Economic Policies And Management

Economic Objectives In Relation To…

Economic Growth And Quality Of Life

The government aims to achieve sustainable real economic growth rates of 3-4% pa. Economic growth involves increasing an economy's production of G+S over time and is measured by changes in real GDP. Economic growth leads to:

- A rise in real per capita income leading to increased standards of living. A rise in income may also lead to greater investment flows in the form of savings for businesses. Expanding businesses will be inclined to employ more resources from the economy, lowering unemployment.
- Due to higher income, consumers have a higher propensity to purchase G+S leading to a rise in aggregate demand. This further leads to lower levels of unemployment, as derived demand for labour from employers rise. All this leads to an expansion in the economy's productive capacity.

Full Employment

Full employment occurs when demand for labour is equal to its supply. This occurs when the economy is at the non-accelerating inflation rate of unemployment (NAIRU). The NAIRU occurs when the level of cyclical unemployment in an economy is zero and is estimated to be at 5% to 6% of the Australian workforce (must account for **Hysteresis**).

The benefits of full employment are:

-Maximising the economy's capacity to produce and therefore maximising living standards by fostering growth whilst minimising the adverse economic and social problems associated with unemployment.

Price Stability

Price stability refers to keeping inflation at a target band of 2-3% which negates its side effects on an economy.

External Stability

External stability refers to the ability of an economy to service its financial obligations to the global economy. Having external stability hedges an economy against flow on effects from the global markets such as the valuation effect.

Distribution of income and wealth

Policies aim to reduce the gap between high and low income earners through redistribution such as bracket tax rates and social security payments. In recent times there has been a focus on those who have limited education opportunities. This will allow for a more equitable income distribution by bridging the differences in the quality of resources and their factor income returns.

Environmental Sustainability

Government policies aim to achieve levels of economic growth and development which meet present needs without compromising future generations. This is referred to as ecologically sustainable development, by maintaining environmental quality and conserving natural resources.

Potential Conflicts Among Economic Objectives

Price stability and full employment may conflict. As the economy is at its NAIRU, and labour market demand rises due to economic growth, business will provide incentives in the form of higher wages against their competitors. This places inflationary pressures on the economy in the form of cost-push inflation, and then demand-pull inflation as there is more wages in a booming economy which ultimately leads to the wage price spiral. **<u>Philips Curve!</u>**

Economic growth and full employment may conflict with external stability. This is because consumers have a higher propensity to purchase internationally competitive imports, leading to a deterioration of the BOGS and a wider CAD. Purchasing imports also leads to a depreciation of the Australian dollar, causing the valuation effect.

Macroeconomic Policies

Rationale for macroeconomic policies – stabilisation and AD shifts

Macroeconomic policies refer to policies directed at stabilising an economy's aggregate demand levels. As such they are generally counter cyclical and smooth out fluctuations of the business cycle. This is achieved by stances of the following:

Fiscal policy: Refers to the government's use of the federal budget to affect the level of economic activity, income distribution and resource allocation in the economy. This is achieved through the two budgetary instruments of taxation and government spending.

Fiscal policy aims to achieve external stability by ensuring the budget is kept in balance over the medium term, and that higher public saving (through accumulated fiscal surpluses) can be used to reduce Australia' reliance on foreign investment flows.

As the domestic saving and investment gap is equal to the size of the CAD, Fiscal policy also targets to keep it under -5% of GDP. (Investment gap = savings not sufficient that must be financed from abroad.)

Monetary Policy: Monetary policy is conducted by the RBA through domestic market operations to influence the cost and availability of money and credit in the economy. The principal medium-term objective of the macroeconomic policy is to contain inflation within the target band of 2-3% per anum through counter cyclical changes to the cash rate. By smoothing out forecasted fluctuations in the business cycle monetary policy also sustains long-term economic growth and maintains full employment, leading to an improvement in living standards.

Overall the government eases monetary and fiscal policy stances to encourage spending, which alongside with the multiplier effect stimulates aggregate demand. Stances are tightened to discourage spending and growth which close inflationary gaps.

Relative to other economies Australia has strong fundamentals, however, there are certain structural challenges that lay ahead in terms of maintaining the supply of labour to the workforce with an ageing population and the continuing structural change as Australia recovers from the dutch disease. Monetary policy should be used to support non-inflationary growth whilst fiscal policy can be used with an expansionary stance if economic conditions deteriorate and fiscal stimulus is needed to prevent the economy from contracting and unemployment from rising.

Fiscal Policy

Federal government budgets and budget outcomes

The budget is an annual statement of expected government revenue and expenditure for the forthcoming financial year. However, this is a forecast and may need revisions due to changing economic conditions. This is why the government issues a Mid-Year Economic and Fiscal Outlook statement in December or January with updates.

With total government revenue expected to be $387.7bn, and total outlays forecasted to be $398.3bn, the 2013-14 Australian budget outcome is a deficit of $18bn. The deficit has fallen by $1.4bn from the 2012-13 financial year's – a net fiscal contraction worth 0.2% of GDP. However its stance is expansionary, considering the previous budget reported a net fiscal contraction of 1.6%. Despite this, mild contractionary effects are expected, with Australia's real GDP growth dampening from 3% to 2.75%. This has been driven by a forecasted 1.75% rise of structural revenue alongside a 1% fall of structural expenditure in comparison to the previous budget.

Underpinning this is the Australian government's goal of fiscal consolidation, with an expected balanced outcome in the 2015-16 budget and eventual surplus in the 2016-17 financial year.

The Disability Care Australia policy will be funded by an increase in the Medicare levy from 1.5% to 2% of all taxable income with $19.3bn to be invested over a period of seven years.

The Gonski school education reforms will be funded for six years, totalling $9.8bn to enhance the Australian workforce's productivity and quality. Furthermore, $97m will fund more Commonwealth supported places for postgraduate university degrees. → The three P's.

From 2013-14 the government will spend $24bn for new road, rail and port infrastructure.

The budget's expansionary policies have outstripped its contractionary components. Despite this the government expects real GDP growth to slow down to 2.75% before a slight improvement back to 3% in 2014-15. This is because the budget's deficit has contracted from the previous year. With inflation expected to stay in the 2-3% target band, this economic growth is through productivity increases rather than increases in aggregate demand.

The **budget outcome** takes into account the government's expenditure and revenue flows quantitatively. It aims to achieve fiscal balance across an economic cycle. **The outcome only looks at a (ONE) budget's revenue versus expenditure.**

- A **balanced budget** occurs when G=T: Where government revenue finances all of government spending and the budget balance is zero.
- A **budget deficit** occurs when G>T: Where government spending exceeds government revenue. When governments finance budget deficits, public debt accumulates and is unsustainable according to the Pitchford thesis.

- A **budget surplus** occurs when G<T: Where government spending is less than government revenue. When governments finance budget surpluses, public savings accumulate.

Stance

The stance of fiscal policy refers to the overall effect of the budget outcome on economic activity. **Stance is compared for change between the new and previous budgets.**

i.e Small deficit → Larger deficit = Expansionary

Large deficit → Smaller deficit = Contractionary

- **Neutral:** When G=T. Has little to no effect on economic activity.
- **Expansionary Stance:** Involves a net increase in government spending through a rise in government spending and/or a fall in taxation revenue. Leads to a larger budget deficit or a smaller budget surplus than the previous outcome. Economic growth is promoted and the unemployment rate falls, but upward pressures are placed on inflation.
- **Contractionary Stance:** Occurs when net government spending is reduced through higher taxation revenue and/or a decrease in government spending. Leads to a lower budget deficit or a larger budget surplus than the previous outcome. Economic growth is dampened and the unemployment rate rises, but downward pressures are placed on inflation.

Structural And Cyclical Components of the Budget Outcome

There are two main components that affect the budget outcome:

- **Structural / Discretional change:** Deliberate changes in government spending and/or taxation policies. The stance of fiscal policy is best measured by changes in the structural component.
- **Cyclical / Non – Discretional:** Changes in government spending and/or revenue which are caused by changes in the level of economic activity or national income.

During the 2007-08 business cycle, government taxation revenue decreased due to the GFC, but spending rose due to higher government spending in the form of stimulus packages.

Both structural and cyclical components caused the budget to move from a cash surplus of $19.7b in 2007-08 to a deficit of -$27bn in 2008-09.

Automatic stabilisers are policy instruments in the government's budget that counterbalance economic activity and help offset the extremes of the business cycle.

- **Progressive taxation:** Taxpayers pay an increasing proportion of their income in tax as incomes rise in a boom which leads to a greater surplus or contracting deficit. Vice versa.
- **Welfare benefits:** During recession the level of economic activity falls, causing a rise in unemployment. This leads to greater government expenditure on unemployment benefits. Vice versa.

Whilst automatic stabilisers help to offset changes in the business cycle through changes to the cyclical component, the government may need to use discretionary fiscal policy to stabilise the economy in the medium term.

Effects of budgetary changes on resource use, income distribution and economic activity

Economic activity

Changes in the stance of fiscal policy can impact on the level of economic activity through changes in the budget outcome.

Expansionary fiscal policy leads to a larger budget deficit or lower surplus which through a reduction in taxation revenue (leakages) or an increase in government expenditure (injections) promotes economic activity. This leads to a multiplied increase in consumption and investment and stimulates AD.

Contractionary fiscal policy leads to a smaller budget deficit or larger surplus which through an increase in taxation (leakages) or decrease in government expenditure (injections) contracts the circular income flow. Economic growth is dampened as the contraction leads to a multiplied decrease in consumption and investment.

Resource allocation/use

Through government expenditure on particular areas of the economy may attract resources to those sectors such as how their investment of the national broadband network has increased demand for Telstra's services, causing an eight year high in its share prices.

Government taxation can also dampen the demand of certain products such as tobacco, and thereby leading to the contraction of the tobacco industry.

Income Distribution

Income distribution is affected by the budget through changes to taxation and social security and welfare systems. The progressive taxation system means that marginal and average rates of taxation both rise as income rises, leading to a redistribution of income from high to low income earners through transfer payments. All this leads to greater equity.

<u>Impact on savings and the CAD</u>

Over the long term a budget deficit is a form of dissaving that will reduce the level of national savings, which is composed of public savings plus private savings.

By borrowing from the private sector, the crowding out effect will occur as competition for a limited amount of savings places upward pressure on interest rates. This leads to increased costs in private sector borrowing.

Crowding out effect: Where government spending is financed through borrowing from the private sector, which puts upward pressure on interest rates and renders private sector investors unable to borrow at the higher interest rates.

As such, borrowers will turn to abroad sources of funds to finance domestic investment and consumption. These flows are recorded as credits in the KAFA, increasing the size of Australia's foreign debt. Alternatively if the government borrows from abroad due to a low savings pool, the inflow of funds will be an addition to Australia's net foreign liabilities. Ultimately this leads to a higher net income deficit as the foreign liabilities is serviced with interest repayments. Thus when fiscal deficits are consistently run, a wider CAD will result, the twin deficit theory.

Furthermore higher interest rates may increase capital inflow, leading to an appreciation of the Australian dollar which erodes the international competitiveness of its exports. As deficit financing leads to the accumulation of national debt and its interest, it will be difficult to service.

Twin Deficit Theory: A budget deficit will lead to a wider CAD.

Methods of Financing

Borrowing From The Private Sector

Debt financing involves selling securities in domestic financial markets which requires the government to repay the principal with interest at a later date. The advantage of debt financing is that there is no increase in net foreign debt, ensuring external stability is maintained.

However, debt financing may cause the crowding out of private investment. In order to have successful sales, the interest rate on government securities must be competitive relative to competing securities. This means debt financing is expensive and inefficient.

Borrowing from the RBA

The government can borrow from the RBA through **monetary financing –** where the RBA buys government securities by printing out cash. The advantages are that there is no change in interest rates or an accumulation of public debt. However there is a rise in money supply and thus, inflation if the economy is at the NAIRU due to expansion.

Borrowing funds in overseas markets

The RBA sells government securities in return for foreign currencies. In doing so they hold these currencies and credits the government with the Australian dollar equivalent of the loan. An advantage is that there is no increase in domestic interest rates. However, foreign debt is accumulated leading to a wider CAD due to the interest rates that must be serviced.

Use of a Surplus

The government can use budget surpluses to **retire public debt –** where accumulated debt is serviced. This involves the purchase of old government securities previously sold to the private sector.

The surplus can be accumulated to finance future expenditure such as infrastructure and public goods, or to fund tax cuts in the present.

The surplus can also be used to **repay foreign debt** through the RBA's foreign currency reserves. These Australian equivalent of the reserves used are debited from the government's account.

Fiscal balance: The fiscal balance is an accrual measure that shows whether the Government has to borrow from financial markets to covers its activities.

Monetary Policy

Monetary policy is conducted by the RBA through domestic market operations to influence the cost and availability of money and credit in the economy. The principal medium-term objective of the macroeconomic policy is to contain inflation within the target band of 2-3% per anum through counter cyclical changes to the cash rate. By smoothing out forecasted fluctuations in the business cycle monetary policy also sustains long-term economic growth and maintains full employment, leading to an improvement in living standards.

Policy Objective	Target	Policy Instrument
Price stability	Achieving a CPI inflation target of 2-3% over a business cycle	Manipulation of the cash rate through domestic market operations.
Full employment	NAIRU of 5% to 6% of the labour force	Changes in the cash rate
Economic Growth	Sustainable economic growth of 3% to 4% over the business cycle	Changes in the cash rate
External Stability	Reducing the volatility of the Australian dollar	Changes in the cash rate

Implementation of monetary policy by the Reserve Bank of Australia

Monetary policy is used as a counter cyclical policy, and conducted by the RBA's open market operations in the overnight money market where commonwealth government securities are bought and sold to influence the cash rate.

Stance	Cash rate changes	Effects
Contractionary	Raised	Dampened economic growth, downward pressures upon inflation
Expansionary	Cut	Stimulated economic activity, rising employment prospects and lowered unemployment
Neutral	No change	Effects of previous cash rate, N/A

Domestic Market Operations

Domestic Market Operations refers to the purchase and sale of second hand government securities by between the RBA and banks which deposit surplus cash to Exchange Settlement Accounts to earn interest or settle transactions amongst them. The interest payable on these funds is called the cash rate.

Market liquidity: An asset's ability to be sold without causing significant movement in the price and with minimum loss of value.

Liquidity management: The RBA sets a cash target each day and attempts to ensure sufficient liquidity to meet the demand for cash so that the rate does not change.

Exchange Settlement Accounts cannot be overdrawn and the reserves of cash which they hold in their ESAs determine the demand for cash in the overnight money market.

If the Reserve Bank supplies more securities than the commercial banks wish to hold, the banks will try to shed funds by lending more in the cash market and thus expand the money supply, resulting in a tendency for the cash rate to fall.

Conversely, if the Reserve Bank supplies less securities than what the commercial banks wish to hold, they will respond by trying to borrow more in the cash market and thus contract the money supply to build up their holdings and bid up the cash rate.

The interest rate in the overnight money market is determined by the demand for and supply of funds. The RBA manipulates this supply to ensure the target interest rate is achieved. This supply is determined by the RBA and will only change if it makes a payment to commercial banks or a bank makes a payment to the RBA.

Impact of changes in interest rates on economic activity and the exchange rate

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Conversely, if the Reserve Bank supplies less securities than what the commercial banks wish to hold, they will respond by trying to borrow more in the cash market and thus contract the money supply to build up their holdings and bid up the cash rate.

Stance of monetary policy	Open market operations	ESA balances	Overnight money market – Money supply	Cash Rate
Tightening	RBA sells CGS	Fall in liquidity	Shortage of funds available to borrow	Higher cash rate.
Easing	RBA buys CGS	Rise in liquidity	Excess of borrowable funds	Lower cash rate
Neutral	RBA ensures demand for cash is met by supply	No change in liquidity	No change in borrowable funds	No change in cash rate

Transmission mechanism: The impacts of changes in interest rates.

In the Australian economy there is a quick and high pass through of changes in the cash rate to deposit and lending rates, as the majority are conducted through variable or short-term fixed rates. However, the transmission mechanism is reliant upon competition in the finance market and because of Australia's oligopoly which is dominated by the four big banks, deposit and lending rates don't always move in lockstep with the cash rate.

When aggregate demand in the economy is strong, there is likely going to be a rise in inflationary pressures and monetary policy can be tightened to dampen economic activity on the short term. A tightening of monetary policy would involve the selling of CGS and constraining the money supply, putting upward pressures on interest rates which would dampen consumer spending and borrowing resulting in lower economic activity and inflationary pressures. According to the Phillips curve this may lead to a rising rate of unemployment, as higher levels of leakages through increased savings due to greater returns will contract the economy. Capital inflow will be encouraged due to rising interest rates. The rising interest rate of returns will raise demand for the Australian dollar and lead to an appreciation. As consequence falling import prices alongside with rising export prices will have a contractionary effect on the economy's trade balance (X-M), as demand for imports and their rising volume outstrips that of exports.

When aggregate demand in the economy is weak inflationary pressures are likely to be diminishing and monetary policy can be eased to provide short term stimulus for economic activity. A loosening of monetary policy would involve the purchasing of CGS and expanding the money supply, placing downward pressures on interest rates which would stimulate consumer and borrowing resulting in greater economic activity and inflationary pressures. This is shown in the Phillips Curve, as a higher level of injections in the form of borrowing and loans will expand the economy. Capital outflow may be encouraged as returns on investment diminish, increasing the supply of the Australian dollar and causing a depreciation. The depreciation will reduce the cost of exports and raise import prices – having an expansionary effect on the economy's trade balance (X-M) as demand for exports and their rising volume outstrips that of imports.

Trends (INFLATION)

Between 1960 to 1993 Australia's cash rate was highly volatile, fluctuating between -1 to 18%. Since the target band's introduction from 1993, inflation has fluctuated between 1-4%. The consumer price index increased by 0.4% in the March quarter 2013 and was 2.5% in year ended terms.

Trends (CASH RATE)

Since 1993 to 2013, the cash rate has fluctuated between 2.5 to 7.5%, disclosing that monetary policy is the main macroeconomic policy to influence aggregate demand.

In 2001-2008, the RBA set a highly contractionary monetary stance due to the resources boom which bought about strong AD. In doing so economic growth was dampened, and rising inflationary pressures eased. Furthermore the rising interest rates lead to an appreciation of the dollar due to rising foreign investments with greater returns, and eroded Australia's international competitiveness – allowing for the boom to be moderated.

However booms are often followed by severely dampened economic growth, as seen through the GFC in 2008 where there was an aggressive loosening of the monetary stance to stimulate economic growth.

From 2011, monetary policy has been steadily loosened to mitigate the effects of sub trend growth due to a reduction of demand for Australia's exports, with the cash rates falling to historic lows of 2.75%. This was in response to the spill over effects China's dampened economic growth due to the Eurozone Crisis has had on Australia. In doing so non-resource sectors of the economy may be able to find factor endowments and achieve comparative advantages with the Australian dollar depreciating sharply from all-time highs to subpar the US's. Despite this depreciation, Australia's underlying inflation rate lies within the target band at 2.5%. The expansionary stance should stimulate Australia's dampening economic growth by allowing its two speed economy to undergo structural change for rebalanced growth as the resources boom subsides.

The expansionary stance will also stimulate the indicators of Australia's growth to recovery – slowed consumption and flat retail sales consistent with fiscal consolidation and moderating income levels due to a weak labour market with unemployment at 5.6%. However despite the cuts the household saving ratio remains high and consumers are less willing to borrow and spend and add to household debt.

<u>Microeconomic Policies</u>

Microeconomic policies are measures that lift the economy's level of efficiency, productivity and thus foster international competitiveness by affecting the conduct of individual firms and industries. Their major objective is to shift the economy's supply curve to the right by encouraging efficient market operation and is therefore central to the government's long term aim of addressing constraints on growth such as structural problems. This is done through promoting the efficient allocation of scarce resources in the economy.

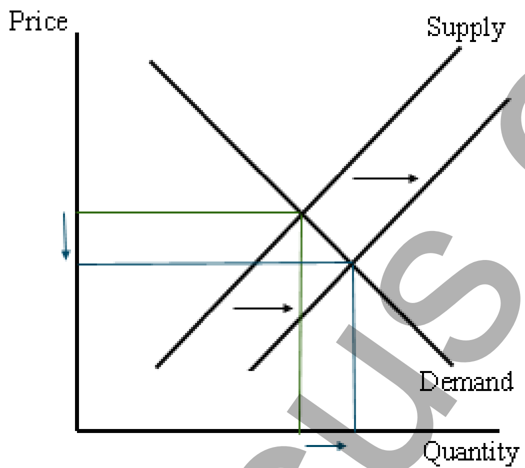
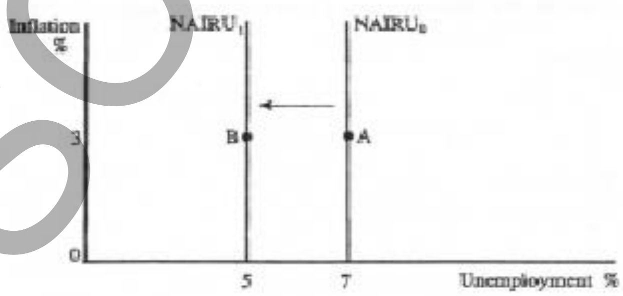


Figure 2.

The rightward shift of the supply curve puts downward pressure on prices, increases GDP and lowers unemployment without the short term trade off of the Phillips curve whereby inflationary pressures are placed upon the economy – as seen through a leftward shift of the Phillips curve. (AS P MOVES DOWN AND UNEMPLOYMENT LOWERS IT IS DEFLATIONARY THEREFORE NAIRU FALLS)



So supply side economics has obvious merit in the eyes of governments under pressure to do "something" about the rate of unemployment. If an economy can shift its NAIRU to the left, then structural unemployment can fall from 7% at A to 5% at B while inflation will not rise above 3% - it may even fall. All that is required is that governments focus on improving microeconomic efficiency and find ways to cut tax rates (hardly an unpopular political decision).

There are three main types of efficiency gains from microeconomic policy:

Technical efficiency: The ability of firms to produce a maximum level of output for a given quantity of inputs and occurs when they produce at the technical optimum in their economies of scale. It can be achieved by encouraging competition in an industry.

Allocative efficiency: The ability of an economy to shift resources to where they are most valued and can be used efficiently, that is, resources are allocated due to free market forces. For example, removing protection would allocate resources away from inefficient industries towards efficient ones with comparative advantages.

Dynamic Efficiency: Refers to an economy's ability to shift resources between industries due to changing patterns of consumer demand and firms' ability to adapt to changing circumstances through innovation to remain competitive.

Structural change: Involves changes in the pattern of production that reflect changes in technology, consumer demand and global competitiveness, resulting in the emergence or disappearance of products, processes and industries.

Australia's structural change since the 2000's has been characterised by the following features:

- Production and employment have shifted away from agriculture and manufacturing towards the services of tertiary sector. The percentage contribution of agriculture and manufacturing towards GDP fell from 13% in the 1960s to 3% and 26% in the 1960s to 12% respectively. In contrast the services sector has grown from 59% to 78%.
- The mining industry grew in importance with large demand for minerals, gas and metals from East Asia. As a result of this economic activity in Australia has tended to shift towards the resource rich states of Queensland and Western Australia at the expense of states with historically large manufacturing sectors such as NSW, Victoria and South Australia.

<u>Terminology</u>

Industry policy: Protection provided to certain firms such as trade barriers and tax breaks.

Competition policy: Government forcing increased competition between firms

Microeconomic reform: Withdrawing benefits from industries.

Productivity: The output per unit of input over time

$$\frac{Output}{Inputs/Time}$$

After modest productivity growth averaging at 0.8%, Australia experienced substantial increases in its productivity levels since 1990. These increases trended at 2.5% between 1990 and 1999, however all measures of productivity slowed to 0.5% - 1% between 2004-2007 as the economy reached full employment and labour shortages and supply constraints emerged. The GFC also reduced productivity as employers cut employees.

Microeconomic Reform Policies	
Deregulation	Environmental management
Reforms to public trading enterprises	Reducing Protection
Competition policy	Tax policy
Innovation and Industry policy	Labour market policy

Effects of Microeconomic Policy

Deregulation: Involves the simplification or removal of rules that constrain the operation of market forces in order to improve the efficiency of industries.

The domestic **aviation industry** was deregulated in 1991 – this allowed for the entry of new competitors into the Australian airline industry, as while Qantas is the major Australian airline, it faces competition from Virgin Blue, its own offshoot Jetstar and Singapore-based Tiger Airways. Deregulation has resulted in lower fares for passengers and a large increase in the number of air passengers, as airlines developed new routes and engages in vigorous product differentiation.

The **telecommunications industry** was partly deregulated in 1992 – until the early 1990s, the telecommunications industry was dominated by Telstra as the monopoly provider of services to businesses and consumers, but the market was opened to Optus and Vodafone in the early 1990s and then opened up to full competition in 1997.

Deregulation in the agricultural sector has given farmers new incentives to innovate – while the total production of farms has increased by 36%, the total number of farms declined by 7% over the past 15 years, indicating productivity gains. There has been a shift towards larger farms with economies of scale as advances in farming technology and chemicals are suited to them.

Reforms to public trading enterprises

Corporatization: Aims to encourage public enterprises to operate independently of the government as if they are private businesses. These enterprises attempt to achieve a rate of return on assets comparable to private sector companies, often operating in competitive markets. i.e New structures, ''competitive neutrality'' where government businesses are treated like private businesses such as Energy Australia

Privatization: Involves selling government businesses to the private sector such as Telstra. In doing so competitive pressures are placed on industries which encourages efficiency and rational pricing behaviour.

National Competition Policy

An agreement between Australia's Commonwealth and State governments signed in 1995 to encourage microeconomic reform throughout the Australian economy in response to the Hilmer report which reviewed levels of competition. It seeks to achieve the government's objective of **workable competition –** the maximum level of competition within an industry that is compatible with the market structure and specific conditions of the industry whereby entry barriers for new firms are low.

It is an extension of Australian consumer law, prohibiting anti-competitive behaviour such as:

- Monopolies: When a firm uses its dominant market position to eliminate competition through temporary price cuts
- Collusion: When firms get together to fix prices or agree on a market sharing arrangement
- Mergers/Takeovers which can lead to market dominance and monopolies

Furthermore it introduced competitive neutrality so that private businesses can compete equally with public ones. In doing so it strengthens pressure in markets to raise technical and Allocative efficiency.

Industry Policy

Involve measures to support the competitiveness of domestic industries against foreign competitors. Formerly protectionist measures, industry policy has shifted towards fostering free trade through tariff reform, to increase the competitiveness of Australian industry and the volume of exports. This is because a tariff reduction reduces costs of production as 1/3 of trade involves intermediate goods – vertical specialisation.

Overall Impacts

Microeconomic reform has brought short term costs however they achieve extensive long term benefits.

Benefits	Costs
Greater efficiency and productivity growth → International competitiveness → Reduction in CAD	Higher short term unemployment
New business and job opportunities	Closure of inefficient businesses
Higher economic growth and living standards – with the Productivity Commission stating Australia's GDP grew by 2.5% in 2005-06 due to national competition policy reforms of the 1990s.	Deterioration of the CAD and worsened external balance due to erosion of protectionism which encourages a greater reliance on internationally competitive imports
Lower inflation	Greater work intensity
Lower rates of unemployment through reforms in the labour market which allows greater flexibility in the allocation and mobility of labour	

Microeconomic policies can be used to cause and lead structural change in the Australian economy to make it more productive, efficient and competitive. Structural change has been supported by the process of globalisation as major microeconomic reform in the 1980's and 90's led to a reallocation of resources to sectors with comparative advantage. The main structural changes included:

- The rising proportion of GDP contribution and employment form the services sector
- Increased international convergence with Australia's X and M's accounting for more than 20% of GDP

Labour Market Policies

Microeconomic reforms that are aimed at influencing the operation and outcomes in the labour market, including industrial relations policies that regulate the process of wage determination as well as training, education and job placement programs to assist the unemployed. In the current policy framework, instead of directly trying to influence wage outcomes, governments have made structural changes to the industrial relations system that encourage wage growth to be determined at the individual enterprise level.

Role of national and state systems

Industrial Relations – Refers to the system used to determine wages and working conditions between employers and employees.

Awards – Set out legal minimum wages and conditions of employment for employees.

The government plays a role in determining legislation that underpins the industrial relations system by:

1. Controlling wage demands and expectations of unions for low inflation outcomes
2. Promoting comparative wage justice through the application of the National Employment Standards act
3. Promoting reform of the labour market through the use of collective enterprise agreements and Modern Awards to enhance workplace flexibility and improve labour productivity.

National Industrial Relations System

The Fair Work Act 2009 (Cwlth) represents a shift in industrial relations policy away from a reduction in minimum standards and an emphasis on individual bargaining and agreements under WorkChoices, to a system based on a stronger wage safety net of the National Employment Standards act and modern awards, emphasising on collective bargaining and enterprise agreements. This represents a fairer system, but a far more regulated and inflexible system.

The Act is enforced by Fair Work Australia and the Fair Work Ombudsman who have been given comprehensive and formal legal powers. One of the main advantages of the new industrial relations system is that it will improve the level of equity in the distribution of income with the wage safety net. Furthermore is the provision for employees in lowly paid industries to receive assistance from Fair Work Australia to engage in bargaining, allowing for greater equity in the wage bargaining process so that the rate of growth in wage dispersion between low-wage and high-wage employees is slowed. This opportunity for bargaining provides an incentive to low-wage employees to increase their productivity through skill acquisition and training to achieve higher wages and improved employment conditions.

In 2008 the Australian Workplace Agreements, which were formal individual contracts between an employer and employee was abolished by the Rudd government. This is because employers have greater bargaining power dealing with individual employees rather than as a group, and as a result the most common method of wage determination in Australia are collective enterprise agreements – which since the early 1990s have generally produced annual wage increases averaging around 4%. This was a ramification of how all workplace agreements must pass the Better Off Overall Test (BOOT) requiring that the employees must be made better off overall by an agreement compared to an applicable award.

The introduction of unfair dismissal laws also provides greater certainty of employment for employees in small businesses which will raise their sentiments about the economy and also help reduce the incidence of retrenchments, assisting with the government's goal of full employment. In consequence, employers may have a lower propensity to hire labour due to their inflexibility and increased responsibilities.

The individual needs of different firms and industries is also accounted for with the introduction of modern awards which provides a set of minimum wages and working conditions for employees specific to their industry or job they perform. These awards also contain a flexibility cause, allowing employees and employers to vary the effect of an award without negotiating a separate agreement.

High income earners with a salary of over $114K fall outside the jurisdiction of the Fair Work Act and often have individual common law contracts with their employer. This is because high income earners are less vulnerable to unemployment and wage changes with changing economic conditions as their skills have a limited supply in the labour market.

The State Industrial Relations System

Employees that are not covered under the national industrial state system are mainly state/local government employees such as the police and fire brigade. The NSW Industrial Relations Commission has jurisdiction over their relations.

Dispute Resolution

One of the main aims of the industrial relations system is to resolve arising disputes quickly, efficiently and fairly as industrial action can result in reduced productivity, lower output and reduced profits. There are three ways to resolve a dispute:

1. Collective bargaining: Reaching an agreement through negotiation without a 3rd party
2. Conciliation: Where a 3rd party mediator tries to get the conflicting parties to make a compromising agreement that is legally binding.
3. Arbitration: Where a 3rd party makes a legally binding decision on the parties of the dispute

The Fair Work Act's jurisdiction has the power to suspend or terminate 'protected' and 'unprotected' industrial action. **Protected industrial action:** If there is intention to negotiate a new agreement.

Wages

Centralised

Under a centralised incomes policy, the government will determine wages and working conditions for all employees regardless of which firm they work for. There are several possible criteria that could be used for wage adjustments such as the needs-based principle, where nominal wages are adjusted according to inflation to maintain the purchasing power of income, capacity to pay principle, relating to the capacity of the economy to afford an across the board wage rise, and sustaining wage growth at the level of major trading partners in order to maintain international competitiveness.

Those in favour of this system argue that it is needed to protect the interests of those on low wages whose skills are in high supply whilst restraining inappropriate and excessive wage increases so as to minimise cost-push inflation. In addition the comparative wage justice and wage indexation where income was adjusted for costs of living should reduce the need for industrial action, and encourage a more equitable distribution of income as employees with low bargaining power are accounted for. This may bring about productivity improvements as industrial action often stales output levels and cause losses. Economic growth can also be stimulated through a centralised wage system as it can be indexed to maintain consumer sentiment and thus aggregate demand during downturns. This in turn may blunt the effects of economic downturns such as a rise in unemployment. Conversely in strong periods of economic growth, wages can be manipulated to soften demand and thus maintain low inflation rates.

However these principles facilitated inflation due to lower productivity growth as employees in individual workplaces may not have enough incentive to improve work practises due to guaranteed uniform wage increases. As evidence, Australia experienced substantial increases in its productivity levels to 2.5% in 1990 after a period of modest growth averaging at 0.8% due to wage decentralisation. In addition to the facilitated inflation a centralised system may also lock in those high rates as income is indexed to them – and this can be worsened through the process of real wage overhanging, where inflationary pressures are placed upon the economy due to wage growth outstripping productivity improvements. Centralised wage determination also slows down the process of structural change as uniform wages means that the ability for profitable and growing industries to attract skilled labour from contracting ones is limited. This erodes the international competitiveness of the Australian economy and reduces its ability to service its CAD. Furthermore in a bid to attain comparative advantage, employers may have a higher propensity to substitute labour for capital to bypass the wage price spiral – leading to higher rates of unemployment. Another reason for the rise in unemployment is the inability of the system to account for the needs of individual firms and industries – deterring employers from seeking labour resources.

Another theory against centralisation is that it may lead to the brain drain where workers with high levels of education may travel abroad where higher rewards are offered. In addition highly skilled labour resources from abroad will be less inclined to migrate into Australia. This would be detrimental to Australia's productivity on the criteria of the three p's, considering that migration contributes to 40-50% of population increases and is important to maintain a high participation rate in light of Australia's aging labour force.

Decentralised

Under a decentralised system of wage determination, wages are determined through negotiations between individual firms and their employees.

This ensures that there is greater wage flexibility and may keep unemployment at lower rates. This is because employers with the ability to adjust wage levels when the economy experiences shock have a higher propensity to seek labour resources due to less binds.

The main advantage of a decentralised system is that the varying levels of income offered by different industries and firms will likely lead to a more efficient allocation of resources and hasten structural change. This is because labour resources are encouraged to shift from contracting firms and industries towards profitable and expanding ones that offer greater wages. In the context of a free trade environment this ensures that Australia is able to exploit its comparative advantages and thus attain or further its international competitiveness.

In addition employees are given the incentive to undertake skills and training for improved work ethic as wage increases are reflected by productivity improvements. As evidence, Australia experienced substantial increases in its productivity levels to 2.5% in 1990 after a period of modest growth averaging at 0.8% due to wage decentralisation. As labour resources are productive, the economy's trend growth rate should rise through a rightward shift of the supply curve that in turn leads to low inflationary pressures – price stability. This in turn further improves Australia's international competitiveness. All this stimulates economic growth which in turn should lead to higher employment.

However the economic growth a decentralised wage system encourages may not be substantial enough to account for the combined increases in both productivity and the labour force, which according to Okun's law may lead to a rise in unemployment. Australia has been compliant with that law after decentralisation with its strong productivity growth complemented by a spike in unemployment to highs of 10.7%. Although this spike may have been sharpened by recession it still highlights how productivity gains from decentralisation may raise unemployment rates.

Wage decentralisation may also lead to greater income inequality through increased wage dispersion due to the difference of productivity and skills between workers. This is particularly problematic for low income earners who have little bargaining power with employers as their skills are in high supply in the labour market. This high supply causes employees to compete with one another, making themselves appealing by accepting lower wages. Contrasting this are high income earners whose skills may have a limited supply. In doing so employers often compete with one another for these workers, offering attractive wages.

Greater levels of industrial disputes may occur which cause losses for employers and stales output. If these disputes are successful, the wage rises of employees aren't supported by productivity gains and will place inflationary pressures (cost-push) upon the economy. This cost push pressure is much more severe during periods of strong economic growth when the economy may reach full employment – across the board wages will rise to attract labour resources.

Education Training and Employment Programs

The Government is able to influence labour market outcomes through policies that are aimed at facilitating the entry of new members of the labour force into jobs and retaining the retrenched due to structural change. This allows the economy to have greater dynamic efficiency, and grow at a faster rate with a quality workforce.

The Gonski school education reforms will be funded for six years, totalling $9.8bn to enhance the Australian workforce's productivity and quality.

$97m will fund more Commonwealth supported places for postgraduate university degrees, and over a four year period $68.8m will be used to deliver flexible pathways for 4000 apprenticeships in high demand industries facing skills shortages. The three P's.

Skills Australia has also been established to identify industries with skills shortages and recommend where training programs should be targeted.

Labour market programs are assistance programs aimed to find work for the unemployed by helping them deal with disadvantages such as disabilities and language barriers. These programs are increasingly integrated with income support payments so that the ability of individuals to receive continued income support is often tied to them making genuine efforts to find paid work. The rationale behind these policies is to reduce the incentive for people to choose to stay on welfare rather than find work and to develop a work ethic amongst welfare recipients.

National and Global context for environmental management

Regulations	The Federal Department of the Environment ensures that the federal government's policies consider global environmental issues. Protection of the Environment Operations Act 1997

	ensures environmental regulatory framework for mining, agriculture and commercial development.
Market Based Policies	The carbon emissions scheme, incentives and tax reductions for solar panels. Plans to create an international market for carbon licences.
Environmental Targets	The aims of the carbon scheme was to reduce emissions by 160m tonnes by 2020 and 80% by 2050. Binding targets were also set by the Kyoto protocol.
International Agreements	The Kyoto Protocol was ratified in 2007, and sets binding targets for the reduction of greenhouse emissions for its signatories.

Limitations of economic policies

There are trade-offs between the simultaneous achievement of economic objectives in both the short and long term.

Time Lags

Significant time delays can exist in implementing changes to economic policy and in waiting for those changes to have an impact on the economy – whilst the effects of changes in monetary policy are realised quickly, the implementation of fiscal policy takes longer as it occurs on an annual basis through the budget.

Significant time delays can exist in implementing changes to economic policy where the government must identify a macroeconomic problem then decide on the necessary action – policy formation lag. This is problematic for fiscal policy which is enacted through an annual budget.

In addition once a policy decision is made its impacts on the economy are not immediately realised. Autonomous expenditure lag refers to the effects on the components of aggregate demand after a change in macroeconomic policy stance. Whilst the effects of fiscal policy are realised relatively quickly in 3-6 months, monetary policy decisions have a time lag of 6-18 months before the full effects are felt on the economy.

This is due to the induced expenditure lag of these policies which refers to the time taken for changes in autonomous expenditure to induce a multiplier effect on aggregate demand and national income.

Monetary policy is also subjected to price adjustment lag on top of this which refers to the time a change in stance takes to affect the price level which usually occurs after impacts on aggregate demand and supply.

Microeconomic policy has an extremely long outcome lag. Its impacts can only be assessed after a period of at least 4 years and perhaps as 20 years to get an accurate measure of its effectiveness. This is because the benefits of structural change can take several years to become apparent as resources are allocated to different sectors. It can also be difficult to accurately measure the impact of microeconomic reforms since several reforms may be implemented simultaneously and it may be hard to distinguish the impacts of one reform from another.

Policy	**Implementation time lag**	**Impact time lag**
Fiscal	Medium Term (annual budget)	Short-term (a few months)
Monetary	Short term (Monthly RBA meeting)	Medium term (6-18 months)
Microeconomic reform	Long term	Long term (up to 20 years)

Global influences

With the process of globalisation leading to economic convergence with the global economy there is a greater susceptibility to flow on effects and external shock. For example, the contagion effect of the GFC and recession in 2008-09 reduced Australia's export income and a lower terms of trade as commodity prices fell. In response the government eased the stances of both monetary and fiscal policies to prevent the economy from falling into recession. This contrasts with the global resources boom between 2005-08 where the stance of monetary policy was tightened to dampen Australian economic growth and contain inflation.

In the global economy short term changes in speculator activity can lead to capital inflow and flight which can cause exchange rate volatility. The government has an important role in maintaining the confidence of international investors, and this encourages good economic management – with the goal of fiscal consolidation ever present in the budget goal.

Furthermore the increased economic convergence of Australia has raised the importance of international competitiveness and in response it has conducted similar microeconomic policies as other economies. In doing so exports would remain competitive through productivity improvements. Monetary policy is also affected as if the cash rate of other economies rise Australia will aim to do so as well. This prevents capital flight from the Australian economy to others with higher returns which will depreciate the dollar and thus shaken Australia's external stability.

Political constraints

A political party must win sufficient public support for its policies, as to continue the process of economic reform for its objectives a government must be re-elected. This is dependent on public perceptions of the government's economic management. Therefore the 3 year political cycle in Australia is a constraint on long term economic policy decision making – with public opinions on Gillard sour despite a strong economy in the context of a slowing world economy. The senate is another constraint as many reforms can only be implemented through legislation, and this may cause excessive time lags.

Effectiveness of economic policies and management

Economic growth and quality of life	The government aims to achieve sustainable real economic growth rates of 3-4% pa. Its macroeconomic policy mix has been successful in sustaining a long period of economic growth in which Australia has enjoyed rising living standards. Since 1995, economic growth averaged at 3.8% pa compared to 2.5% for other OECD economies. Although trend growth has fallen from 3.25% to 3% this is much higher than the 0.9% average in the Eurozone due to the financial crisis where countries such as Spain are experiencing deep recession. A factor to this has been the recent aggressive loosening of monetary policy. However the falling trend growth suggests that the government's microeconomic policy mix has been ineffective.
Full employment	The Australian economy fails to fully utilise its labour force, with annual unemployment in Australia averaging at 7% between 1998-2009 compared to the OECD average of 6.3%. However with our sustained economic growth and weak productivity growth in the past decade the unemployment rate is at 5.8% in comparison to the

	OECD average of 8%. This is due to our labour market policies which encourages individuals on welfare to find work.
Price stability	Australia's average inflation rate of 2.7% is above the OECD average of 2%. However, since its introduction monetary policy has been highly effective at maintaining inflation levels within a target band of 2-3%. In addition Australia's microeconomic reform such as the shift from protectionism and adoption of free trade has reduced inflationary pressures such as imported inflation.
External stability	Australia's current account has always been in a deficit, average at -3.8% of GDP in comparison to the OECD average of a 0.3% surplus. This is because Australia's economic growth has been reliant on investment from abroad. The Australian dollar has recently shown to be volatile with jumps from historical highs to sub-par with the US dollar. In response Australia's cash rate has always been higher relative to other economies to discourage capital flight and attract speculators with higher rewards. However its effectiveness is questionable with the dollar's drop following the halted quantitative easing of other central banks.
Distribution of income and wealth	Australia has a greater level of income inequality than most OECD countries with its bottom 2 deciles of income earners being having the worst share of national income. However mitigating this is the budget's emphasis on equity such as the Disability Care Australia policy and Gonski School Reforms. In addition is the National Employment Standards and BOOT test of the Fair Workers Act which protects the interests of low income workers.

Environmental stability	Relative to other OECD countries Australia has the highest dioxide emissions per capita. The government has sought to address this through market based policies such as the carbon emissions scheme and incentives in the budget such as tax rebates for solar panel installations. These carbon scheme been highly effective, reducing emissions by 7.4% in the first year of its implementation.