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AUSTRALIAN FISCAL POLICY IN THE AFTERMATH OF THE GLOBAL FINANCIAL CRISIS

by

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DISCUSSION PAPER 12.11

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The 2012-13 Budget, which provides for an increase in taxes of $ 39 billion and a reduction in expenditures of $ 7 billion, is strongly contractionary, reducing aggregate demand by about 2 per cent. The government deserves praise for starting the process of fiscal consolidation in a possible election year. Still, given the low Australian government debt, there is no pressing need to restore an even budget within one year and a worsening of the economic crisis in Europe will make the budget unattainable.

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Australia has been at the forefront of using fiscal policy to mitigate the macroeconomic effects of the Global Financial Crisis. It could well afford to do so as the Australian government debt is small by international standards. Even after several years of sizeable fiscal deficits, the net federal debt is still less than 10 per cent of GDP. This compares favourably with the debt ratio of the U.S. government of about 70 per cent - not to speak of Japan and some European countries.

Sustainable fiscal policy requires that the public debt does not increase relative to GDP in the long-run. An increase in the government debt ratio is permissible during an economic contraction but the debt ratio must be brought back to the old level when the economy recovers. The 2012-13 Budget reveals how the federal government intends to phase out the fiscal stimulus that has been applied during the Global Financial Crisis.

Table 1. Australian Government Budget

Fiscal year	Receipts $ billion	Payments $ billion	Net Debt $ billion	% of GDP
2007-08	295	272	-45	-3.8
2008-09	293	316	-16	-1.3
2009-10	285	337	42	3.3
2010-11	302	346	85	6.0
2011-12	330	371	142	9.6
2012-13	**369**	**364**	**143**	**9.2**
2013-14	393	387	144	8.9
2014-15	414	405	140	8.1
2015-16	438	427	132	7.3

Sources: *Budget Overview*, Appendix I; and *Historical Australian Government Data*, Table 3.

Table 1 tracks fiscal policy in Australia since the onset of the Global Financial Crisis in 2007. Government expenditures rose by a massive $ 100 billion from $ 272 billion to $ 371 billion from 2007-08 to 2011-12. Since taxes did not change much until 2010-11, the government

debt ratio increased, peaking at 9.6 per cent by 2011-12. Before the crisis, the Australian government had been a net creditor. Thus, the fiscal stimulus was mainly implemented by an increase in government expenditures and it will end with an increase in taxes.

In the 2012-13 Budget, the government signals the most dramatic fiscal reversal at least since the 1970s. A substantial increase in receipts of $ 39 billion, amounting to 2.6 per cent of GDP, and a minor reduction in expenditures by $ 7 billion, will turn the deficit of $ 41 billion in the preceding year into a small surplus of $ 5 billion in 2012/13. The budget improvement will be long lasting, with small surpluses being predicted until the end of the forecast period in 2015-16. From 2011-12 to 2015-16, the government debt ratio will fall from 9.6 per cent to 7.3 per cent. As the projected budget surpluses are small, the debt ratio will fall mostly because of economic growth in the coming years.

Two competing economic theories deal with the macroeconomic effect of fiscal policy. Fiscal policy is weak if consumers are aware of the long-run consequences of government budget deficits. In fact, governments cannot rollover debt forever. Like Bernhard Madoff, Greece is now discovering the hard way that a debt will increase exponentially if the accruing interest is habitually added to it. A country may borrow to pay for new expenditures but eventually taxes must be raised to service the growing debt.

This basic insight became increasingly popular in the 1980s and 90s until it completely dominated macroeconomic teaching and research in graduate schools. It implies that the increase in government expenditures during the Global Financial Crisis had no effect on the Australian economy.[1]

[1] See Romer (2012, pp. 588-598) for the so-called no-Ponzi-game condition and Ricardian equivalence.

The fiscal stimulus did not increase aggregate demand because the prospect of higher future taxes reduced private consumption. Similarly, the 2012-13 Budget will not reduce aggregate demand because consumption declined earlier, at the time of the fiscal stimulus when consumers factored in a future tax hike. The theory that fiscal policy does not affect aggregate demand is supported by the observation that private saving increased, offsetting the decline in government saving in many countries during the Global Financial Crisis.

By contrast, in traditional macroeconomic analysis it is assumed that consumers do not consider the long-run consequences of government budget deficits, either because they are myopic or because they lack access to the credit market. Poor people who cannot pledge collateral in credit contracts are liquidity constrained. A consumer who would like to borrow but does not qualify for a loan spends the entire income and he will increase consumption if lower taxes give him more cash. The same applies to an increase in income that is caused by an increase in government expenditure: the extra income will be spent by households whose labour and capital services the government buys. For this reason, an increase in the government budget deficit that is caused by lower taxes or an increase in expenditures raises aggregate demand.

Keynesian multiplier analysis predicts that aggregate demand will increase by a multiple of the initial fiscal stimulus because the induced increase in consumption will give rise to second and third round effects, and so on. Keeping in mind that fiscal policy is completely ineffective if consumers consider the long-run consequences of fiscal deficits, it is likely that the fiscal multipliers are small. Andrew Leigh (2012) found that Australian households spent 41 to 42 cents of each dollar they received during the fiscal stimulus. This implies a government purchase multiplier of 1.7 and a tax multiplier of 0.7 if the Reserve Bank keeps the interest rate constant during a fiscal policy operation and there is no leakage in aggregate

demand through higher imports. Most economists agree that fiscal multipliers are small, lying between 1 and 2 for an increase in government expenditures and maybe less than 1 for a reduction in taxes. In the following analysis it is assumed that the government purchase multiplier is 1.5 and the tax multiplier 0.5.

Table 2. Australian Fiscal Policy

Fiscal year	Annual change in receipts $ billion	Annual change in payments $ billion	Net effect on GDP $ billion	% of GDP
2008-09	-2	44	67	5.4
2009-10	-8	21	36	2.8
2010-11	17	9	5	0.3
2011-12	28	25	24	1.6
2012-13	**39**	**-7**	**-30**	**-2.0**
2013-14	24	23	23	1.5
2014-15	21	18	17	1.0
2015-16	24	22	21	1.2

Sources: Nominal GDP: *IMF International Financial Statistics* (2008–2011) and projections using 5 per cent nominal GDP growth (2012-2015).

The 2012-13 Budget, which provides for an increase in taxes of $ 39 billion and a reduction in expenditures of $ 7 billion, is strongly contractionary. Using the suggested fiscal multipliers and the budget figures from the first Table, the following calculation shows that the negative effect of the fiscal turnaround on GDP is about $ 30 billion: $(-0.5)\times 39 + 1.5\times(-7) = -30$. Since Australian GDP is about $ 1,500 billion, this reduces aggregate demand and GDP by 2 per cent.

Table 2 displays the macroeconomic effect of Australian fiscal policy since the start of the Global Financial Crisis and fiscal policy projections until 2015-16. Fiscal policy was strongly expansionary in the first two years of the crisis, it will be contractionary in the financial year

2012-13 and again expansionary afterwards. The balanced budget that is projected for 2012-13 will be maintained in the following years. This creates an expansionary net fiscal effect because the government purchase multiplier is stronger than the tax multiplier.

In Australia there exists strong bipartisan support for sustainable fiscal policy that keeps the government debt ratio stable over the business cycle. The government also deserves praise for starting the process of fiscal consolidation in a possible election year. Still, there was no pressing need to restore an even budget within one year and a worsening of the economic crisis in Europe will make the budget unattainable. Given the low government debt, Australia can easily afford a more gradual return to a balanced budget. The fiscal shock to aggregate demand will require an accommodating monetary policy in 2012-13. The imminent fiscal turnaround explains why the Reserve Bank lowered the cash rate by 0.75 per cent to 3.5 per cent in May and June 2012. More interest rate cuts will follow if the government implements the Budget to the letter in the coming financial year.

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