schools' brief

Fiscal Policy

Penny Neal

Fiscal policy – i.e. government spending and taxing policy – has reassumed prominence in macroeconomic policy making since the election of the Coalition Government in March. Lower budget deficit outcomes are perceived as being important. The so-called $8 billion budget black hole – in fact, Treasury's estimate of the underlying budget deficit – captured the attention of the Government and commentators as the Government searched for expenditure cuts and revenue savings. By tightening fiscal policy, the Government intends to eliminate the underlying deficit by 1998-99.

There are three levels of government in Australia – Commonwealth, State and local – all of which need to raise monies to finance their activities. Each level of government records receipts and expenditures on an annual basis in a budget. The budget is balanced when government spending equals government revenue. When outlays exceed revenue, the budget is in deficit; and when government revenues are greater than government outlays, the budget is in surplus.

An excess of outlays over revenue for the Commonwealth budget sector indicates that the Commonwealth budget is in deficit. However, because the Commonwealth budget sector is only one part of the public sector, to obtain the net public sector borrowing requirement (PSBR), also known as the *net financing requirement*, the deficits or surpluses of the budget sectors and government business enterprises of all levels of government must be combined. The Commonwealth Government budget deficit or surplus is the major influence on the PSBR and so is the focus of most attention with respect to fiscal policy.

The Headline Deficit

The budget deficit figure that is more often quoted than any other and which, to date, has been the figure reported by the Commonwealth Government at budget time is variously referred to as the actual deficit, the cyclical deficit and the headline deficit. In recent commentary, it has most often been referred to as the headline deficit. The size of the cyclical or headline deficit is important as it gives an indication of the Commonwealth Government's financing requirement. *The actual, headline or cyclical deficit is the amount that the Commonwealth Government needs to borrow to finance its commitments after all its revenues from other sources have been taken into account.*

By spending more than it raises from taxes and other revenue sources, i.e. by running budget deficits, the Government can increase the level of aggregate demand in the economy and so provide a stimulus to economic activity. Conversely, if the Government raises more revenue than it spends (runs budget surpluses), aggregate demand will fall and cause the economy to contract. In this way, the Government can use fiscal policy to boost the economy in times of recession, and to bring about a slowdown in economic activity in times of boom.

The *stance* of fiscal policy changes when the Government changes tax or expenditure *policies*. However, budget deficits can rise and fall with no change in the stance of fiscal policy. The size of the budget deficit is influenced by the economic cycle. Assuming that there are no policy changes with respect to expenditure programs or taxes, an increase in economic activity will lead to a higher level of income and so to changes in taxes and expenditures that are linked to income. For example, with no change in tax *rates* or expenditure *policies*, higher personal incomes will mean that the Government will collect a higher level of personal income taxes, higher profits will mean that firms

__Penny Neal__ is a Senior Economist in the South Australian Department of Treasury and Finance. She is the author, with Colin Rogers, of __Macroeconomics and the Australian Economy__ (Prentice-Hall Australia, 1994). The views expressed in this paper are her own and do not necessarily represent the views of the South Australian Department of Treasury and Finance.

pay a higher level of company taxes, and the Government's expenditure on unemployment benefits and other welfare payments will fall. As Government receipts are rising whilst expenditures are falling, the budget will move either to a smaller deficit or larger surplus position.

Similarly, if income falls in the absence of any fiscal policy change, Government receipts will fall at the same time as expenditure is increasing so that there will be a shift to either a larger budget deficit or a smaller budget surplus position. The increase in Government spending and the fall in taxes prevent the fall in economic activity from being as severe as it would be if there was no Government sector in the economy. Thus, changes in taxes and Government spending which arise from the fluctuations of the economic cycle are known as automatic stabilisers. This is because they reduce the peaks and troughs of the business cycle. Automatic stabilisers cause economic activity to be more stable over the economic cycle than it would be in the absence of the Government sector in the economy.

The cyclical deficit varies with the level of economic activity in the economy even when there is no change in the stance of fiscal policy. Thus, changes in the size of the cyclical deficit cannot be used to determine whether fiscal policy is expansionary or contractionary.

The Structural Deficit

The concept of the structural budget deficit has been developed to gauge the stance of fiscal policy. The structural deficit is the deficit that occurs at some benchmark level of income. The Organisation for Economic Co-operation and Development (OECD) has estimated potential output for all OECD countries, and uses its estimate of potential GDP for each country as the benchmark. Potential output is the level of real GDP and associated rates of growth, which would be sustainable over the medium term at a stable rate of inflation. This is the level of output which would occur if the economy was operating at its normal level of capacity utilisation with all resources almost fully employed.

The economy need not be operating at its potential output level for an estimate of the structural deficit to be made. *The structural budget deficit is the deficit which would occur, given current tax and spending policies, if the economy was operating at its potential level of GDP.*

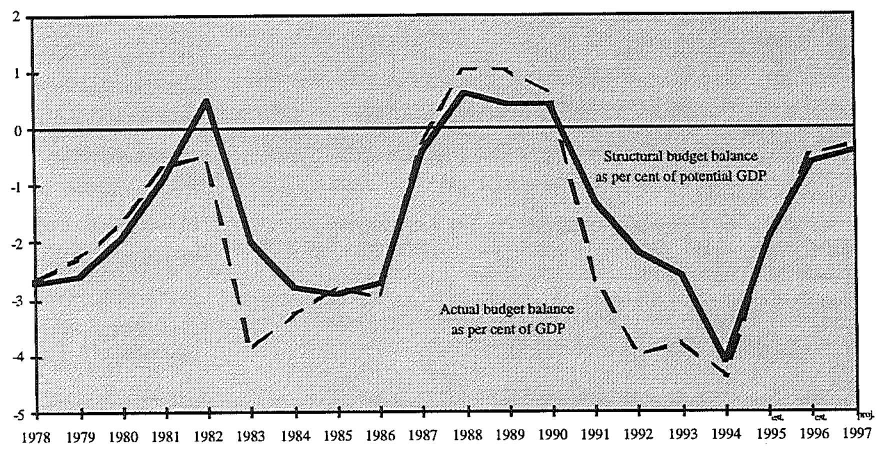
Changes in the stance of fiscal policy require that there be a change in the size of the structural deficit. Suppose that the structural budget is initially in balance. Assume that, in response to recession, the Government eases fiscal policy by increasing spending programs without changing tax policies. As a result of the higher level of government spending, a higher cyclical budget deficit (or lower cyclical budget surplus) occurs at any given level of income. More particularly, the previous structural budget balance is converted into a structural budget deficit. Expansionary or easy fiscal policy leads to an increase in the size of the structural budget deficit (or decrease in the size of the structural budget surplus). Conversely, contractionary or tight fiscal policy leads to a reduction in the size of the structural budget deficit (or increase in the size of the structural budget surplus).

Commonwealth and State government budget sectors are divided into two parts: the general government sector and the public trading enterprises (PTEs) sector. (An alternative name for PTEs is government business enterprises or GBEs.) The general government sector comprises those government departments and agencies involved in income redistribution or which provide public goods and services that are primarily non-market in nature, whilst the PTEs sell goods and services largely in competition with the private sector.

Figure 1 illustrates actual and structural budget balances estimated by the OECD for general government in Australia for calendar years. The chart shows that actual or cyclical budget deficits tend to be more procyclical than structural budget deficits – the actual deficit rises more in a recession than does the structural

Figure 1

GENERAL GOVERNMENT BALANCES



Source: *OECD Economic Outlook*, Nos. 57 and 58, June and December 1995.

deficit whereas the actual surplus rises more in a boom. For example, the actual budget surplus in the boom of the late 1980s was higher than the structural surplus, and the actual deficit in the 1990-92 recession was greater than the structural deficit.

The actual and structural budget deficits are likely to be lower than those projected by the OECD for 1997 as a result of the Government's tightening of fiscal policy in the 1996-97 Budget. There have been some calls in Australia for further structural repair to the budget deficit. To understand the reasons for this we need to examine the complex effects that fiscal policy and deficit financing have on economic activity.

Economic Impacts of Deficit Financing

Unfortunately, fiscal policy gives rise to more complex impacts on economic activity than the pure expansions or contractions of the economy previously described. If the Commonwealth Government budget deficit is positive, the Commonwealth Government is *dissaving*. Herein, lies the concern in Australia about Governments continuing to run budget deficits. Although dissaving can allow the Government to provide more goods and services or charge lower taxes than when the Government is balancing its budget or running a budget surplus, borrowing to finance the excess of spending over revenue can lead to a host of potential problems. These include higher domestic interest rates, crowding-out of private sector investment, higher current account deficits, increasing foreign debt, downgrading of a country's credit rating, and thus higher international interest rates, an increasing reliance by private sector persons on the Government for provision of handouts and services, and by firms for tax and other business concessions, increasing public debt and a transfer of the tax burden associated with servicing government debt to future generations.

The nature of the problems associated with running budget deficits may depend on the way in which the budget deficit is financed. The Commonwealth Government can finance its activities in the following ways; it can:

- raise monies through taxes;
- borrow from the non-bank public by issuing them with bonds;
- borrow from the Reserve Bank by issuing it with bonds (i.e. monetise the deficit);
- sell public assets and/or public enterprises; and
- co-operate with the private sector for joint provision of public goods and services.

Deficit financing and higher interest rates

In recent years, the Commonwealth Government has primarily been financing its budget deficit by issuing Treasury Bonds in domestic financial markets. When the Government issues bonds, it is competing with other institutions, firms and persons to borrow money. The increased competition for funds may push domestic interest rates higher. Orr, Edey and Kennedy (1995) have estimated that if the budget deficit is financed exclusively by borrowing from the domestic private sector, a rise in a country's budget deficit by one per cent of GDP could raise real interest rates (interest rates less the expected rate of inflation) by around 1/6 of a percentage point. If the budget deficit is financed entirely from abroad so that the current account deficit worsens, Orr, Edey and Kennedy have estimated that the rise in real interest rates is approximately 1/3 of a percentage point.

Higher real interest rates, in turn, act as a disincentive to private investors. The consequent fall in private investment causes a subsequent reduction in economic activity which is referred to as the 'crowding-out effect'. An increase in government expenditure leads to increased government borrowing which induces higher interest rates so that some private sector activity is reduced or 'crowded-out'. Thus, the initial stimulus to the economy from higher government expenditure is wholly or partially offset by the reduction in private sector activity. Crowding-out may mean that expansionary fiscal policy intended to stimulate aggregate demand is ultimately ineffective.

Furthermore, once an issue of bonds has been made, the Government acquires a debt which requires servicing. In the absence of other changes to budget receipts and outlays, interest payments on the debt in future periods add to Government expenditures and so cause future budget deficits to rise – necessitating even higher levels of future borrowing and higher levels of public debt.

Deficit financing and the current account deficit

Public sector borrowing or dissaving has contributed a large amount to national dissaving in Australia. Policy concern over continuing current account deficits has made most people aware that current account deficits arise when there is insufficient national saving. Domestic spending is higher than the value of domestic production. If persons, firms and governments in an economy are spending more than they are producing, then they must be dissaving. The size of the current account deficit is identically equal to national dissaving (See Box, p.61). Assuming that the gap between private saving and private investment remains stable over time, the Government can reduce the amount

The link between fiscal policy and the current account deficit

GDP may be expressed as the sum of expenditures as in the first line below, or alternatively as the sum of the means of dispersal of income as in the second line.

$$y = c_p + i_p + g + x - z$$
$$y = c_p + s_p + t + f$$

where y = GDP, c_p = private consumption, s_p = private saving, i_p = private investment, g = government consumption and investment expenditure, x = exports, z = imports, t = taxes and f = net factor payments made overseas (mostly interest and dividend payments).

Equating the first line with the second line and rearranging gives:

$$s_p + t + f = i_p + g + x - z$$
$$(s_p - i_p) + (t - g) = (x - z - f)$$
$$\text{S} - \text{I gap} + \text{GBD} = \text{CAD}$$

where S – I gap is the difference between private saving and private investment, GBD is the government budget deficit (if negative) and CAD is the current account deficit (if negative). Private dissaving occurs if private investment is greater than private saving. Likewise, public dissaving (a budget deficit) occurs when government spending is greater than government revenue. The sum of private dissaving and public dissaving equals national dissaving. Thus the current account deficit is identically equal to national dissaving.

The above equation suggests a number of ways in which the current account deficit might be reduced:

- reduce private sector investment (generally not to be advocated as falling investment limits future economic growth);
- increase private sector saving;
- reduce the government budget deficit (that is, increase public sector saving by tightening fiscal policy); or
- increase net exports either by increasing exports or restricting imports or by some combination of the two.

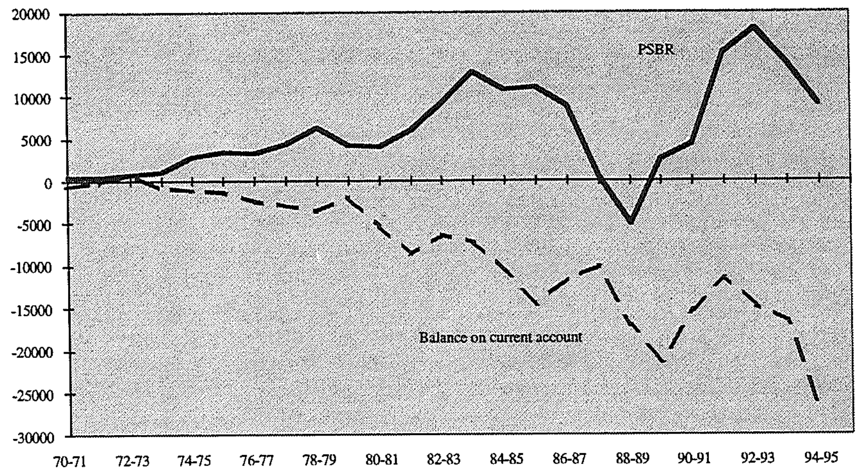
of national dissaving, and thus the current account deficit, by tightening fiscal policy. This link between fiscal policy and the current account deficit is known as the twin deficits hypothesis because the reduction in the budget deficit is mirrored or 'twinned' by an equal reduction in the current account deficit.

Figure 2 illustrates the PSBR and the current account deficit for Australia since 1970-71. It shows that, over the last few decades, the current account deficit has generally fallen when there has been a decline in the PSBR. However, when the Commonwealth Government tightened fiscal policy in the late 1980s, Figure 2 shows that, despite the consequent fall in the PSBR, the current account deficit worsened.

The twin deficits hypothesis is based on the assumption that the private saving-investment imbalance is stable over time. For a variety of reasons, private investment increased rapidly in the late

Figure 2

THE PSBR AND THE BALANCE ON CURRENT ACCOUNT



Source: Reserve Bank of Australia, *Bulletin*, Various issues.

1980s which led, despite tighter fiscal policy, to a widening of Australia's saving-investment imbalance and thus an increase in the current account deficit:

- because the Government was perceived as addressing Australia's problem with the current account deficit by tightening fiscal policy, private sector confidence may have increased and led to a larger rise or 'crowding-in' of private sector investment than would have otherwise occurred;
- the late 1980s was a period of high asset price inflation and so more private sector investment was undertaken with a view to making speculative capital gains than would have occurred in a time of lower inflation; and
- the tax system in Australia by allowing the deduction of the nominal rather than real value of interest payments encourages over-investment when inflation is high. Similarly, taxing the (higher) nominal value of interest receipts rather than their real value discourages saving when inflation is high. Both of these features of the tax system led to a widening of the saving-investment imbalance in the late 1980s.

An alternative to issuing bonds in domestic markets is for the Government to issue bonds overseas. In this case, the Government is borrowing from foreign markets and therefore increasing both public and foreign debt. The rising foreign debt to GDP ratio over the 1980s and into the 1990s to a level exceeding 40 per cent by 1993 became of increasing concern to policymakers, and an objective of successive Governments has been to stabilise and then reduce the ratio. The net foreign debt to GDP ratio stood at 38.8 per cent in the March quarter 1996. Concern at the high ratio arises as it both requires that an increasing proportion of export receipts be used to service the debt, and as with domestic borrowing the debt servicing charges themselves add to subsequent current account deficits; instituting a vicious circle necessitating further foreign borrowing and transferring the increasing burdens associated with debt servicing to future generations.

Deficit financing and inflation

Governments have been reluctant for some years to finance budget deficits by issuing bonds to the Reserve Bank because of its inflationary consequences. When the Government borrows from the Reserve Bank, the Reserve Bank issues new money in exchange for Treasury bonds. An increase in the money supply tends to have inflationary effects particularly if the economy is operating close to potential output. However, Governments in recent years have found an alternative, and sometimes controversial, revenue source – the sale of public assets.

The Underlying Deficit

In recent years, the Commonwealth Government has sold some major assets or PTEs such as QANTAS and the Commonwealth Bank. The proceeds of the sale of these assets have been applied to the reduction of the headline or cyclical deficit. State Governments also borrow from the Commonwealth Government and thus have to make repayments on this debt. These repayments can be quite large and lumpy and can also have a sizable impact on the cyclical budget deficit. Because the sale of assets and State debt repayments give rise to large and lumpy impacts on the cyclical budget deficit in the year that the sales or repayments are made, the current Government is attempting to change the policy focus from the headline or cyclical budget deficit to the underlying budget deficit. *The underlying budget deficit is equal to the cyclical deficit less the proceeds of asset sales and less net repayments of debt by the State Governments to the Commonwealth Government.*

The underlying budget deficit gives a better indication than does the headline deficit of the Commonwealth Government's contribution to Australia's saving-investment imbalance and thus the Government's net contribution to the current account deficit.

The Commonwealth Government intends to achieve underlying budget balance by 1998-99 by cutting $4 billion from the actual budget deficit in each of the 1996-97 and 1997-98 budgets. The reduction in the budget deficits is to be achieved primarily by expenditure cuts including reductions in financial assistance to the States from the levels which had previously been promised. Estimated GDP growth of 3 per cent per annum in 1996-97 and 1997-98 and some savings in revenue, for example, reducing the incidence of tax avoidance and evasion will increase tax revenue so that an underlying budget surplus should be achieved in 1998-99.

The International Monetary Fund (IMF 1996) has undertaken a study of 62 episodes of fiscal consolidation in industrial countries including Australia in order to determine factors which might contribute to the success of tighter fiscal policy (see Alesina and Perotti 1995; Giavazzi and Pagano 1995). The IMF study suggests that fiscal consolidation will be successful if fiscal contraction is sizeable and if reductions in the deficit are achieved primarily by expenditure cuts rather than by measures to increase revenues. Thus, the IMF study suggests that the Coalition Government's current strategy to achieve underlying balance by concentrating on expenditure reduction is more likely to be successful than a strategy which is comprised substantially of new revenue-raising measures.

Budget balance over the course of the business cycle would seem to be a desirable goal. If achieved, government savings arising from budget surpluses in boom times can be used to finance budget deficits in times of recession. This requires the Government to run budget surpluses when the economy is growing strongly. Economic growth has been strong since 1994 and yet Australia has been running budget deficits. The Treasurer has indicated that, at this point of the economic cycle, the budget should be in surplus rather than deficit. Tighter fiscal policy in 1996-97 and 1997-98 should improve the cyclical, underlying and structural budget balances of the Commonwealth Government, and reduce both pressure on interest rates and the Government's contribution to Australia's saving-investment imbalance.

References

Alesina, Alberto and Roberto Perotti 1995, 'Fiscal adjustment: Fiscal expansions and adjustments in OECD countries', *Economic Policy*, October.

Budget Statements 1995-96, Budget Paper No. 1, Statement 2: Economic conditions, prospects and policies, Statement 5: Budget financing and debt management strategy, and Statement 6: The public sector, Australian Government Publishing Service, Canberra.

Giavazzi, Francesco and Marco Pagano 1995, 'Non-Keynesian effects of fiscal policy changes: International evidence and the Swedish experience', *NBER Working Paper* No. 5332, November.

Giorno, Claude, Pete Richardson, Deborah Roseveare and Paul van den Noord 1995, 'Potential output, output gaps and structural budget balances', *OECD Economic Studies* No. 24, 1995/I, OECD, Paris.

International Monetary Fund 1996, *World Economic Outlook*, IMF, Washington DC.

Organisation for Economic Co-operation and Development 1995, *OECD Economic Outlook*, Nos. 57 and 58, June and December, OECD, Paris.

Orr, Adrian, Malcolm Edey and Michael Kennedy 1995, 'Real long-term interest rates: the evidence from pooled time series', *OECD Economic Studies* No. 25, 1995/II, OECD, Paris.

Rogers, Colin and Penny Neal 1994, *Macroeconomics and the Australian Economy*, Prentice-Hall Australia, Sydney.

The Economist 1996, 'It's not what you do ...', January 20th - 26th: 96.

Amity Shlaes, 'Doom, Gloom and the Middle Class', *Commentary,* February 1996.

Shlaes examines some books which rage over the supposed disappearance of the middle classes as the economy stagnates and society polarises between the very rich and the poor. *The End of Affluence* argues that economic growth has ceased in the US for lack of an industrial policy. *America Unequal* is even more pessimistic because its authors hold that not even economic growth would help the poor. They want billions to be spent on workfare. However a book by Robert J. Samuelson 'shows the extent to which Thomas Jefferson's nation of yeomen has become a land of perpetual dependents ... fully 51 per cent of our families receive some form of federal payment'.

Welfare payments and perhaps other forms of 'black' income are so substantial that 'Americans in the bottom quintile spend just about twice the income they officially report. Thus, some 60 per cent of America's poor own VCRs compared with 39 per cent of Danes and 35 per cent of the French'. For this reason, claims about inequalities based on income figures will be wide of the mark.

Shlaes claims that the advocates of intervention have chosen the wrong targets for their concern. The real problems are overregulation, also the challenge of technology and the need to anchor inflation. The interventionists love 1973 as a golden year for wage growth, but Shlaes points out that this wage surge set off an inflationary spiral which sent property and other prices out of reach of huge numbers of low wage earners.

Malcolm Gladwell, 'The Tipping Point', *The New Yorker,* 3 June 1996.

Gladwell is concerned to account for the remarkable reduction in crime figures in New York. 'Homicides are now at the level of the early 70s, nearly half of what they were in 1990...On the streets [of the poorest areas] it is possible to see signs of everyday life that would have been unthinkable in the early nineties'. He suggests that two concepts may explain this situation; the 'tipping point' for the spread of disease and the 'broken window' phenomenon as a cause of antisocial behaviour.

A tipping point is a critical level of some activity, whether the spread of a disease, the flow of traffic on a highway or a crime rate, at which a slight increase triggers a cascading effect in the form of an epidemic, a traffic snarl or a crime wave. Conversely, if events move the other way the cascading effect can work benignly.

The 'broken window' effect is the US experimental observation that a car can be left for some days and little harm will come at first, but if a window is broken the car is likely to stripped within 24 hours (even in a respectable neighbourhood). A little disorder prompts further disruption. This type of thinking prompted a clean-up of the New York subways, starting with the removal of graffiti from every car and cracking down on people who leapt turnstiles without paying. These problems were regarded as 'broken windows' which, unchecked, might prompt more serious delinquency. A similar strategy has been taken up by the New York Police Department with incremental changes that can be effected without increased funds. Hence, for example, a push for more streamlined law enforcement and the systematic dispersal of street-corner loiterers before they become disruptive. Gladwell suggests that these modest advances (with others) have generated a 'tipping point' and so have considerably reduced the level of criminal activity.

Loek Halman, 'Is There a Moral Decline? A Cross-national Inquiry into Morality in Contemporary Society', *ISSJ* 145/1995.

Modern times have seen a rise of individualism and a drift from traditional allegiances to communities, congregations, tribes, families, etc. As Halman puts it 'Modern individualized people are guided mainly by ideas of personal happiness, self-realization and an immediate gratification of needs, at the cost of collective authority'. Many consider that this has resulted in a collapse of moral standards.

Halman reports on research which provides some hints about the state of play in the modern moral universe. The database is the European Values Study (EVS).

Two dimensions of morality are probed, one labelled private morality (such as sexual acts in private), the other civic morality, relating to public activity (littering, drink driving, cheating on taxes or welfare). Many intriguing cross-national variations occur· France and Belgium score high on permissiveness and low on civics; the Irish are not permissive and are high on civics (IRA excepted?); the Dutch are highly permissive and only moderately civic-minded; the Hungarians are appalling in civics and are not very permissive.

The young are more permissive and less civic-minded than are older people. However in those countries such as Scandinavia which were most permissive a decade ago, AIDS has produced a shift the other way. 'It seems as if it is not that morality has declined, but that the basis of morality has changed. Instead of a morality which is dominated and legitimized by the churches, a personal morality seems to be emerging'.

Rafe Champion