Fiscal Policy

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Multiple Choice

1	A	**6**	C	**11**	D	**16**	C
2	B	**7**	A	**12**	B	**17**	A
3	C	**8**	C	**13**	D	**18**	A
4	C	**9**	B	**14**	A	**19**	C
5	B	**10**	D	**15**	A	**20**	A

Short Answers

Question 1

(a) $500m surplus, $200m surplus, $400m surplus, $400m surplus.

(b) Budget was expansionary in year two because there was a reduction in the size of the surplus.

(c) An expansionary fiscal policy reduces the size of the surplus or increases the size of the deficit - this reduces national savings and, other things being equal, may result in higher interest rates.Expansionary fiscal policy pumps money into the economy, increasing aggregate demand and lowering unemployment. The increase in spending may spill over into higher imports and result in an increase in the current account deficit.

(d) Firstly, it reduces the national debt accumulation. Lower levels of debt result will ensure the financial stability of the economy and maintain its international credit rating. Secondly, it assists in the repayment of previous debts. Surpluses from forthcoming years can be used to pay off accumulated debts. Thirdly, reduces the crowding out effect. Public sector debt drains national savings, leading private investors to borrow from overseas financial institutions, worsening the current account deficit. Finally, once a surplus has accumulated it can act as a safety net or source of funds for recession in the future, natural disasters etc..

Question 2

(a) A: The main source of government revenue is personal income tax.Australia has a progressive personal income tax system, which means that those on higher incomes pay higher marginal rates of tax. As shown in the table, another source of revenue is company taxes, including corporate tax and tax on resources industries. Finally, dividends from government owned companies are a source of revenue.

(b) The main area of government spending is social security and pensions, such as for the elderly and the unemployed. Another important area is health care, where the government spends money on private health insurance rebates and hospitals. Another source of spending is Defence, which is an important responsibility of the Federal Government.

(c) Fiscal policy is limited by time lags - because it is only implemented once per year. Fiscal policy is limited by the crowding out effect - excessive government spending can result indirectly result in higher interest rates, which reduces the level of private sector investment. Fiscal policy can encourage spending, but if this flows onto imports, it reduces the impact on domestic demand. Finally, fiscal policy is mainly implemented by the Federal Government, but if there are offsetting changes but state or local government, it can reduce the effectiveness of policy.

Question 3

(a) The Government can fund an underlying budget deficit by selling assets such as infrastructure and government owned companies. The Government can fund a deficit by borrowing from the RBA - so called ‘printing money’. The Government can fund a budget deficit by issuing new bonds - i.e. borrowing money from the private sector.

(b) The Government may use funds from a budget surplus to pay down government debt. The Government may use funds from a budget surplus to invest in new government business enterprises, such as a company to build a national broadband network. Finally, the Government may use funds from a budget surplus to create an investment fund that can be used in the future.

(c) Fiscal policy can influence resource allocation in a number of ways. Direct spending such as on infrastructure will increase resources in that sector, such as transport infrastructure. Taxes on a sector, such as resources rent taxes, will, other things being equal, shift resources away from that industry. Less directly, policies such as progressive taxation may shift resources away from luxury industries that are more dependent on expenditure from higher income earners. Finally, more generally, policies such as export subsidies may shift resources towards export industries.