoughts were expressed by the RBA Governor in late 2016 in the following way:

> *…it is important that we ensure our public finances are on a sustainable track. This requires a better balance to be established, over time, between recurrent spending and revenue. It is worth pointing out that this does not preclude government spending on infrastructure, where this is backed by a strong business case. Such spending can provide support for the economy and can help generate the productive assets that a prosperous economy needs. Done well, infrastructure spending is not inconsistent with establishing a better balance between recurrent spending and revenue.*
>
> **Source: RBA** *Governor (P.Lowe) speech at the Committee for Economic Development of Australia (CEDA) Annual Dinner (15/11/2016)*

Box A: Current versus capital spending: Bad versus Good debt

A useful way to think about the importance of the distinction between the government's current (or recurrent) and capital spending is to equate its finances to that of two typical households over a given year. Assume that the disposable income of two households (A and B) amounted to $100,000, while the total expenditure of each household was different: Household A's total expenditure amounting to $110,000 and Household B's amounting to $140,000.

The scenario is summarised in the table below:

Cash balances for Household A and B				
Household	Income ($)	Expenditure ($)	Cash outcome ($)	
A	100,000	110,000	10,000	Deficit
B	100,000	140,000	40,000	Deficit

On the face of it, the financial stability of Household A appears to be superior to Household B because its cash deficit is smaller by $30,000 and it will need to have borrowed $30,000 more to fund its cash deficit. [Let's ignore the possibility of selling assets to fund the deficit for simplicity]. In other words, it looks as though Household B is spending well 'beyond its means' compared to Household A.

To fully appreciate the implications of any cash deficit for an entity, it is really necessary to explore the nature of the expenditure undertaken over the course of the year. For any entity, whether it is a household, business or government, expenditure can be broken up into two broad types: **current** (or recurrent) expenditure and **capital** expenditure. For a household, current expenditure includes all items of spending that are necessary and mostly re-occur every year in order to keep the household running. This includes payments for gas, electricity, water, council rates/rent, food, entertainment, holidays, school fees, etc. These types of payments 'typically' provide benefits to the household in that year only – in other words, they are consumed within that year. In contrast, capital expenditure includes less regular payments for items or assets that continue to provide benefits for the household (or entity) into the future. For example, it includes the purchase of property, motor vehicles, whitegoods (e.g. a fridge or washing machine), furniture, electrical goods and/or computer equipment. It will even include the purchase of a (share in) small business, such as mum or dad buying a new car to provide Uber driving services.

Determining the split between recurrent and capital spending for each household will helps us to better understand the fuller implications of a cash deficit for each household. If we assume for simplicity that Household A spent nothing on capital items and Household B spent $40,000 in capital expenditure, then it should be clear that Household B's financial position is not as bad as first

thought. Provided the $40,000 has been spent on genuinely useful capital items, that really do provide financial or social returns to the household in future periods, then it is possible (even likely) that household B is in a better position than Household A. For example, if Household B used $40,000 to purchase a new motor vehicle to be used as an Uber vehicle, then Household B's cash deficit of $40,000 will have led to an increase in 'good debt' (e.g. a $40,000 loan) because it generates benefits for the household into the future (e.g. profits from the business come back into the household as additional income). In contrast, with no capital expenditure, Household A's cash deficit of $10,000 will have led to an increase in 'bad debt' (e.g. a $10,000 loan) because it is being used to finance recurrent spending.

Overall, Household A is clearly spending beyond its means because it has an **operating deficit** of $10,000 that results in (bad) debt. If the same income and spending patterns were to continue into the future, then Household A is likely to experience financial difficulty as it will struggle to service its growing debt.   In contrast, despite having a cash deficit of $40,000, Household B actually has no **operating deficit** at all (i.e. it has an operating outcome of $0). This is because the $40,000 capital investment in the motor vehicle/business is deducted from the $140,000 in cash expenditure to arrive at an operating expenditure figure of $100,000. Household B will therefore be less likely to be spending beyond its means because the capital expenditure is providing ongoing benefits for the household that are not enjoyed by Household A. In this hypotheitical scenario, Household B will be better able to service its (higher) debt given that the capital expenditure is providing financial benefits in the form of higher income from the use of the motor vehicle in the passenger transport industry.

Net operating balances for Household A and B				
Household	Income ($)	Expenditure ($)	Operating outcome ($)	
A	100,000	110,000	10,000	Deficit
B	100,000	100,000	0	Balance

The (Estimated) budget outcome compared to the Actual budget outcome

When the budget is released it is simply reported as an underlying outcome for the next financial year. For example, the 2019-20 Budget estimates as of December 2019 reported as an underlying budget surplus of $5.0B (0.3% of GDP). However, this actually refers to the estimated outcome for the financial year ahead (i.e. 2019-20).   The actual underlying budget outcome for 2019-20 will not be known until after June 2020, and it is invariably quite different to the outcome that was estimated at budget time – even during 'normal times'. The actual outcome will depend heavily on the accuracy of a range of economic forecasts for key variables such as growth in nominal and real GDP, wages growth, inflation and the rate of unemployment. If the outcome for these variables is different to the government forecasts, then the actual budget outcome will deviate from the estimated budget outcome.

This is indeed the situation facing Australia in 2020. While the budget outcome for 2019-20 was estimated to be a small $5B (underlying) surplus, the actual budget outcome will be significantly worse, with a sizeable budget deficit now expected owing to the economic impact of the coronavirus. Even without discretionary changes to the budget that took place in the first half of 2020 (which worked to increase government expenditure relative to revenue – more on the operation of these 'discretionary stabilisers' later), the fall in economic growth and increase in unemployment (and underemployment) from February 2020 will work to increase government expenditure (e.g. an automatic increase in income support payments) and decrease government revenue (e.g. less income tax received). This will result in an actual budget deficit when the government anticipated a budget surplus. Recent estimates suggest the actual budget outcome for 2019-20 will be a deficit of approximately $140B. [The budget deficit for the following financial year 2020-21 is expected to be approximately $130B, which compares to the December 2019 estimate of a $6.1B surplus.]

Overall, when economic activity is lower than anticipated, the surplus is likely to be smaller (or deficit bigger) than estimated at budget time because tax receipts (and other forms of income) should be lower than estimated and transfer payments (plus other forms of expenditure) higher than estimated. The reverse is also true if economic activity is higher than anticipated, with the surplus is likely to be higher (or deficit smaller) than estimated at budget time because tax receipts will be higher than estimated and government expenditure lower than estimated.

Table 2 below contains some of the key forecasts upon which the 2019-20 Budget figures were based.

Table 2: Major economic parameters

	Outcomes	Forecasts		Projections	
	2018-19	2019-20	2020-21	2021-22	2022-23
Real GDP	2.0	2 1/4	2 3/4	3	3
Employment	2.5	1 3/4	1 3/4	1 1/2	1 1/2
Unemployment rate	5.2	5 1/4	5 1/4	5	5
Consumer price index	1.6	2	2 1/4	2 1/2	2 1/2
Wage price index	2.3	2 1/2	2 1/2	2 3/4	3
Nominal GDP	5.3	3 1/4	2 1/4	4 3/4	4 3/4

Due primarily to the economic effects of the coronavirus, the actual budget surplus for 2019-20 **will be** lower than the December estimate of $5.0B because the rate of growth in nominal GDP will be lower than the forecast 3.25%; the growth in

'wages' **will be** lower than the forecast 2.5% and the unemployment rate **will be** higher than the forecast 5.25%. In fact, as mentioned earlier, the budget surplus will disappear, to be replaced by a budget deficit because of the expected fall in government revenue and rise in government expenditure.

Table 2 provides only a snapshot of only some of the variables relied upon by Treasury when estimated budget receipts and payments. A more complete list is contained in Budget Paper No. 1 (Statement 2) or the Mid-Year Economic and Fiscal Outlook. This list is included within Table 3.

It is worth considering the impact of changes in other variables, such as the forecasts for the terms of trade (which ultimately impact on the growth in nominal GDP). It is worth remembering that an increase in the terms of trade (or commodity prices) above the rates forecast by the government will (ceteris paribus) result in larger budget surplus because mining company profits and incomes across the economy will rise, adding to taxation revenue. For 2019-20, the government has forecast for the TOT to fall by 5.25%. In event that the TOT actually deteriorate more than this over 2019-20, then it will cause a further deterioration in the budget outcome – on top of the coronavirus effects – causing the deficit to climb even higher.

Table 3: Domestic economy forecasts

	Outcomes(b) 2018-19	Forecasts 2019-20 MYEFO	Forecasts 2020-21 MYEFO
Real gross domestic product	2.0	2 1/4	2 3/4
Household consumption	2.0	1 3/4	2 1/2
Dwelling investment	0.0	-9	-3 1/2
Total business investment(c)	-1.0	1 1/2	6
By industry			
Mining investment	-9.5	1	12
Non-mining investment	1.6	2	4 1/2
Private final demand(c)	1.0	3/4	2 3/4
Public final demand(c)	4.1	4 3/4	3 1/4
Change in inventories(d)	-0.1	0	0
Gross national expenditure	1.6	1 3/4	2 3/4
Exports of goods and services	3.9	2 1/2	2 1/2
Imports of goods and services	0.2	1/2	3
Net exports(d)	0.8	1/2	0
Nominal gross domestic product	5.3	3 1/4	2 1/4
Prices and wages			
Consumer price index(e)	1.6	2	2 1/4
Wage price index(f)	2.3	2 1/2	2 1/2
GDP deflator	3.2	3/4	- 1/4
Labour market			
Participation rate (per cent)(g)	66.0	66	66
Employment(f)	2.5	1 3/4	1 3/4
Unemployment rate (per cent)(g)	5.2	5 1/4	5 1/4
Balance of payments			
Terms of trade(h)	5.6	-4	-8 3/4
Current account balance (per cent of GDP)	-0.6	- 3/4	-3 1/4

Source: Mid-Year Economic and Fiscal Outlook, 2019-20, DECEMBER 2019

> **Exam Tip:** It is possible that an examination question will ask students to determine the likely change to the budget outcome in the event of forecasting errors by the government. Indeed, a table similar to Table 2 (not Table 3) might be included in a MC or structured question and students might be required to explain how changes in each (or some) of the variables will impact on the actual budget outcome. Students should familiarise themselves with how each of the variables are related to budget receipts/payments and the budget outcomes.

Financing a budget deficit or dealing with a budget surplus

When the budget is in deficit it means that the government needs to raise funds to finance the deficit. The Treasury department (via its subsidiary the Australian Office of Financial Management) determines the amount of money required and issues Australian Government Securities (AGS) in the form of Treasury bonds or Treasury notes. These are simply debt instruments where the purchasers of the bonds (or notes) effectively become lenders to the federal government and, in return, they receive interest on the bonds/notes. Generally, there are three types of purchasers (i.e. lenders) and the extent to which a budget deficit 'expands' an economy will depend on who purchases the AGS (i.e. who lends to the government). [As at 24 April 2020, there were $597B of AGS issued in the market place ($565.2B in Bonds and $31.8B in Notes), which simply means that the federal government 's stock of gross debt at this date is $597B.]

> **Exam Tip:** For the purposes of assessment in VCE Economics, it is not expected that students will know the difference between Treasury Bonds and Treasury Notes. For those curious, Treasury Bonds are longer term debt instruments, with repayment of the principal (i.e. face value of the bond) made out to a range anywhere up to 30 years. In contrast, Treasury Notes are shorter term debt instruments repayable within one year.

Selling bonds to the RBA

This is most expansionary (and most inflationary) as money that was previously not in the money supply is now released into circulation. This type of financing has become rare since the late 1980's because the government and the RBA were keen to have a clear separation of monetary and budgetary policies. This point was reiterated by the RBA Governor in early 2020 when he clarified that the RBA's purchasing of AGS on 'secondary markets' (i.e. not directly from the federal government) during the first half of 2020 was an attempt to support budgetary policy efforts to stimulate the economy rather than an example of the RBA funding budget deficit(s) per se.

Selling bonds to Australian investors (lenders)

This is least expansionary because domestic bond sales place upward pressure on interest rates (because the demand for 'money' increases, which lifts the price of 'money'). These higher interest rates result in a *crowding out* of the private sector as consumers and businesses reduce Consumption and Investment. In addition, the higher interest rates force some local borrowers (e.g. corporations) to borrow from overseas lenders, resulting in capital inflow and a higher exchange rate. This contributes to *crowding out* of Australia's tradables sector, where exporters and import

competing businesses lose market share. The effect of crowding out constrains AD over time and reduces the expansionary impact of a budget deficit. This type of financing is the most common.

Selling bonds to overseas investors (lenders)

This results in capital inflow that exerts upward pressure on the value of the AUD, which in turn has a negative impact on net exports and AD. This reduces the expansionary impact of a budget deficit and relates to the point made earlier with respect to the contractionary nature of budget deficits. The degree to which Treasury issues bonds or notes in overseas markets depends on the state of financial markets and the confidence foreigners have in Australian 'sovereign debt'.

> **Exam Tip:** In the 2018 exam, students were asked to outline two options available to the government when deciding how to finance a budget deficit. Many students erred by referring to an increase in taxes or a reduction in expenditure. These two measures will indeed help to reduce deficits in the future, but they are NOT means of financing an existing deficit. Be sure to avoid this mistake in the event that a similar question appears on the 2019 paper. The 25% of students who achieved full marks for this question will have adequately explained two of the above three means of financing a deficit.

> **Exam Tip:** Question 2(b) of the 2014 exam required students to outline one economic implication for prolonged budget deficits. A common problem is to state that prolonged budget deficits will increase NFD! Always remember that NFD is made up of public and private sector debt and the budget deficit will only increase net government debt. [NFD may indeed fall if private sector debt levels decrease over time in response, at least in part, to higher budget deficits].

Dealing with a budget surplus

Budget surpluses can either be invested financial markets (e.g. putting money into an account held with the RBA, topping up the Future Fund or repay existing government debt). The latter primarily occurred over the early to late 2000s and *net government debt was eliminated,* allowing the federal government to focus on investing the surplus in financial markets. The government was able to invest in funds such as the *Future Fund, Education Investment Fund (EIF), Building Australia Fund (BAF) and the Health and Hospitals Fund (HHF).* Billions of dollars were invested into a portfolio of investment assets (e.g. shares and bonds) that were to be used to pay for the government's future superannuation liabilities (Future Fund), to invest heavily in infrastructure such as transport and roads (BIF), and to provide for increased capital investment in educational institutions (EIF) and the health sector (HHF). Over recent years the government has introduced a number of other funds designed to achieve specific future goals. These funds include the Asset Recycling Fund (ARF), the Medical Research Future Fund (MRFF) and the DisabilityCare Australia Fund (DCAF).

> **Exam Tip:** In examinations, it is common for students to argue that a budgetary policy measure to stimulate the economy is a reduction in interest rates. Interest rate manipulation is not a feature of budgetary policy – this is an instrument of monetary policy. However, budgetary policy can and does have an impact on interest rates via the size of the deficit or surplus - where a deficit places upward pressure on interest rates and a surplus places downward pressure on interest rates.

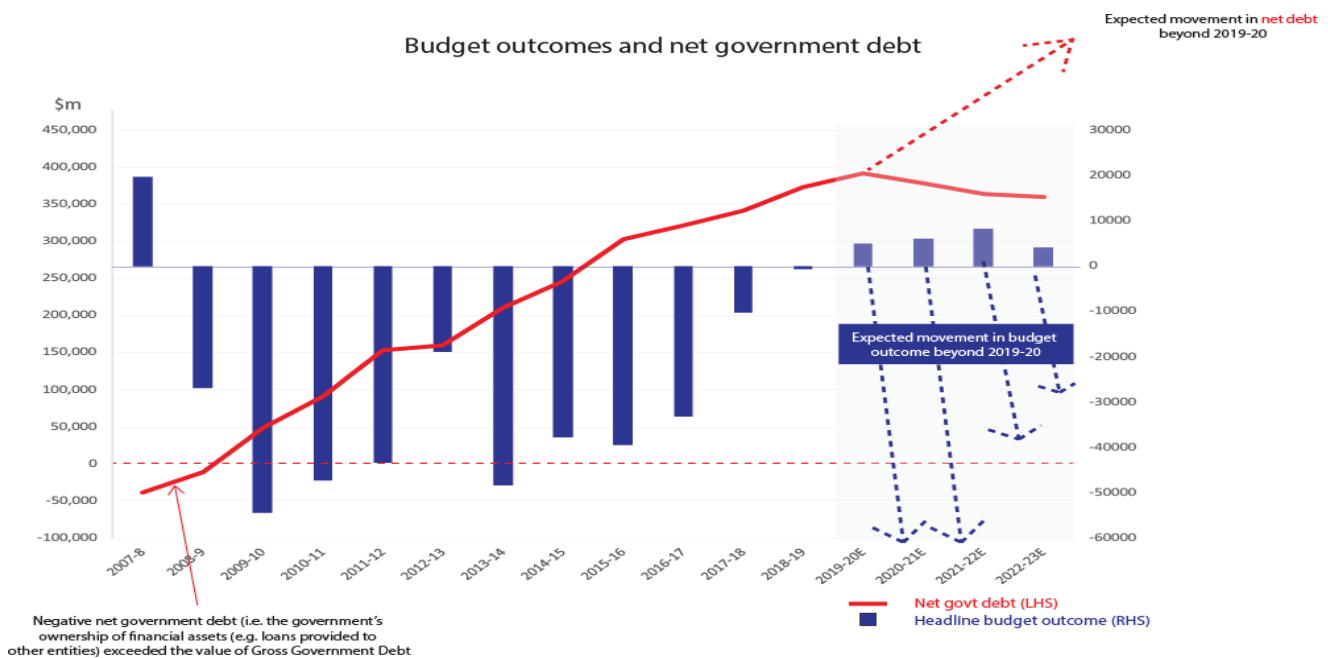## *The relationship between the budget outcome and the level of government (public) debt*

It should be clear from reading the previous sections that budget deficits will require funding in the form of debt (or the sale government equity over time) and budget surpluses will facilitate the repayment of government debt. Accordingly, continuing budget deficits over time will add to government debt which requires the repayment of both interest and principal into the future. This debt is recorded as a liability on the government's balance sheet and is generally considered to worsen the government's financial position in the sense that it makes the government less able to respond to economic shocks to support the economy. For example, the succession of budget surpluses up to 2007-8 resulted in the elimination of net government debt at the time. This meant that the government was in an excellent position to support the economy during the global economic downturn via the delivery of large budget deficits (lower taxes or higher levels of government spending). It is generally accepted that the strength of the government's balance sheet at the time was a key factor behind Australia being one of the few advanced economies avoiding a recession during the global financial crisis.

Australia is currently once again in the midst of an economic downturn as a consequence of the negative supply and demand shocks emanating from the global response to the coronavirus pandemic. This has resulted in substantial budgetary policy support (which we will examine shortly) that has resulted in a budget 'blow out', with expected budget deficits of approximately $140B for 2019-20, and $130B for 2020-21. This will result in the issue of more CGS to fund the deficit and a corresponding increase in the size of public debt.

The chart below highlights the relationship between budget outcomes and net government debt since 2007-8.

Budget outcomes and net government debt

It clearly shows the inverse relationship between budget outcomes and (net) government debt, with an improved budget outcome (lower deficit or higher surplus) leading to a lower level of net debt, and a deteriorating budget outcome leading to a higher level of net debt. The budget surpluses prior to and including 2007-8, helped the government to repay debt to the point where net debt became negative (i.e. the government was a net lender). Since 2008-9, however, the budget moved into deficit following the GFC and economic downturn, and remained in deficit for the entire period up to 2019-20. As a consequence, the government's borrowing requirement increased, with the stock of net debt increasing to an estimated $392B by 2019-20. However, this 2019-20 estimate of both net government debt and the budget outcome ($5B surplus) was made in December 2019 which of course preceded the catastrophic economic events of the first half of 2020. The coronavirus induced economic downturn will see net government debt accelerate beyond 2019-20 and the budget to move into a huge deficit for both 2019-20 and 2020-21, followed smaller deficits thereafter.

Cyclical and Structural components of the budget

Any time the federal government decides to change the way it collects money or makes payments (composition of receipts/payments) or adjust the volume of its receipts/payments (level of receipts/payments) it will typically impact on the size of the budget outcome (e.g. increase or decrease the surplus/deficit). This change in the budget outcome reflects a deliberate attempt (i.e. an actual policy decision) to use the budget to change the allocation of resources or assist with the achievement of its goals. In this respect, the actual 'structure' of the budget is deliberately altered by the government. This represents the **structural** component of the budget and changes of this nature are sometimes referred to as **discretionary stabilisers**. For example, the recent reduction in the company tax rate to 27.5% for smaller companies is an example of a change to the structure of the budget (a discretionary stabiliser).

Clearly, the structural changes (or discretionary stabilisers) do not account for all the changes in budget outcomes. This is because the budget outcome also changes automatically in response to changes in the level of economic activity. Lower

levels of economic activity should negatively impact on the budget outcome as receipts from taxation (primarily individual and company taxes) are likely to fall and the payments for government services or transfer payments (such as unemployment benefits) should increase. In essence, the budget outcome will change in line with the economic or business cycle, with the surplus falling during downturns and increasing during recoveries. This represents the **cyclical** component of the budget and is sometimes referred to as **automatic stabilisers**. For example, a reduction in the amount of tax actually received by the government (as distinct from a change in the tax rate) will tend to reduce receipts relative to expenditure and therefore result in an automatic increase in the size of the deficit.

> **Exam Tip:** In the 2018 examination, MC question No. 2 was the second most poorly handled MC question on the paper, with 53% of students selecting the incorrect response. Essentially, the question required students to have some understanding of the relationship between monetary and budgetary policies. It required students to appreciate that expansionary monetary policy [at this stage simply think of this as low(er) interest rates] would tend to cause an automatic decrease in government expenditure on welfare. This is because low interest rates stimulate AD, economic growth and employment, which then helps to reduce both unemployment and government welfare (income support) payments. Those students who chose the incorrect response to this MC question are likely to have struggled to understand the cyclical component of the budget outcome.

These cyclical stabilisers help the budget to automatically respond to changing economic conditions by slowing growth rates during periods of high economic activity (e.g. booms), as the budget moves into greater surplus, and slowing the rate of decline during periods of low or negative growth (e.g. a recession), as the size of the surplus falls. This is highlighted in the diagram below:

The movement in the cyclical component of the budget outcome over time
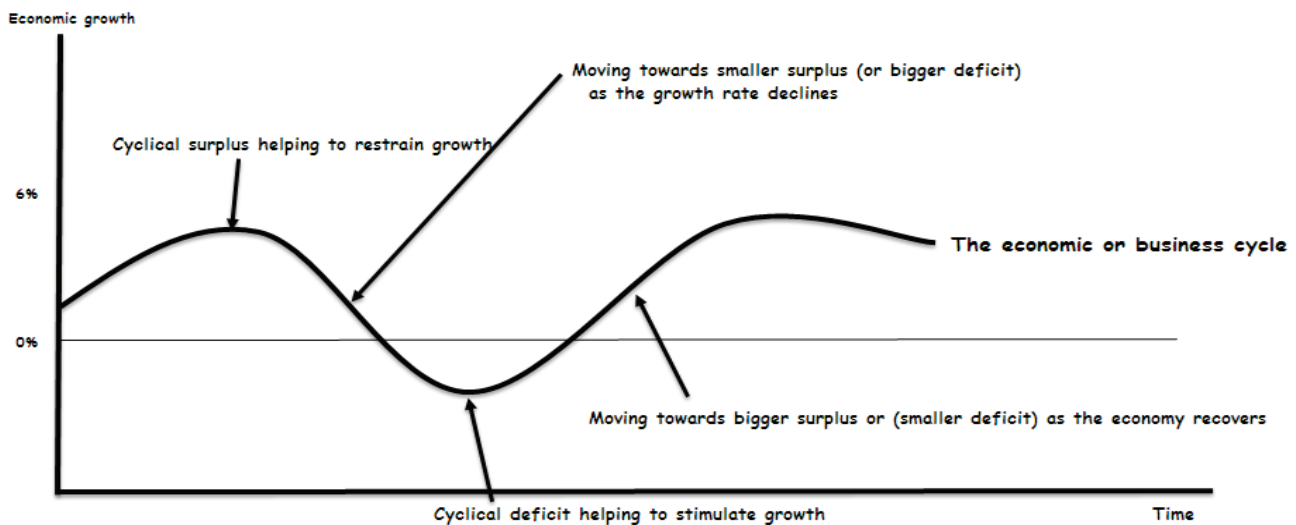
> **Exam Tip:** When trying to explain the cyclical component of the Budget, be very careful that you tailor your answer to the question being asked. This is because automatic stabilisers can be explained in terms of the impact they have on budget outcomes (e.g. during downturns the Budget automatically moves towards a deficit) and also the impact they can have on the economy (e.g. during downturns, a lower tax burden helps to prevent spending or AD from falling to even lower levels).

> **Exam Tip:** Qb of the 2019 exam required students to 'select one example of a budgetary policy automatic stabiliser and describe how it operates to influence aggregate demand and the rate of economic growth'. Some students made the mistake of examining the impact that automatic stabilisers have on the budget outcome and therefore made no reference to how it helps to influence AD and the rate of economic growth.

> **Exam Tip:** Q2c of the 2016 exam was handled very poorly by students, with 63% of students scoring 0/2. The question asked students to outline one reason for government intervention 'in the market' in order to stabilise the level of economic activity. While the question related to a specific key knowledge point in the previous Study Design, it is not impossible for it to resurface in the 2020 exam. Most students misinterpreted the question by focusing on 'market failures', which was understandable given its placement between two questions relating to specific markets/market structures (i.e. micro rather than macro). In the event that a similar question surfaces, students should focus on the word 'stabilise' (a more macro concept) rather than 'market' (a more micro concept).

Structural vs cyclical stabilisers during the coronavirus

There has been huge decline in economic activity in response to the negative demand and supply side effects of the coronavirus. Government lock-down and social distancing measures in Australia and abroad have resulted in a large-scale reduction in the demand for most (but not all) goods and services (shifting AD left), combined with a reduction in productive capacity as many businesses were forced to close or reduce hours of operation (shifting AS left). This is expected to cause negative economic growth over 2020 (and even a recession) as well as a significant increase in unemployment. The negative growth and higher unemployment will naturally result in lower income tax revenue for the federal government and a much higher level of expenditure on income support (e.g. unemployment benefits). This will happen automatically, leading to a huge increase in the size of the budget deficit for cyclical reasons (i.e. 'cyclical stabilisers' will cause the budget deficit to rise by a significant amount). However, during March 2020, the federal government announced three separate 'stimulus' packages worth over $200B that primarily involve spending initiatives that will further increase the size of the budget deficit for 2019-20 (and 2020-21). These measures are deliberate attempts to manipulate the budget outcome and do not happen automatically. They are referred to as 'discretionary stabilisers' and lead to an increase in the size of the budget deficit for structural reasons (i.e. the government made changes to the structure of the budget that will cause the budget deficit to rise by a significant amount).

Overall, the large deterioration in the size of the budget deficit from $0.7B in 2018-19 towards $140B in 2019-20 is due to a combination of cyclical factors (i.e. automatic stabilisers) and structural factors (discretionary stabilisers).

Automatic stabilisers and government debt

We have already seen that automatic stabilisers represent the cyclical component of the budget. Growth in economic activity will cause government taxation receipts to rise, government welfare expenditure to fall, and the budget deficit to decrease as a result. It therefore stands to reason that periods of strong rates of economic growth are likely to result in an automatic reduction in the level of government debt. This is precisely what occurred in the last boom, the period up to 2007-8, when Australia experienced a prolonged period of strong economic growth that contributed to both large cyclical budget surpluses, which were then partly used to repay government debt to the point where net government was eliminated. Of course, since the global financial crisis of 2008-9, the reverse occurred, with sluggish rates of economic growth leading to cyclical budget deficits that required government borrowing (i.e. the issue of bonds) and a growing stockpile of (net) government debt. As noted earlier, the coronavirus induced economic downturn (and likely recession) of 2020 will once again lead to a large increase in the cyclical budget deficit and a corresponding rise in government debt.

Using the Budget to stabilise the business cycle

Over many years (since the 1980's), budgetary policy was not specifically used to manage or manipulate the *business cycle*. Whilst 'automatic stabilisers' did work in a counter-cyclical fashion, the budget was rarely used to contract the economy when growth (or inflation) was too high, or expand the economy when growth was too low. This counter-cyclical arm of policy making was left primarily to the RBA and monetary policy.

This approach changed slightly following the election of the Labor government in late 2007. First, Prime Minister Rudd declared that budgetary policy had a real role to assist monetary policy efforts to fight inflation. Accordingly, its first budget adopted a 'contractionary stance' to help ease capacity constraints and dampen inflationary pressures. More profound, however, was the government's response to the onset of the global financial crisis and the global economic downturn in 2008-9. Recognising the need for budgetary policy intervention, the government noted:

> *In normal times, monetary policy is the main tool for stabilising the economy. But these are not normal times. Extraordinary times call for extraordinary macroeconomic policy measures. In the current circumstances, monetary policy action alone will not be sufficient to restore growth within a reasonable time period……The extraordinary speed and scope of the deterioration in the global economy means that there is a much greater macroeconomic stabilisation role for discretionary fiscal policy than would normally be the case.*
>
> **Source:** *Updated Economic and Fiscal Outlook, February 2009* www.budget.gov.au

Accordingly, over 2008-9, the government adopted a much more interventionist or 'Keynesian' approach to budgetary policy, which included the delivery of large budget deficits between 2009-10 and 2011-12. The continuing sluggish performance of the economy since then, triggered by the significant fall in commodity prices (up until 2016), resulted in persistent (albeit smaller) budget deficits during a period where the government was keen to implement fiscal consolidation. For example, the budget deficits up until 2018-19 were estimated to be smaller than the preceding year and, despite the government's commitment to its fiscal strategy, they contained a number of measures that were designed to provide 'fiscal stimulus' to the economy. For example, in 2018-19 the cyclical improvement to the budget (due to higher than expected commodity prices) motivated the government to announce significant tax relief and boosts to (capital) expenditure, partly for political reasons (with a federal election taking place at the time of writing). More recently, the three generous stimulus packages during March 2020, totalling more than $200B, is a clear demonstration of the willingness of Australian governments to use 'Keynesian' stimulus to support the economy and 'stabilise the business cycle'. The forced lockdown to counter the Coronavirus Pandemic meant that many firms were forced to close or reduce hours, and many workers effectively had their jobs "removed". This made it impossible for many people to support themselves, resulting in the need for significant government support.

Overall, the focus during an economic downturn is to prevent large falls in economic growth and higher unemployment - the budget will typically move into an expansionary phase (see next section). But this will be reversed once the economy starts to recover, as the government will become concerned with the need to reduce the size of the debt that was built up during the downturn (or recession). As the budget eventually returns towards a surplus over time, it then becomes imperative that the surpluses are wisely invested as a form of insurance against the next economic downturn, allowing the budget to more freely move into structural deficit, as was the case after the global financial crisis and the current coronavirus epidemic. Australian government debts are relatively low compared to most of our major trading partners as a percentage of GDP and this has allowed us to introduce discretionary measures to stimulate the economy that are a much larger proportion of GDP than our peers.

The importance of fiscal discipline in the context of budgetary policy's stabilisation role was highlighted by the RBA Governor in early 2017 and again in 2020.

> *The final issue that I will mention this evening is that of ensuring that our public finances are on the right track. Australia has a good historical record here. Net government debt, as a share of GDP, is still low, although it is higher than it used to be. Our good record has provided us with a form of insurance. It meant that when difficult times did strike last decade, fiscal policy had the capacity to play a stabilising role. We had options that not all other countries enjoyed.*
>
> **Source:** *RBA Governor, Philip Lowe, in remarks to A50 Australian Economic Forum, 9 February 2017*

> *Australia's long record of responsible fiscal policy has allowed the government to use its balance sheet to help smooth out the income shock and to offer protection to those most affected. In doing so, it is making a major difference.*
>
> **Source:** *RBA Governor, Philip Lowe, in speech titled 'An Economic and Financial Update' 21 April 2020.*

The use of the budget to stabilise the economy over many years is highlighted in the chart below:

Underlying budget deficits
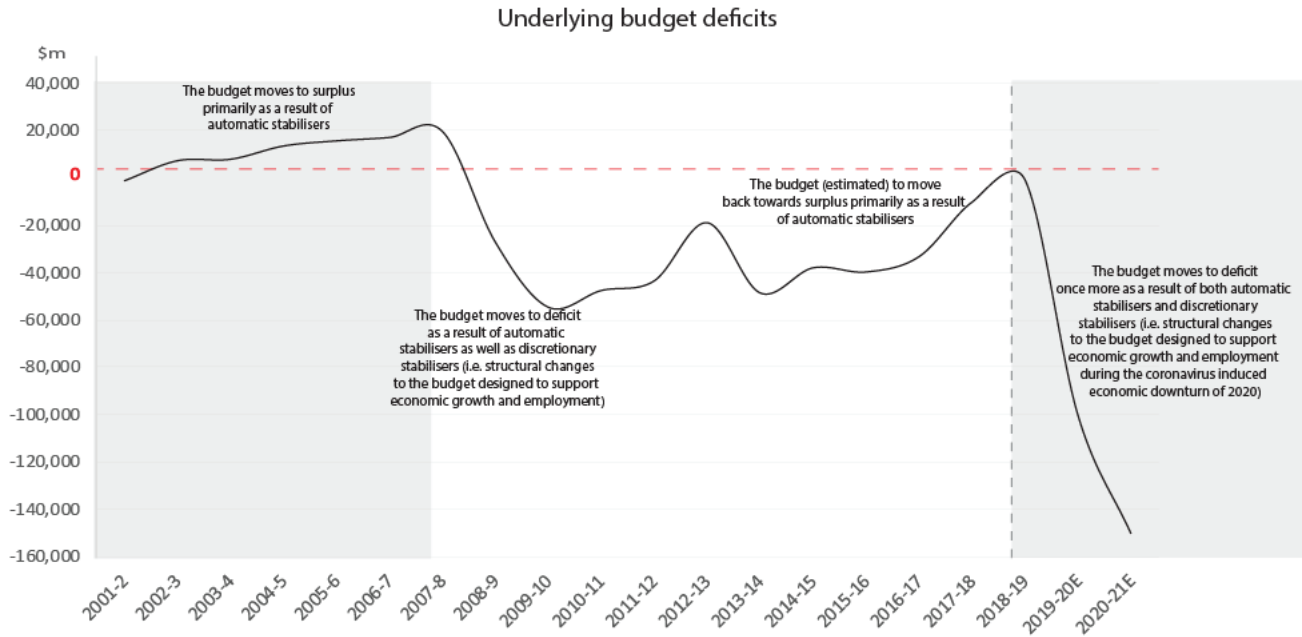
In addition to managing the business cycle in this way, budgetary policy has the flexibility to assist with the achievement of all our economic goals, such as the use of government funds to address market failures (such as climate change) or to directly preserve our living standards (such as funding for national security). This highlights that budgetary policy's ultimate goal is to improve the welfare or living standards of all Australians.

Expansionary or contractionary Budgets

The following table provides a 'general rule of thumb' to help one determine whether a budget is expansionary or contractionary.

Budget outcome (or change of outcome)	Expansionary/contractionary
Deficit	Expansionary
Surplus	Contractionary
Smaller deficit	Less expansionary (or contractionary)
Bigger deficit	More expansionary
Smaller surplus	Less contractionary (or expansionary)
Bigger surplus	More contractionary

While the table provides a good starting point from which to analyse the nature and impact of a budget, there are a number of possible exceptions to the general rule.

Can a surplus be expansionary?

It is more common to refer to budget deficits as expansionary, however some economists will argue that a budget surplus can be expansionary over the longer term. This is because a surplus means that the government becomes a net lender for that year (rather than a borrower) and this leads to less pressure on funds in financial markets. This should then lead to a reduction in interest rates (and/or exchange rates), which increases Consumption, Investment, (net exports), AD and economic growth. This is sometimes referred to as the **'crowding in' argument** (or the opposite of the 'crowding out' argument related to budget deficits). In addition, some would argue that reduced deficits (or increased surpluses) could be evidence of the government interfering less in the operation of the free market (e.g. less subsidies, less expenditure on regulation, etc.) which further encourages an increase in private sector Investment.

In addition, the movement in the budget outcome from a big surplus one year to a smaller surplus the next year could be evidence of an expansionary stance, particularly if the change in the budget outcome has occurred for structural rather than cyclical reasons. While a surplus would still exist in the second year, its smaller size may have been due to a reduction in tax rates and/or an increase in discretionary spending that will have an expansionary effect on the economy.

Can a deficit be contractionary?

Those economists who argue that a surplus can be expansionary over time will also argue that a deficit can be contractionary in the long term. This time, the deficit leads to **'crowding out'** of the private sector, as the increased borrowing by the government exerts upward pressure on interest rates (and/or exchange rates), which then reduces AD and economic growth.

> **Exam Tip:** It is highly unlikely that students will be asked to explain either the *crowding out* or *crowding in* argument in the VCE examination. In any case, there is some debate about the validity of the crowding out/in argument in relation to interest rates given that Australian borrowers (including governments) will typically have ready access to offshore funds. Assuming an almost perfectly elastic supply of loan funds from abroad, this means that bigger budget deficits will have a negligible impact on interest rates. Instead, the *crowding out* effect will occur via upward pressure on the exchange rate, which 'crowds out' the external sector, therefore reducing the net export component of AD.

In addition to the cost of financing budget deficits and the crowding out problem, budget deficits lead to a build-up of government debt over time. This creates additional problems for governments in terms of the impact on government credit ratings, which if downgraded (currently AAA), leads to higher borrowing costs and an even bigger deficit. Further, deficits must eventually be reined in over time, which may involve future restraint in the form of higher taxes and lower government spending, which then have negative consequences for economic and employment growth. Accordingly, to avoid future pain, governments need to achieve the right balance by delivering deficits that do just enough to fill the void in the economy when recession (or contraction) arrives, without imposing too big a burden on taxpayers and the economy in the future.

A movement in the budget outcome from a big deficit one year to a smaller deficit the next year could be evidence of a contractionary stance, particularly if the change in the budget outcome has occurred for structural rather than cyclical reasons. While a deficit would still exist in the second year, its smaller size may have been due to an increase in tax rates and/or a decrease in discretionary spending that will have a contractionary effect on the economy.

> **Exam Tip:** Q3c required students to identify the most recent budgetary policy stance [for 2019-20] and examine the impact on FE and PS. Unfortunately, too many students ignored or failed to comment on the recent stance, not appreciating that a return to surplus 'implied' a contractionary stance. Too many students failed to demonstrate an understanding of the goals in the question, and simply outlined how budgetary policy initiatives (such as tax cuts) might help to increase aggregate demand (economic growth and inflation). Importantly, very few students were able to make the link back to the government's budgetary policy stance.

> **Exam Tip:** Question 4a of the 2015 exam required students to observe a table containing budget outcomes for three years and then describe the change in stance over two of those years (from a $41.1B deficit to a $35.1B deficit). If a similar question surfaces in this year's exam, it is best to approach the question in simple terms and ignore any reference to cyclical or structural factors that may have impacted on the outcomes over the relevant period. In other words, students only need to appreciate that the changed outcome represents a contractionary (or less expansionary) BP stance and then justify why this is the case.

Overall, to determine whether a budget is likely to *expand* or *contract* economic activity, it is important to do three things.

1. Examine the actual size of the outcome itself to determine its likely impact on the economy. A Deficit is generally considered **expansionary** because the government is injecting more money into the economy than it is extracting. Conversely, it is generally **contractionary** if there is a surplus because the government is extracting more funds from the economy than it is injecting. However, this is examining the budget impact from a relatively static point of view, ignoring any changes to the budget from the previous year.

2. Examine the movement of the budget outcome over two or more years to determine the *setting* and/or *stance* of policy. For example, a reduction in the size of a deficit generally indicates a less expansionary (or contractionary) budget and a reduction in the size of the surplus indicates a less contractionary (or expansionary) one.

3. Examine the changing composition or structure of the budget itself and ignore any cyclical factors that caused the budget outcome to change. For example, in isolation, the replacement of $1B of foreign aid with $1Bm on

infrastructure is expansionary, even though it will have no impact on the size of the budget deficit or surplus. Similarly, any changes to the precise nature of government spending within the budget can impact on the degree to which it expands or contracts the economy 'over time'. For example, replacing recurrent expenditure (e.g. spending on welfare) with capital expenditure (e.g. spending on infrastructure) will tend to be less expansionary in the short term but more expansionary in the long term.

> **Exam Tip:** In economics, the term 'fiscal multiplier' or 'Keynesian multiplier' is sometimes used to describe the effect that any increase in (net) government spending will have on real GDP. A multiplier of more than 1 suggests that higher government spending will ultimately boost real GDP over time. Accordingly, the bigger the multiplier, the bigger the expansionary impact of any increase in government spending. Interestingly, the size of the multiplier will be determined by the 'composition' of government spending. Consumption spending will have a lower multiplier than Investment spending, meaning that the expansionary/contractionary impact of any change to the budgetary policy will depend on the precise changes to spending programs in the budget. Having said all of this, you will not be examined on 'multipliers' in the VCE Economics examination, but it is useful to remember the importance of changes to the composition of the budget, as distinct from a change in the budget outcome.

Fiscal drag or bracket creep and the impact on the budget outcome

Fiscal drag, also referred to as '**bracket creep**', occurs during times of inflation for countries with a progressive tax system. When inflation occurs it results in a decrease in 'real wages' and workers seek to protect their 'real wage' by demanding increases in their nominal wage. As nominal wages increase, it pushes some workers into higher marginal tax brackets. This increases the 'average' rate of tax paid by these taxpayers, having two major effects:

First, it increases the total personal income tax revenue received by the federal government, thereby increasing the surplus (or reducing the deficit). It is another cyclical component of the budget, but it does not rely on the growth rate in GDP to change the budget outcome automatically. Instead, it relies on the rate of inflation to change the budget outcome, with higher inflation rates working to increase the size of the surplus (or reducing the deficit).

Second, some taxpayers will experience a decline in their 'real disposable income' because they will be paying a higher average rate of tax on their 'nominal wage', which reduces the 'purchasing power' of their 'after tax and after inflation wage'. This has the effect of slowing the rate of spending (or consumption) and reduces the incentives to work.

> **Exam Tip:** The difference between nominal and real wages is similar to the difference between nominal and real GDP. Assume that a person receives an annual salary (or wage) of $100,000 for the 2019 year. If they receive the same wage over 2020, and inflation was 10%, then the purchasing power of this $100,000 is less in 2020 compared to 2019. The 'real wage' will be $90909, which means that a worker will need a 10% nominal wage increase (to $110,000) in order to purchase the exact same bundle of goods and services as they did in 2019. If this wage rise is granted, then the 'real wage' remains at $100,000, but the 'nominal wage' increases to $110,000.

> **Exam Tip:** The current VCE Economics Study Design no longer requires students to have knowledge of 'the ways BP can be used to influence equity in the distribution of income'. Australia's progressive personal income tax system is an important means by which the government's budget is used to transfer income from higher to lower income earners. Students traditionally struggle defining a progressive tax system and it remains possible (although it is unlikely) that students will be required to demonstrate an understanding of this term in the 2018 exam, particularly in relation to fiscal drag/bracket creep and the announced changes (flattening) to the tax system proposed by the Liberal Government. Always remember that it refers to a system where the rate (or proportion) of tax payable on a person's income (i.e. their marginal tax rate) rises as their income rises. It is not defined as 'the more one earns the more tax they pay (note that this could also describe a proportional tax system (where the same rate of tax applies to all income earners).

Federal governments, both Labor and Liberal, have been fully aware of 'bracket creep' and have been happy to accept an *automatic* rise in the tax burden over time For example, over recent years, the growth in wages (albeit relatively low) has pushed many workers into higher tax brackets, resulting in windfall gains for the government. However, the government also recognises that a reliance on fiscal drag to help return the budget to surplus will tend to stifle incentives and have a negative impact on participation and productivity. In this context, the government announced changes to the tax system which, if passed through the Senate in full, will see a significant 'flattening' of the tax system by 2024. [The removal of the 37% tax bracket already has already been legislated for implementation in 2024]. This is expected to result in the following outcomes:

- 94% of taxpayers facing a marginal rate of 30% or less;
- 60% of all personal income tax being paid by the highest earning 20%; and
- an income earner on $200,000 will pay around 10 times more tax than someone earning $45,000.

The current and proposed tax changes are detailed in the table below:

Table 3: New personal tax rates and thresholds

Rate (%)	2017-18 tax thresholds Income range ($)	Current tax thresholds From 1 July 2018 Income range ($)	New tax thresholds From 1 July 2018 Income range ($)	New tax thresholds From 1 July 2022 Income range ($)
Tax free	0 - 18,200	0 - 18,200	0 - 18,200	0 - 18,200
19	18,201 - 37,000	18,201 - 37,000	18,201 - 37,000	18,201 - 45,000
32.5	37,001 - 87,000	37,001 - 90,000	37,001 - 90,000	45,001 - 120,000
37	87,001 - 180,000	90,001 - 180,000	90,001 - 180,000	120,001 - 180,000
45	>180,000	>180,000	>180,000	>180,000
Low and middle income tax offset	-	Up to 530	Up to 1,080	-
LITO	Up to 445	Up to 445	Up to 445	Up to 700

Rate (%) From 1 July 2024	New tax thresholds From 1 July 2024 Income range ($)
Tax free	0 - 18,200
19	18,201 - 45,000
30	45,001 - 200,000
45	>200,000
LITO	Up to 700

Source: www.budget.gov.au (BP. No. 1)

The government claims that the tax reductions/changes announced in previous budgets are partly designed to 'protect middle-income Australians from bracket creep'. [Remember, however, that the tax cuts are also being delivered for political reasons given that a federal election took place shortly after the delivery of the 2019-20 Budget.]

The current government's fiscal strategy

While the overriding goal is to improve living standards, the government outlines its medium term fiscal strategy which enables it to better achieve its ultimate goal. The current government's **medium term fiscal strategy** is to achieve budget surpluses, on average, over the course of the economic cycle. The key elements of the strategy are for the Government to:

1. invest in a stronger economy by redirecting Government spending to quality investment that helps to boost productivity and workforce participation;
2. maintain strong fiscal discipline to reduce the Government's share of the economy over time in order to free up resources for private investment to create jobs, boost economic growth and stabilise/reduce net debt over time. This fiscal discipline involves a commitment:
   a. to reducing the 'payments-to-GDP ratio' over time
   b. to maintaining the 'tax-to-GDP ratio at or below 23.9% of GDP'
3. support growth in government revenue by developing policies that raise economic growth and national income; and
4. strengthen the Government's balance sheet by improving net financial worth over time.

The Government has its **Budget repair strategy** that is designed to assist with the achievement of its medium term fiscal strategy by delivering budget surpluses to the point where they reach 1% of GDP as soon as possible. This strategy requires that:

- any new spending initiatives will be more than offset by spending reductions elsewhere in the budget;
- any cyclical improvement in the budget outcome will be 'banked' rather than spent; and
- a clear path back to surplus is underpinned by decisions that build over time.

Importantly, the 2019-20 Budget papers noted that:

> *'the Budget repair strategy will stay in place until a strong surplus is achieved and so long as economic growth prospects are sound and unemployment remains low'.*

This means that the government's Budget repair strategy would be abandoned in the event that the economy experiences a downturn and unemployment climbs to unacceptable levels. This is precisely what has occurred in the first half of 2020, with the government adopting huge spending and revenue measures designed to stimulate the economy, support jobs, preserve incomes and protect Australian living standards. This reinforces the point made earlier; that discretionary budgetary policy still plays a role in macroeconomic stabilisation.

Despite the size of the budget deficits during the current economic downturn, it does not necessarily mean that the government's actions are in breach of its medium term fiscal strategy as reiterated in the 2019-20 Budget. This is despite the fact that the huge budget deficits worsen the government's balance sheet (i.e. increase the government's indebtedness) and increase the Government's share of the economy – both of which the government has committed to reducing over time. This is because fiscal strategy was designed with economic downturns (or economic crises) in mind. However, the government could never have anticipated an economic crisis of the magnitude we are experiencing at the moment. One that has resulted in huge budget deficits that will take many years to repay, and which will impose significant financial burdens on future generations (e.g. higher taxes and lower levels of government expenditure). As a consequence of this reality, it is likely that the government will change the fiscal strategy somewhat when it delivers the 2020-21 Budget in October 2020. The emphasis is likely to be one of 'reducing the size of the budget deficit over time' as opposed to 'achieving budget surplus on average over the cycle.

The economic rationale for returning the budget to surplus – the argument for fiscal consolidation.

Fiscal consolidation refers to the government consolidating its finances by returning the budget to surplus (consistent with its fiscal strategy) and therefore enjoying the economic benefits this provides. The potential for a budget surplus to have expansionary effects was briefly discussed earlier in relation to the downward pressure a surplus places on interest rates and the stimulus this gives to Investment and AD over the longer term. Other economic arguments to support a return to surplus include the following:
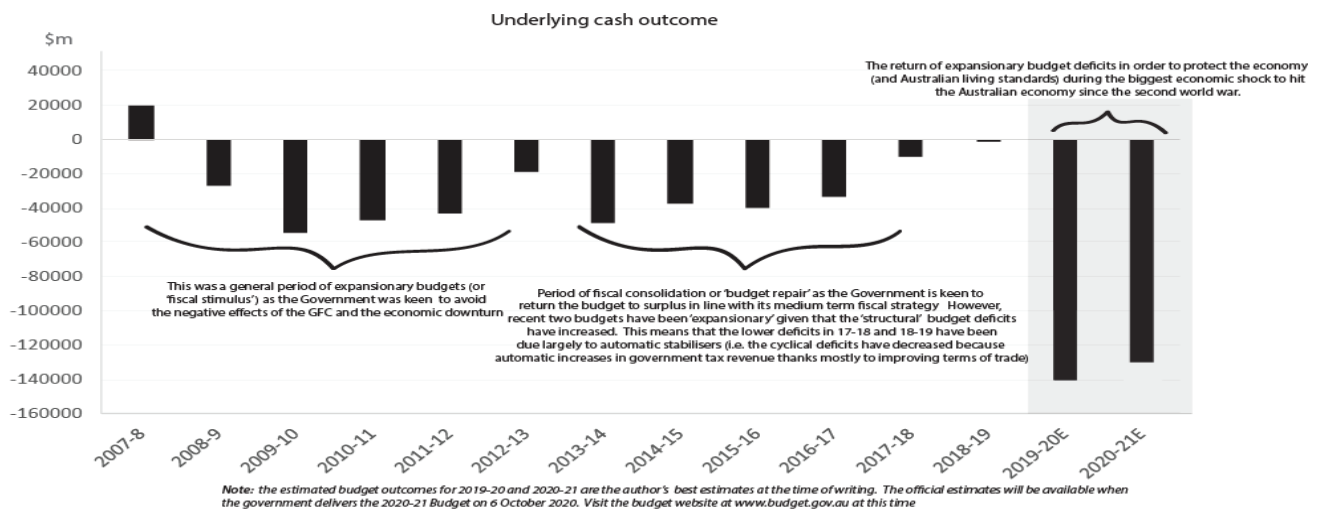
- A surplus is consistent with the government's medium term fiscal strategy, facilitating debt reduction and helping to buffer Australia against future economic decline
- A surplus helps to generate greater international investor confidence in the Australian government finances thereby preserving Australia's excellent AAA credit rating and reducing the cost of future debt issues
- A surplus allows the cyclical component of the budget to do its job of automatically buffering the economy when economic growth declines in the future
- A surplus allows monetary policy to better manage the economy (particularly the rate of inflation) as the RBA can loosen policy with less fear about its inflationary effects
- A surplus is usually a sign of strength and boosts confidence which further stimulates economic activity.

> **Exam Tip:** In the 2018 examination, students struggled with Q4c (average score of 43%) which effectively asked students to outline the economic rationale for returning the budget to surplus. This was virtually identical to Q2b of the 2011 exam that was equally troublesome for students. In both cases, students misread the question and outlined 'how the government could return the budget to surplus' or outlined 'the likelihood of returning the budget to surplus'. It was also common for students to confuse the budget deficit with the current account deficit. Students should ensure that they understand precisely what is being asked in the event that a similar question surfaces on the 2019 examination.

> **Exam Tip:** Question 2c of the 2011 examination then required students to explain two government policy actions that *might* be used to return the budget to surplus. The use of the terms 'government policy actions' is prone to confuse students into thinking that they needed to talk about two different arms of policy (e.g. monetary and budgetary policies). This was not a requirement of the question and makes it difficult to answer the question effectively. Instead, students simply needed to focus on two specific budgetary policy actions or measures (such as raising particular tax rates or reducing government expenditure, such as welfare). The use of the word 'might' in the first sentence also makes it easier to respond as students were not required to focus on actual policy initiatives (although reference to actual policy initiatives was desirable). Finally, it was tempting to make reference to increases in government spending on things like infrastructure in order to boost Aggregate Supply and economic growth. Whilst this does have the capacity to return the budget to surplus in the long term (via automatic stabilisers), an omission of any reference to the short term impact would have been costly.

Recent budgetary policy stances

You should recall that the current government's *medium term fiscal strategy* is to achieve budget surpluses, on average, over the course of the economic cycle. The fiscal strategy involves automatic stabilisers being allowed to push the budget back towards surplus as economic growth increases in the future and for any future surplus to fall as the economy enters its next downturn in the future. The huge budget deficits that will be delivered over the current financial year (2019-20), as well as the 2020-21 financial year, are clear examples of the current budgetary policy stance being expansionary – one that is designed to stimulate economic growth and reduce unemployment. The actual and estimated budgets since 2007-8 are highlighted in the chart below.

Note: the estimated budget outcomes for 2019-20 and 2020-21 are the author's best estimates at the time of writing. The official estimates will be available when the government delivers the 2020-21 Budget on 6 October 2020. Visit the budget website at www.budget.gov.au at this time

The movement from surplus to deficit and then back towards surplus reflects the cyclical nature of the budget, with a strong surplus when the economy was going well (i.e. up to 2007-8) being replaced by deficits when the economy entered a downturn (i.e. after 2007-8 following the effects of the global financial crisis). The cyclical changes in the budget outcome over this period were mostly supported by structural changes (e.g. tax relief and increased discretionary spending) that further helped the budget to stabilise the economy.

Since 2013-14, the budgets generally became less expansionary (or contractionary) in nature, evidenced by lower budget deficits (and the expected return to surplus) as the government was keen to consolidate its finances (i.e. pursue fiscal consolidation) and allow monetary policy to focus more on economic stabilisation. However, periods of below trend rates of growth, caused by the significant fall in the terms of trade (between 2011 and 2016), caused automatic stabilisers to increase budget deficits above that which would have otherwise occurred (i.e. the government deliberately allowed automatic stabilisers to buffer or support the economy). In addition, recent budgets up until 2019-20 were less aggressive in their attempt to achieve fiscal consolidation, with a number of expansionary or stimulus measures introduced, particularly the current 2019-20 'election budget'. The rationale for the stimulatory measures pre-2020 was partly economic, as the government was keen to support a sluggish economy, and partly political, particularly given the unpopular contractionary 2014-15 Budget (which contained a number of contractionary initiatives that did not receive Senate approval) as well as the need to 'win votes' in both the previous 2016 election and the later 2019 election.

The most recent budgets

The most recent budget is the **2019-20 Budget** that was delivered in April 2019 and, ordinarily, it would have been followed by the **2020-21 Budget** in May this year. Up until January this year, the government would have expected both budgets to be consistent with its fiscal strategies (e.g. 'fiscal consolidation'), with an expectation that the budget deficit would be replaced by budget surpluses (of $5B for 2019-20 and $6.1B for 2020-21). However, the coronavirus pandemic of 2020 has forced the government to postpone the delivery of the 2020-21 Budget until the 6th of October. This delay allows the government to focus on ways to address the health, social and economic effects of the coronarvirus.

In terms of the economic effects, the government has introduced a number of **discretionary budgetary policy measures** that will deliver aggregate demand side (and supply side) benefits to the economy. In total, these discretionary measures, worth more than $200B, were primarily delivered via the following three separate stimulus packages.

Stimulus package No. 1 (12th March 2020)

The government announced a $17.6 billion economic plan to support the Australian economy. The package is focused on keeping Australians in jobs and helping small and medium sized businesses to stay in business. The package has four parts:

Supporting business investment

- $700 million to increase the instant asset write off threshold from $30,000 to $150,000 and expand access to include businesses with aggregated annual turnover of less than $500 million (up from $50 million) until 30 June 2020. For example, assets that may be able to be immediately written off are a concrete tank for a builder, a tractor for a farming business, and a truck for a delivery business.

- $3.2 billion to back business investment by providing a time limited 15 month investment incentive (through to 30 June 2021) to support business investment and economic growth over the short term, by accelerating depreciation deductions. Businesses with a turnover of less than $500 million will be able to deduct an additional 50 per cent of the asset cost in the year of purchase.

Cash flow assistance for small and medium sized business

- $6.7 billion to Boost Cash Flow for Employers by up to $25,000 with a minimum payment of $2,000 for eligible small and medium-sized businesses. The payment will provide cash flow support to businesses with a turnover of less than $50 million that employ staff, between 1 January 2020 and 30 June 2020. The payment will be tax free. This measure will benefit around 690,000 businesses employing around 7.8 million people. Businesses will receive payments of 50 per cent of their Business Activity Statements or Instalment Activity Statement from 28 April with refunds to then be paid within 14 days.

- $1.3 billion to support small businesses to support the jobs of around 120,000 apprentices and trainees. Eligible employers can apply for a wage subsidy of 50 per cent of the apprentice's or trainee's wage for up to 9 months from 1 January 2020 to 30 September 2020. Where a small business is not able to retain an apprentice, the subsidy will be available to a new employer that employs that apprentice.

Stimulus payments to households to support growth

- $4.8 billion to provide a one-off $750 stimulus payment to pensioners, social security, veteran and other income support recipients and eligible concession card holders. Around half of those that will benefit are pensioners. The payment will be tax free and will not count as income for Social Security, Farm Household Allowance and Veteran payments. There will be one payment per eligible recipient. If a person qualifies for the one off payment in multiple ways, they will only receive one payment.

Assistance for severely-affected regions

- $1 billion to support those sectors, regions and communities that have been disproportionately affected by the economic impacts of the Coronavirus, including those heavily reliant on industries such as tourism, agriculture and education. This will include the waiver of fees and charges for tourism businesses that operate in the Great Barrier Reef Marine Park and Commonwealth National Parks. It will also include additional assistance to help businesses identify alternative export markets or supply chains. Targeted measures will also be developed to further promote domestic tourism. Further plans and measures to support recovery will be designed and delivered in partnership with the affected industries and communities.

Stimulus package No. 2 (22nd March 2020)

The government released the second stage of its economic plan with a further $66B to cushion the economic impact of the coronavirus and help build a bridge to recovery. This includes:

Coronavirus supplement

- The Government is temporarily expanding eligibility to income support payments and establishing a new, time-limited (6 months) Coronavirus supplement to be paid at a rate of $550 per fortnight. This will be paid to both existing and new recipients of the JobSeeker Payment, Youth Allowance jobseeker, Parenting Payment, Farm Household Allowance and Special Benefit.

Payments to support households

- In addition to the $750 stimulus payment announced on 12 March 2020, the Government will provide a further $750 payment to social security and veteran income support recipients and eligible concession card holders, except for those who are receiving an income support payment that is eligible to receive the Coronavirus supplement.

Early release of superannuation

- The Government will allow individuals in financial stress as a result of the Coronavirus to access up to $10,000 of their superannuation in 2019-20 and a further $10,000 in 2020-21.

Boosting Cash Flow for Employers

- The Government is providing up to $100,000 to eligible small and medium sized businesses, and not-for-profits (including charities) that employ people, with a minimum payment of $20,000. These payments will help businesses' and not-for-profits' cash flow so they can keep operating, pay their rent, electricity and other bills and retain staff. Under the enhanced scheme from the first package, employers will receive a payment equal to 100 per cent of their salary and wages withheld (up from 50 per cent), with the maximum payment being increased from $25,000 to $50,000. In addition, the minimum payment is being increased from $2,000 to $10,000.

Stimulus package No. 3 (30th March 2020)

The government will provide a temporary (6 months) wage subsidy (referred to as the JobKeeper payment) to around 6 million workers who will receive a flat payment of $1,500 per fortnight through their employer, before tax. The $130B JobKeeper payment is designed to keep Australians in jobs and is open to businesses that experience a significant drop in revenue (more than 30%) caused by the coronavirus. The payment will provide the equivalent of around 70 per cent of the national median wage and will help to ensure that eligible employers and employees stay connected while some businesses move into hibernation. The many businesses facing reduced sales do not have to make their workers redundant because the costs of their wages are being met by the government.

A selection of budgetary policy initiatives announced in the 2019-20 Budget (April 2019)

- Extending the **'Personal Income Tax Plan'** to provide further reductions in individual income tax rates, including immediate tax relief to low-and middle-income earners of up to $1,080 for single earners or up to $2,160 for dual income families (via the low and middle income tax offsets) as well as increasing the threshold of the 19 per cent tax bracket from $41,000 to $45,000 by 2022-23 and reducing the 32.5% rate to 30% for taxable incomes between $45,000 and $200,000 on 1 July 2024.
- Extending and expanding the ATO's **Tax Avoidance Taskforce**, which will help ensure multinationals, trusts and high wealth individuals pay the right amount of tax in Australia - estimated to raise $4.6 billion in additional tax liabilities over time.
- Further **reducing taxes for small and medium-sized businesses** by increasing the instant asset write-off threshold to $30,000 (from $20,000) and expanding access to it alongside fast-tracking the company tax rate cut to 25% for small and medium sized companies.
- Establishing the $2 billion **Australian Business Securitisation Fund**, which will enhance small businesses' access to finance.
- **Boosting infrastructure** spending to $100 billion over the next decade, on assets such as a $2 billion contribution to the Melbourne-Geelong fast rail project; $15.6 billion for additional road and rail projects across the country; and $500 million for a Commuter Car Park Fund to improve access to public transport by funding park and ride facilities at rail stations.
- The **Delivering Skills for Today and Tomorrow package** invests $525.3 million in vocational education and training, including 80,000 new apprenticeships and employer payments/subsidies ($4,000).
- Providing **more affordable access to medicines** by increasing the list of items on the Pharmaceutical Benefits Scheme (PBS).
- The provision of $736.6 million over seven years for **mental health services**, including a commitment of $461.1 million for youth mental health.
- Creating **new drought resilience and emergency response funds** that are designed to support Australians during drought and natural disasters (e.g. $6.3 billion of assistance and concessional loans).
- Spending $3.5 billion in a new **Climate Solutions Package**, including a $2 billion Climate Solutions Fund that is designed to support projects that will diversify regional economies and help reduce emissions by an anticipated 103 million tonnes by 2030.
- The provision of $284 million for a one-off, income tax exempt payment to over 3.9 million Australians to assist with **power bills and cost of living pressures**.
- The provision of $453.1 million to support continued access to 15 hours per week of quality preschool education for Australian children in the year before school.
- Increasing the funding for **aged care** by $3.7 billion from $21.6 billion in 2019-20 to $25.4 billion in 2022-23, helping to ensure quality and safe care, as well as increased funding for home based care of the elderly as well as residential care.
- Increased funding to strengthen Australia's **national security and law enforcement** agencies to increase Australia's ability to counter foreign interference, including $512.8 million to enhance the Australian Federal Police's ability to deliver on national security and community policing priorities and $58.6 million to continue to build the capabilities of the Australian Security Intelligence Organisation.
- The development of a new employment services model to deliver more intensive **support for disadvantaged job seekers** via the provision of digital services for job-ready job seekers and enhanced services for disadvantaged job seekers.

- Increased funding to improve the **safety of Australian communities**, such as money for prevention initiatives and frontline services to address domestic and family violence, and providing $527.9 million over five years for the Royal Commission into Violence, Abuse, Neglect and Exploitation of People with Disability.
- Responding to the **banking royal commission** by providing the Australian Securities and Investments Commission (ASIC) with additional funding of $404.8 million so that it can undertake an accelerated enforcement strategy, implement an enhanced onsite supervisory capability for large institutions.

A selection of budgetary policy initiatives announced in the 2018-19 Budget (May 2018)

- The **'Personal Income Tax Plan'** which involves significant reductions in individual income tax rates in three stages over a number of years. The government claims that it is an attempt to make the tax system simpler and fairer, and one which 'rewards working Australians' and protect Australians from bracket creep. The changes involve higher Low Income Tax Offsets, a higher income threshold applying to the 32.5% tax bracket and the eventual removal of the 37% tax bracket by 2024.
- An expansion of the government's **Pension Loans Scheme** which provides pensioners and self-funded retirees greater opportunities to reverse mortgage their homes to the government which helps to improve cash flow/income for older Australians.
- Allowing **pensioners the ability to earn more income** (up from $250 per fortnight to $300) without their fortnightly pension payments being affected.
- The extension of the $20,000 **instant asset write-off** for an additional 12 months in an effort to stimulate capital investment by smaller businesses.
- The continued **reductions to company tax rates** as part of the '10 Year Enterprise Tax Plan', with medium-sized businesses (those with annual turnover up to $50 million) set to enjoy a lower 27.5% corporate tax rate from 1 July 2018.
- The commitment to spend $24.5 billion on new nationally significant **transport infrastructure projects** and initiatives across Australia such as the Melbourne to Brisbane Inland Rail Project announced in the previous budget as well as various road infrastructure projects, including $1 billion on the M1 Pacific Motorway, $5 billion on the Melbourne Airport Rail Link, $1.75 billion on the North East link and $3.3 billion on the Bruce Highway in Queensland.
- Investing $1.9 billion (over 12 years) in **national research infrastructure** which is designed to deliver high-impact research that can be used across the economy, from industries including, health, manufacturing and agriculture.
- $500 million to secure the future of the **Great Barrier Reef**, including through improving water quality in conducting scientific research.
- Promoting **more open trade** and improving access to markets as well as supporting Australia's agricultural and defence industry exports
- A new **public hospital agreement** delivering more than $30 billion in additional funding between 2020-21 and 2024-25 which is designed to ensure that Australians have access to high-quality health care and therefore improve health outcomes.
- Expenditure of $24.5 billion on the **Quality Schools Package**, where funding is designed to be on a needs basis such that the best outcomes can be achieved for all students.
- The introduction of the government's new **childcare package** providing support for families most in need.
- Reforms to **improve the integrity of the welfare system**, including approximately $300 million to extend fraud detection and debt recovery activities, as well as extending the waiting period (to 4 years) before newly arrived migrants can access certain welfare benefits.
- **Extending the goods and services tax (GST)** to Australian hotel bookings made through offshore digital businesses to ensure that these businesses face the same tax treatment as Australian businesses.
- Increased funding to tackle **multinational tax avoidance**, including reform to Australia's anti-avoidance rules by broadening the scope of large multinationals that will be subject to the Multinational Anti-Avoidance Law (MAAL) and the Diverted Profits Tax (DPT).
- Funding to support the **cracking down on the black economy** (e.g. increasing actions against tax agents who facilitate activity in the black economy), as was the creation of burn **Illicit Tobacco Task Force** which is designed to dismantle organised crime groups operating in illicit Tobacco.

> **Exam Tip:** With some government initiatives, it will be very difficult to establish a direct link to one of the three domestic macroeconomic goals listed in the Study Design, but much easier to establish a link to 'living standards'. For example, more funds committed for the strengthening of national security or defence might create more jobs and assist with Full Employment – this is clearly not the rationale behind the initiative. However, this initiative is directly designed to re-allocate resources to areas of national interest and address a market failure (without governments, the private sector will be unlikely to provide national security or defence services). Accordingly, if an exam question directed students to provide an example of a government policy that is *designed to* reduce unemployment, it could be inaccurate to refer to an increase in spending on national security/defence. This is because the spending is designed to strengthen security/defence rather than create jobs, even though job creation is a useful by-product of the policy initiative.

The effect of budget initiatives from the past two years on the Australian Government's domestic macroeconomic goals

In this section will examine how the budget has been used to assist in the achievement of:

- Low inflation
- Full Employment
- Economic Growth

> **Exam Tip:** Technically, the past two years encompasses budget initiatives from the May 2018-19 Budget deliliverd in May 2018, in addition to the 2019-20 Budget handed down in April 2019, as well as the BP measures introduced over 2020 (e.g. the stimulus measures from March 2020) and the 2020-21 Budget to be delivered in October 2020. It is important to note that students are not expected to be aware of *all* of the initiatives delivered in these budgets. This is particularly the case in relation to the 2020-21 Budget that will be delivered in October 2020. Instead, students should be in a position where they can outline, describe, explain, discuss, analyse or evaluate more than one budgetary policy initiative in terms of the impact on the government's macroeconomic goals and living standards.

The simultaneous achievement of Price Stability, Strong and Sustainable Economic Growth and Full Employment means that we have achieved *stability in the level of domestic economic activity*. This is also referred to as either *internal stability* or *domestic economic stability*. However, always remember that the government's overriding goal is to achieve the best (or most efficient) allocation of the nation's resources. This occurs when the nation's resources are used in such a way that national welfare and living standards are maximised – both in material and non-material terms. Accordingly, *every* budgetary policy initiative will, in some way, change the allocation of resources in an effort to reach the ideal outcome (or the pareto optimal allocation of resources). Some initiatives, such as many environmental policies, are designed to improve the allocation of resources via their impact on the goal of sustainable economic growth. However, others such as increased spending on defence and national security, are designed to improve the allocation of resources by rectifying market failures rather than their impact on the goal of sustainable economic growth.

When examining how budgetary policy can be used to assist with the achievement of the government's goals it is useful to focus on two things:

1. **specific initiatives** that could be implemented (e.g. reducing a particular tax rate or introducing a new tax, such as the reductions in some taxes in recent budgets); and

2. changes to the **overall budget outcome** (e.g. targeting for a higher or lower surplus).

The following section provides you with examples of how particular budgetary policy initiatives from each of the last three budgets can assist in the achievement of each goal. [Note that no attempt has been made below to distinguish between Aggregate Demand or Supply initiatives. The section is purely designed to provide students with examples to draw upon if asked to highlight how budget measures can assist with the achievement of a particular domestic economic goal. As a general guide, BP initiatives that are designed to assist with the achievement of low inflation will be 'supply side' driven. Supply side BP initiatives will be examined more closely in Area of Study 2]

From the 2020 stimulus measures

- *Full employment:* $130B wage subsidy (via the JobKeeper payment) will not only ensure that workers 'remain on the books as employees of businesses', it will also help to stimulate Consumption demand in the economy, which supports growth in AD/GDP and helps to further support the demand for labour and employment beyond that which would otherwise have occurred.

> **Exam Tip:** It is worth remembering that the JobKeeper payment, as part of the March 2020 wage subsidy, is strategically designed to prevent the 'recorded level' of unemployment from climbing to historically high levels. It is able to achieve this because employees are kept 'on the books' despite working very few hours (or none at all) during the relevant period. As a consequence, unemployment statistics will be a less useful indicator of both the degree of spare capacity in labour markets and the success of discretionary budgetary measures introduced by the government. A more useful indicator is the labour force underutilisation rate (including measures of unemployment and underemployment), which will rise by much more than the unemployment rate during the coronavirus pandemic.

- *Economic growth:* $6.7 billion to Boost Cash Flow for Employers by up to $25,000 with a minimum payment of $2,000 for eligible small and medium-sized businesses., which helps to simulate business Investment, AD and economic growth.

- *Low inflation*: The increase in the instant asset write off threshold from $30,000 to $150,000 should encourage an increase in capital investment which has the potential to boost productivity/efficiency and reduce cost inflationary pressures.

> **Exam Tip:** One could justifiably argue that, in the current recessionary climate, the stimulus measures introduced over 2020 can actually assist with the achievement of price stability given that inflation has been below or at the lower end of the RBA's target 2-3% range. For example, given that the underlying rate of inflation (trimmed mean) for the year to end March 2020 was 1.8%, one could argue that without the government stimulus measures, the rate of (underlying) inflation could fall dangerously low, even to the point where deflation is recorded. In this context, stimulus measures that stimulate AD and inflation can actually support the achievement of the price stability goal.

From the 2019-20 Budget released in April 2019

- *Full employment:* The lower effective tax rates for lower and middle income earners (via the increase in the low and middle income tax offsets) combined with the one-off, income tax exempt, payment to over 3.9 million Australians to assist with power bills and cost of living pressures, which help to stimulate AD (via Consumption), economic growth and employment.
- *Economic growth:* Further reducing taxes for small and medium-sized businesses by increasing the instant asset write-off as well as the further increase in infrastructure spending, which both boost AD (I and G2) and economic growth.
- *Low inflation*: The increased spending on vocational education and training, including 80,000 new apprenticeships and employer payments/subsidies that is designed to help boost skills, productivity and efficiency.

From the 2018-19 Budget released in May 2018

- *Full employment:* Allowing age pensioners and self-employed individuals to earn up to approximately $7,800 per year (or approximately $150 per week) without reducing their pension benefits. This can increase participation rates and boost employment in the longer term (on both the demand and supply sides).
- *Economic growth*: Phased lowering of corporate tax (e.g. cutting the rate to 27.5% for medium sized businesses) and individual taxes (e.g. the immediate increase in the Low Income Tax Offset and lower rates for all income earners over time) can help to stimulate both Consumption and Investment, boosting AD and economic growth.
- *Low inflation*: The further extension of the $20,000 immediate tax deductibility threshold for small business capital investment and the boost to transport infrastructure spending, both of which help to reduce cost inflationary pressures.

> **Exam Tip:** Students should note that any initiative that is designed to stimulate AD and economic growth can also be used as an initiative to achieve full employment. Students simply need to establish a connection between real GDP and the rate of unemployment by focusing on the increased demand for labour and greater employment that will typically stem from growth in real GDP.

> **Exam Tip:** Examination questions relating to budgetary policy will sometimes direct students to focus on either the demand or supply side in their responses. Those students who fail to pay close attention to the specific requirements of the question will be at a distinct disadvantage. For example, Q3b of the 2016 exam required students to explain how a change in personal income and company tax influence aggregate supply and economic growth. Too many students erred by focusing (exclusively) on the demand side, such as saying that lower (personal) income taxes will stimulate AD, real GDP and economic growth, without paying attention to the supply side benefits that can stem from the greater incentive to work (and/or become entrepreneurial) and the links to productivity/efficiency.

> **Exam Tip:** While students are expected to have a knowledge of specific BP initiaves over the last two years, they are not expected to remember the fine detail contained in all of the measures. However, they will be expected to broadly draw upon some of the recent measures to support their analysis or explanation of how budgetary policy has been used to achieve the domestic macro goals. For example, knowledge of tax breaks given to small businesses in the last two budgets can be used to support an explanation of how the budget can be used to stimulate Investment, AD and Economic Growth. It is unrealistic to expect students to deliver the fine detail relating to how these tax breaks were provided! Although, a reference to the write off of capital asset purchases to the value of $20,000 and the reduction in the corporate tax rate to 27.5% for small companies would enhance the quality of a response.

Some other important exam tips relating to budgetary policy and the achievement of the government's domestic macroeconomic goals

Exam Tip: When answering questions related to any policies, remember that students who incorporate into their responses a reference to recent policy examples are likely to be rewarded with more marks – ceteris paribus – than those who do not. It is necessary to develop an understanding of some recent budgetary policy measures and how or why they have been introduced. When examining recent budgets, check for measures or initiatives that assist in the achievement of each economic goal, remembering that every BP initiative should be designed to lift material or non material living standards. Notice that in recent exams, many questions have required a knowledge of recent policy initiatives. Those students that have not worked hard to develop an understanding of recent policy use will be at an disdvantage.

Exam Tip: In past exams, many students found it difficult to discuss the likely effects of a bigger budget surplus on full employment. First, don't make the common mistake of discussing how FE is likely to impact on the surplus. Second, don't argue that a surplus means more funds are available for spending *in that year* to create jobs and reduce U/E (why not?). Finally, there are a number of ways to answer the question, with the easiest being to argue that a bigger surplus is likely to be 'contractionary' and therefore is unlikely to assist in achieving FE.

Exam Tip: You are likely to be asked questions like: 'Discuss how budgetary policy can be used to assist in the achievement of the government's economic growth and full employment goals. After you demonstrate knowledge of the goals, you will need to fully analyse how these types of measures operate to improve the key variable underpinning the goals – i.e. real GDP and the unemployment rate. Along the way you need to fully explain the 'links in the chain' just as you are required to do for all the demand and supply factors affecting the goals (Unit 3). For example........ 'lower business tax rates lead to higher levels of Investment which stimulates AD and real GDP, thereby assisting with the achievement of the Economic Growth (EG) goal (which is defined as.......) The resulting higher EG is likely to lift the demand for labour, create employment and reduce the unemployment rate, bringing us closer to Full Employment (which is defined as.....')

Exam Tip: Often examiners will ask questions like 'discuss two examples of budgetary policy actions that have been used over the past year to support 'economic growth and jobs.' It is tempting to think that assessors are only looking for a discussion of the nature of the policy initiative itself, rather than how the initiative works to support growth and jobs. Whilst it is important to show an understanding of the nature of the particular policy initiative, don't overdo it!! Assessors will actually be looking for a clear discussion of how the chosen policy initiative actually supported economic growth and employment!!

Exam Tip: The 2014 exam required students to describe one example of a discretionary budgetary policy that could be implemented to reduce the rate of **structural** unemployment. It was common for students to simply focus on any policy that boosts AD and reduces unemployment without making any attempt to discuss those policies that tackle the underlying causes of structural unemployment. Students should have focused on policies that are designed to improve the skills set of those structurally unemployed, which makes them more employable. For example, funds for re-training of manufacturing workers who have been made redundant over recent years.

Exam Tip: Be careful when examining how a reduction in marginal tax rates is likely to impact upon unemployment. A common mistake is to assert that a lower tax burden will boost employment because more people will seek work. Many students erred in this way for question 3(c) of the 2012 exam. While it is true that more people are encouraged to work or seek employment, this fact will actually serve to increase the unemployment rate in the shorter term, as the participation rate increases. Unemployment may decrease over time if the increased labour supply exerts downward pressure on wages (or lifts labour productivity) and increases the demand for labour. The safer way to start answering a question like this is focus on the 'demand' side and illustrate how lower marginal tax rates work to increase disposable income, increasing C, AD, GDP, EG, D for L and reducing unemployment.

Exam Tip: Be careful when examining how a reduction in welfare payments impacts upon unemployment. Commonly, students will argue that lower welfare payments increases the incentives to work and causes more people to get jobs. As noted in the previous Exam Tip, the increased willingness of people to look for work causes an increase in the participation rate, pushing up the unemployment rate. Again, it is only if the increased labour supply exerts less pressure on RULCs and induces an increase in the demand for labour that the unemployment rate will come down. Indeed, some may even argue that lower welfare payments increases unemployment via the negative impact on Consumption.

Exam Tip: When relating budgetary policy measures to inflation it is easy to make the mistake of thinking that any factor causing an increase in AD will be 'bad for inflation' per se. Whilst it is true that an increase in I or G2 will add to 'demand inflationary pressure' in the short term, this is likely to be reversed if and when the 'investment' results in an increase in 'aggregate supply' or 'productive capacity'.

Budgetary policy, living standards, and efficiency in the allocation of resources

Remember that the ultimate goal of all policies is to improve the efficiency in the allocation of resources (*allocative efficiency*) so that living standards or welfare are maximised. In this respect, initiatives designed to lift economic growth, reduce unemployment, control inflation, improve equity and achieve external stability are all intermediate goals that are necessary if Australia is to experience an increase in general living standards. Arguably, every single measure announced in the budget is unlikely to exist if a proper functioning government did not believe it would result in our resources being shifted around in such a way that our collective welfare or living standards is improved.

An alternative way to think about how the budget impacts on living standards is to tap into your knowledge of Unit 3 material, in particular, *market failures.* Indeed, many of the initiatives that are announced and delivered through government (Federal and State) budgets occur in an effort to address *market failures*. For example, a handful of recent initiatives that attempt to address failures in the market include:

- Funding for national security and defence;
- Funding to improve the safety of Australian communities;
- Amending S46 of the Competition and Consumer Act to prevent abuse of market power;
- Increased funding for child care;
- Flood and cyclone assistance as well as funding for drought relief;
- Maintaining the level of Official Development Assistance (foreign aid);
- funding for border protection and/or refugee assistance;
- Funding to expand drugs listed on the Pharmaceutical Benefits Scheme;
- Funding for environmental measures (including direct action initiatives and the recent 'Climate Solutions Package');
- Increased funding for health and education;
- The continuing increases in the excise on tobacco;
- Plain cigarette packaging laws;
- Funding for the national disability insurance scheme;
- Funding to address the housing affordability issue affecting many Australians.

Any supply side budgetary policies that are designed to improve productivity or reduce costs of the private sector (such R&D tax concessions, spending on national infrastructure, privatisation of GBEs, as well other microeconomic reforms implemented through the budget) will assist in lifting *technical* and *dynamic efficiency*. An improvement in these types of efficiency will necessarily result in a more efficient allocation of resources and improved living standards.

Budgetary policy measures involving major shifts in the savings and spending patterns of the public and private sectors (e.g. superannuation incentives and the investment in the *Future Fund*) should also improve *intertemporal efficiency* and, by extension, result in a more efficient allocation of resources and improved living standards in the long run. This also applies to those policies that are designed to achieve more sustainable development over time, such as measures to address climate change which result in slower growth today in exchange for stronger growth in the long term.

When we examine the most recent budgets, you should discover that any initiative or measure that you could not relate directly to other economic goals, can be related to the overriding goal of governments – to boost national living standards or welfare.

Budgetary policy: external stability and the distribution of income

Budgetary policy plays an important role in helping to achieve the government's goals of external stability and greater equity in the distribution of income. However, the current VCE Economics Study Design no longer requires students to demonstrate an understanding of how the policies are used, or have been used, to tackle these goals. Instead, the focus from 2017 onwards is the policy impacts on the domestic macroeconomic goals of strong and sustainable economic growth, full employment and low inflation (price stability).

Strengths and weaknesses of Budgetary Policy

Some **strengths** of budgetary policy include the following:

- it can target particular sectors or industries of the economy (unlike monetary policy);
- it can target a greater range of economic goals better than monetary policy;
- the impact lag (the time it takes for the implemented policy to change economic activity) is relatively short compared to monetary policy;
- there are many parliamentary 'checks and balances' in place to help reject any policy measures that are 'ill-designed' (e.g. the budget Bill must pass through both houses of parliament);
- the 'budget' is open to significant public scrutiny, helping to make policy makers more accountable and transparent, making it 'less likely' (but not impossible) that bad policy decisions are made; and

- it can be very responsive to the needs of the electorate, which is a feature of our democratic system of government, making it more likely that average living standards are improved.

> **Exam Tip:** The new VCE Economics Study Design requires students to have a *knowledge of* the strengths and weaknesses of BP to achieve the government's domestic macroeconomic goals and how these goals may affect living standards. Remember that a strength of a policy refers to an aspect that makes it a particularly powerful tool (when compared to another policy for example). Similarly, a weakness or constraint of policy refers to an aspect that makes it less effective or powerful. Accordingly, in the event that you are specifically asked to provide a strength or weakness of policy, you should not refer to the success/failure of the policy in achieving a particular goal. Success/failure of policy refers to an evaluation of how well the policy has performed in trying to achieve its stated goals. For example, has BP been effective at achieving strong and sustainable growth over the past two years?

> **Exam Tip:** In the 2017 examination, Q3e required students to evaluate one strength and one weakness of using each of budgetary policy and monetary policy in achieving increased 'jobs and growth'. It was insufficient to simply list strengths and weaknesses, as many students did, without linking the strengths/weaknesses to the policy's ability to create jobs and growth. Accordingly, it is not good enough to simply say that 'a weakness of BP is the implementation lag that is involved in the preparation and delivery of budget initiatives'. While this is indeed a weakness, it is necessary to extend the discussion to how this might negatively impact on the ability to achieve 'jobs and growth'. For example, to the extent that the income tax cuts announced in the 2018-19 budget might create jobs and growth in the long term, the perceived regressive nature of the some of the tax cuts (e.g. the flattening of the system from 2024) is likely to cause lengthy delays in the passage of the Bill through the Senate (if they get through at all), which compromises the ability of the policy initiative to achieve stronger employment and economic growth in the future.

Some **weaknesses** of budgetary policy include the following:

- it can be subject to political hurdles that prevent good policies from being implemented (e.g. parts of the 2016-17 company tax cuts remain blocked in the Senate and might never become law);
- it is prone to political bias, particularly around election time, where bad policy decisions can be made in the process of trying to 'buy' votes;
- the implementation lag can be long (compared with monetary policy) given that the budget Bills must pass through both houses of parliament;
- like all federal government policies, they are weakened by the fact that many policies require state government cooperation (given that State governments have sole or joint control in a number of areas, such infrastructure, health, education, etc); and
- *most* budgetary policy initiatives are announced in the annual May budget, resulting in the policy becoming (generally) less responsive to the needs of the electorate.

> **Exam Tip:** The new VCE Economics Study Design requires students to *evaluate* the strengths and weaknesses of AD policies in achieving the government's domestic macroeconomic goals. Evaluation requires students to do more than simply 'have a knowledge of' (see previous Exam Tips). Students will need to weigh-up the strengths against the weaknesses for any particular policy initiative (or the policies in general) to determine which initiative or policy is likely to be most effective. For an evaluation type question, the best performing students will be those who meaningfully analyse/discuss issues such as the costs vs benefits (or advantages versus disadvantages); the key stakeholders affected; and short run versus long run implications.

> **Exam Tip:** When discussing the respective strengths and weaknesses of policies it can be useful to compare and contrast the strengths or weaknesses of one policy relative to another. For instance, saying that budgetary policy is superior to monetary policy in that it can can target particular sectors or problems in the economy. In this respect, one policy's strength becomes another policy's weakness. To illustrate, BP is much more effective at targetting the housing affordability problem because it can focus on both the demand and supply side of the problem (as it attempted to do in the 2017-18 Budget), whereas MP is blunt and one dimensional, limited in its ability to do much more than offer interest rate relief, which only serves to further increase house prices and do little to solve the problem.

REVIEW QUESTIONS 1 – Nature and operation of budgetary policy

1. *Explain what is meant by budgetary policy.*
2. *Outline the goals of budgetary policy.*
3. *List the three major components of government revenue and government expenditure.*
4. *Distinguish a budget surplus from a budget deficit.*
5. *Distinguish a headline budget surplus from an underlying budget surplus and identify the underlying and headline budget outcomes for the 2019-20 Budget (as reported in Table 1 on page 8).*
6. *Distinguish the underlying budget balance from the net operating balance and identify the net operating balance for the 2019-20 Budget (as reported in Table 1 on page 8).*
7. *Distinguish the 'cyclical' and 'structural' components of the budget.*

8. Explain how an 'estimated' budget surplus can become an 'actual' budget deficit.
9. Analyse the impact on the actual budget outcome for 2019-20 given that the government's forecast 2.75% growth in real GDP will be significantly over-estimated (i.e. real GDP for 2019-20 will be less than 2.75%).
10. Analyse the hypothetical impact on the budget deficit for 2019-20 if growth in wages is higher than the 2.5% forecast.
11. Outline how 'bracket creep' can assist with the current government's effort to achieve continuing budget surpluses in the future.
12. Distinguish an 'expansionary' budget from a 'contractionary' one.
13. Outline how the government can finance the estimated $140B headline budget deficit that is now expected to exist for 2019-20.
14. Assuming that the budget outcome does return to surplus sometime in the future, outline how the government can use this budget surplus.
15. Describe the relationship between the budget deficit and net government (public) debt.
16. Explain how it is possible for a bigger surplus to be consistent with expansionary budgetary policy.
17. Explain how it is possible for a bigger deficit to be consistent with a contractionary budgetary policy.
18. Outline how the rise in the 'terms of trade' in recent years impacted on the budget outcomes. In your answer, make reference to automatic stabilisers.
19. Outline how discretionary stabilisers impacted on the 2019-20 Budget outcome. In your answer, make reference to the 'structural component of the budget' or the 'structural budget deficit'.
20. Describe the federal government's 'medium term fiscal strategy'
21. Budgets up to 2019-20 have been consistent with the government's medium-term fiscal strategy and simultaneously been expansionary in nature. Discuss.
22. Outline one BP measure from recent budgets that has been designed to boost skills and explain how the success of this policy is likely to affect Low Inflation and Economic Growth.
23. Identify two recent budgetary policy measures that might assist with the achievement of low inflation.
24. Discuss how $6.3 billion of assistance and concessional loans to support those affected by drought can improve Australian living standards.
25. Outline how a lower company tax rate is likely to impact on Economic Growth and Full Employment.
26. Explain how the increase in the excise on cigarettes is designed to improve living standards.
27. Explain how lower individual tax rates might impact on economic growth.
28. Discuss whether increased funding for defence and national security in recent budgets can both stimulate employment growth and enhance Australian living standards.
29. Without using the same examples provided in earlier responses, provide two examples of policies that have been introduced to boost Australian living standards.
30. Discuss two strengths and two weaknesses associated with the use of budgetary policy.

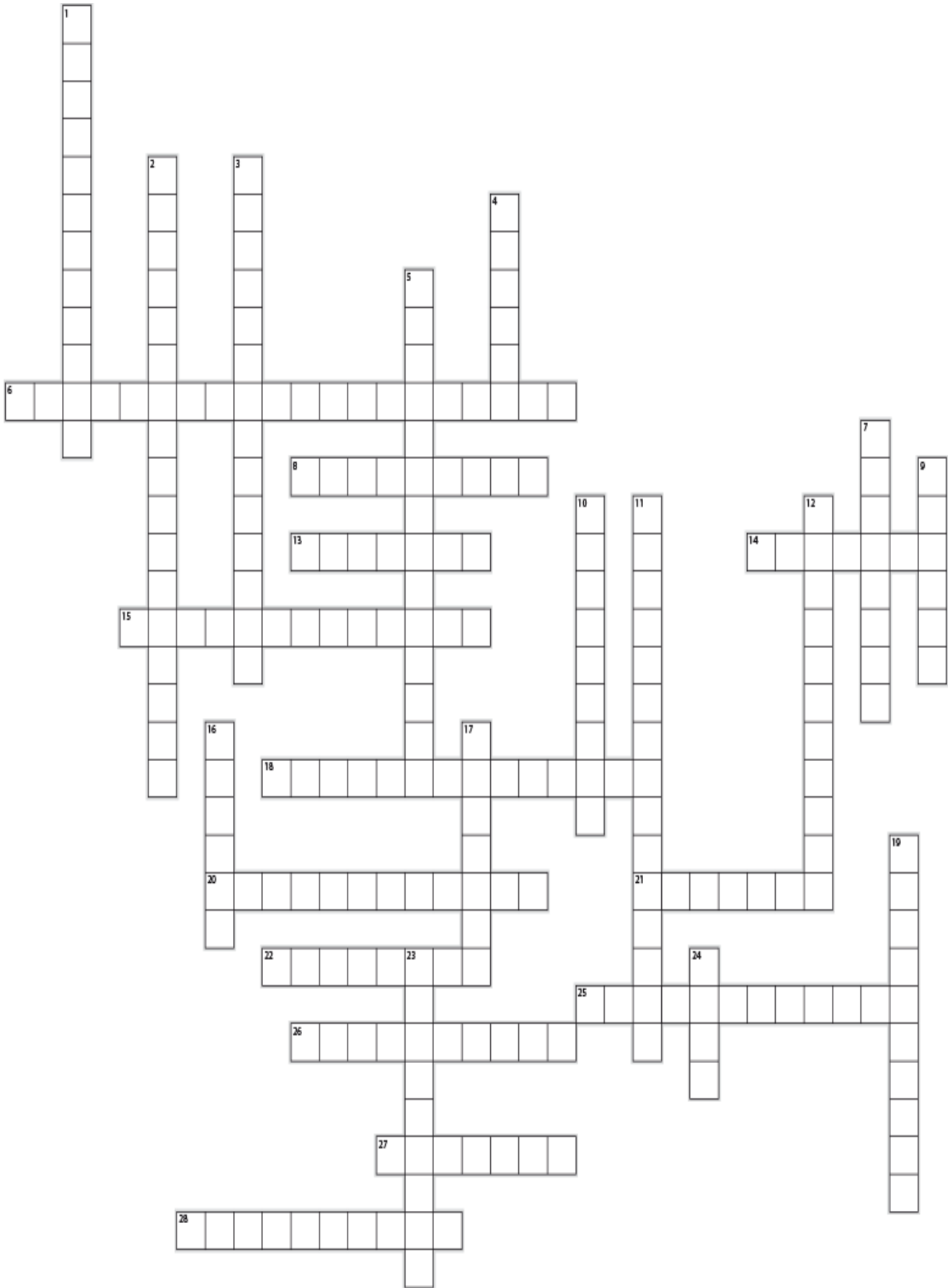## Quick revision crossword No 1: Budgetary policy

Across

6. A reason why the underlying budget deficit is projected to fall over the next few years (2 words)
8. These stabilisers relate to the cyclical component of the Budget
13. The budget outcome when Receipts (revenue) = outlays (expenses)
14. The budget outcome when Receipts (revenue) > outlays (expenses)
15. These changes to the Budget are related to the structural component of the Budget
18. A budget surplus can be used to reduce this (2 words)
20. Generally, this describes a budget deficit (or an increase in the structural deficit)
21. The Budget outcome when Receipts (revenue) < outlays (expenses)
22. In terms of budget outcomes, this is the total cash received by the federal government less the total cash paid
25. The short term strategy employed by the government in order to achieve its medium term goal of budget surplus on average over time (2 words)
26. This component of the Budget will only change in response to deliberate policy decisions by the government
27. The largest component of government expenditure (2 words)
28. Also referred to as 'bracket creep' and occurs during times of inflation for countries with a progressive tax system because of the increase in the 'average' rate of tax paid by taxpayers (as their nominal wages increase in line with inflation) (2 words)

Down

1. Infrastructure investment in the budget aims to boost this as a means of increasing the nation's productive capacity
2. The simultaneous achievement of Economic Growth, Low inflation and Full Employment (2 words)
3. Generally, when the Budget is in surplus (or when the structural surplus has increased)
4. A fund established to pay for the federal government's future superannuation liabilities
5. This particular lag represents a weakness of budgetary policy given that budget Bills must pass through both houses of parliament
7. This component of the Budget will change in line with changes in economic activity
9. The budget outcome that relates to revenue that has been earned over the relevant period compared to expenses that have been incurred
10. How budget deficits are typically financed (2 words)
11. The overriding objective of government policy initiatives (2 words)
12. When budget deficits place upward pressure on interest rates and result in reduced Consumption, Investment and net exports (due to the relationship between interest rates and the value of the $A (2 words)
16. The major fiscal document released each May containing details about all income (or revenue) and expenditure (outlays) of the federal government.
17. The government has attempted to reduce this impediment to the growth of many businesses (2 words)
19. In terms of budget outcomes, it is the Headline balance but excluding those 'non-core' items like net asset purchases for policy purposes and future fund earnings
23. The largest component of government revenue (2 words)
24. One of these has been introduced in the banking industry and another has been increased in order the fully fund the national disability insurance scheme.