ECONOMICS
ESSAY RESPONSE

Evaluate the effectiveness of Australia's fiscal policy in managing economic growth, unemployment, inflation and income and wealth distribution.

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Response

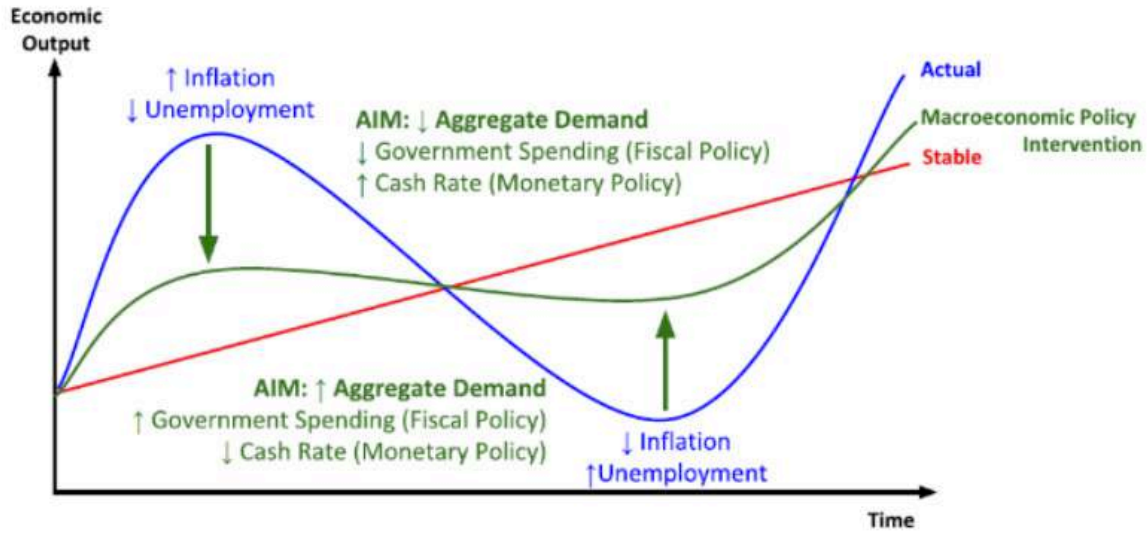
Introduction

Fiscal policy (FP) is a counter-cyclical demand-side tool designed to reduce fluctuations in the business cycle in order to achieve the government's internal objectives. Namely, the government aims for strong, sustainable economic growth (EG) between 3% and 4%, stable inflation between 2% and 3%, full employment (at NAIRU, which is estimated to be 4% currently), and an equitable distribution of income. Largely, the government's use of FP has achieved these objectives, with EG averaging 3.1% between 1980 and 2022, and inflation averaging 2.5% between 1991 and 2022. Yet, Fiscal policy has been inadequate in managing inequality, with the wealth of the richest 200 Australians rising from 8.4% to 23.7% of GDP (2004-2024). Moreoever, the shortcomings of macroeconomic policies are clear; for instance, the inability to address supply-side constraints that impact Australia has been laid bare during the current "cost-of-living crisis", and the ineffectiveness of fiscal policies when misaligned with monetary policies was demonstrated during a period of secular stagnation (2013-19). Further, fiscal policies have a large implementation time lag, reducing the efficacy of such tools, and additionally suffer from political constraints, especially in an election year.

Theory

Fiscal policy is a counter-cyclical demand-side tool that influences AD (C+I+G+X-M) to counteract fluctuations in the business cycle, and can be categorised into its discretionary (the decisions made within the Budget) and non-discretionary (automatic stabilisers) components. By Keynes' economic theory, the government can stimulate economic activity, reduce cyclical UE, and slow inflation during a downturn through larger budget deficits or smaller budget surpluses (and vice versa). In addition, the government's taxation and welfare spending have a significant influence on income distribution; the progressive income tax system and welfare benefits redistribute income from high-income earners to low-income earners, improving the Gini Coefficient by an estimated 0.12. As shown in Figure 1, troughs and peaks in the business cycle are thus softened to ensure the sustainable growth of the Australian economy, without excess inflation or unemployment.

FIGURE 1:



MIB II (2010-12): Effective

FP's effectiveness in cooling down an overheating economy was evident during the 2010-13 MIB II. An increase in global commodities demand put upwards pressure on Australia's export prices and a 33% higher ToT stimulated AD (AD = C+I+G+X-M) in the Australian economy. During this period, economic growth reached a peak of 3.9% of GDP growth (2012) and inflation rose from 1.8% (2009) to 3.3% (2011). Higher commodity prices also led to the formation of a two-speed economy, where the rapid appreciation of the AUD to US$1.1 (March 2013) reduced the international competitiveness of non-mining sectors while the inelastic demand for commodities continued to rise.

Signs of an overheating economy prompted the government to employ a contractionary fiscal policy stance, with the size of budget deficits falling from to -3.7% (2011) of GDP to -3% (2012) to -1.6% (2013). This acted as a handbrake on AD, reducing growth to 2.6% by 2016 and decreasing demand-pull inflation to 2.5% by 2014. However, this came at the cost of higher cyclical unemployment which rose from 5.1% (2011) to 6.1% (2014). Moreover, contractionary FP accelerated the advent of the Dutch Disease Phenomenon, the closure of the PMV sector in 2017 marking the 'death' of the domestic high-value added manufacturing industry. To some extent, income inequality increased between mining and non-mining sectors, with the Gini coefficient increasing from 0.320 (2012) to 0.333 (2015).

All-in-all, while the 2010-13 MIB II demonstrated the limitation of FP as a blunt-tool that is unable to target specific industries, the efficacy of FP as a demand-side tool to slow down the economy when economic growth and inflation trend beyond their targets was highly evidenced.

Secular Stagnation (2013-19): Ineffective

Contrary to the effectiveness of FP during the 2010-13 MIB II, the 2013-19 Rebalancing period

illustrated the importance of a macroeconomic synergy between FP and MP in order for government policy to be effective.

The government's goal of fiscal consolidation, which aimed to improve the CAD through reducing NPY debits in the form of interest repayments on public debt, drove a mildly contractionary FP stance, as shown by the decrease in the budget deficits from -2.8% of GDP (2014) to -0.4% (2018). However, this conflicted with the RBA's expansionary stance, which saw the RBA cut the cash rate from 4.5% (Nov 2011) to 1.5% (Aug 2016).

The conflict in macroeconomic policy stances contributed to below-trend growth of 2.6% from 2013-19 and underlying inflation of under 2% from 2015 onwards. Contrary to Okun's Law, which states that economic growth must exceed growth in the labour force and productivity for UE to fall, UE fell from 5.7% (2013) to 5.2% (2019). Nonetheless, the decline in UE did not signal lower levels of underutilisation of labour because it failed to account for rising levels of underemployment from 5.5% (2007) to 9% (2019). The casualisation of the workforce during this period disproportionately affected casual workers with limited job security, worsening income inequality in some respects.

Thus, the government's use of FP during the 2013-19 Rebalancing period was ineffective in achieving the government's objectives, underscoring how coordination between demand-side policy tools is necessary.

COVID-19 (2020): Effective

Shortly after, the global COVID-19 recession demonstrated the effectiveness in FP in simulating dampened AD through the simple multiplier effect. The pandemic emerged as a simultaneous health and economic crisis – the imposition of lockdowns required to contain spread of the virus curbed economic activity and global confidence, with GWP contracting 4.9% in 2020. A significant slowdown in consumer spending, business investment and export revenues in Q2 2020 led to a record contraction in GDP growth of 6.9%, a spike in cyclical UE to 7.5%, and deflation of 0.3%.

The unprecedented fall in AD prompted a swift and strong response from the government – the government injected $507Bn in fiscal spending to stimulate dampened AD and bore the macroeconomic burden of stimulating demand due to the lower zero bound and 12-24 month impact lag of MP.

Expansionary FP spending targeted lower income earners to take advantage of the multiplier effect, with economic growth rebounding to 3.4% by Q3 2021. Moreover, the $101Bn JobKeeper program provided 3.5Mn employees with a $1500/week wage subsidy, preventing a widespread retrenchment of workers and curbing UE at a peak of 7.5% (Q2 2020) despite MYFEO estimations of 13%. However,

as seen with the GFC, FP was unable to manage the sudden increase in underemployment from 8.5% to 14% (April 2020) as lower derived demand for labour led employees to reduce working hours. Moreover, heightened AD led to higher demand-pull inflation of 1.1% by Q1 2021. Furthermore, FP played a major role in narrowing income inequality. Targeted fiscal spending provided a significant boost in income for low-income earners – real wages for the lowest quintile grew by 5.2% compared to 3% for the middle quintile and 2.4% for the highest quintile. On the other hand, the government's income support payments had little to no effect on wealth inequality. In fact, an increase in residential property prices by 22% from December 2021 led to a slight decline in wealth inequality, since housing is distributed more evenly across the population than other assets.

Thus, the effectiveness of FP as the primary tool the government utilises to achieve internal balance in the short term due to its relatively shorter impact lag and ability to target specific demographics and provide specific support.

Post-COVID (2021-23): Effective

A V-shaped recovery followed the lifting of lockdowns, resulting in all-time low unemployment figures of 3.5% and the rebounding of growth to 4.3%. Yet, supply-side constraints led to sticky and elevated inflationary pressures, with inflation reaching a high of 7.8% in December of 2022. Poor price stability could be largely attributed to the supply chain issues that remained in the wake of border closures, as well as the 12.5% increase in petrol prices in the midst of the Russo-Ukraine conflict, with 70% of inflation being driven by supply-side factors.

In response to this overheating economic climate, the government adopted a highly contractionary FP stance, with the budget outcome moving from a deficit of 6.6% of GDP in 2021-22 to a surplus of 0.9% in 2022-23 and 0.2% in 2023-24. At the same time, however, political limitations drove the government to pursue policies aimed at easing the "cost of living crisis", providing a $3Bn energy bill relief package for low-income households, a $3.5Bn increase to Bulk Billing and a 15% increase in rent assistance. Whilst these ease the sting of high inflation economic conditions, they ultimately serve to increase demand-pull inflationary pressures, providing consumers with the highest MPC (low-income households) additional means to consume.

Despite this, fiscal policy was mostly effective in managing their objectives, with inflation slowing to 3.6% and U/E increasing back up to 4%. Yet, the limitations of fiscal policies in juggling multiple objectives simultaneously were demonstrated as growth slowed to 0.1% in the first quarter of 2024.

Currently (2024-25): Inconclusive

Throughout 2024, and continuing this current election year, Fiscal Policy is chiefly concerned with easing the cost of living (despite inflation returning within target range, currently 2.4%), and

secondarily, stimulating growth (less than 1% in 2024). Unemployment has remained below NAIRU, expected to peak at 4.25%, adding to inflationary pressures alongside rising rental prices. Of their economic objectives, inequality seems of the least priority, with the top quintile of Australians having wealth 146 times greater than the bottom quintile.

Albanese's revised Stage 3 Tax Cuts were furthered in the 2025-26 budget, costing an additional $17.1Bn, boosting disposable income and incentivising workforce participation to increase consumption, increasing AD to promote economic growth. Moreover, a $3Bn investment into green metals production and $2Bn into clean energy similarly supports economic activity. Furthermore, reforms to Medicare, namely increasing the levy low-threshold and increasing access to bulk billing, aim to curb increasing costs associated with autonomous consumption. Ultimately, as a result of tax cuts and increased government injections, the budget stance continues to be expansionary, with a 1% of GDP deficit (2024-25) increasing to 1.5% (2025-26).

Whilst theoretically, the 2025-26 budget should work to increase AD, increasing economic growth and supporting already strong employment levels, the impact lags associated with fiscal policy make it difficult to asses the effectiveness of the most recent budgets.

Conclusion:

All-in-all, the government's conduct of FP has, for the most part, been able to achieve the goals of internal balance and improve income distribution. This is not to say FP is without limitations; FP is a blunt tool and is unable to target supply constraints that may lead to higher inflation. In addition, the government, armed with scarce resources, may be unable to cater to all individuals in the economy through its discretionary budgetary decisions and must choose to allocate its resources wisely.