

Box C

Fiscal Policy and Economic Activity

Changes in the fiscal positions of the state and federal governments can have an important bearing on the outlook for economic activity. A key issue, however, is whether those changes reflect other shocks affecting economic activity or changes in governments' policies. This box addresses this issue by focusing on the Australian Government budget.¹

Budget Aggregates

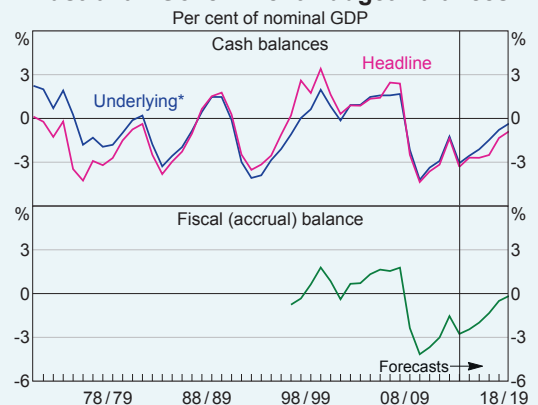
In its latest budget, the Australian Government projected several years of deficits, meaning that operating revenues would be insufficient to cover operating expenses and investments in operational assets, such as national defence equipment. These deficits will be financed by an increase in government debt.

The deficit is projected to be a bit wider than 2 per cent of GDP in 2015/16 and to narrow progressively over the forecast period (Graph C1).²

The projected deficits are a little wider than those in the earlier Mid-year Economic and Fiscal Outlook (MYEFO) update. This largely reflects the operation of so-called 'automatic stabilisers', which respond to changes in economic conditions (Graph C2). In

particular, the forecasts for bulk commodity prices and labour market conditions were revised down in the latest budget, which implies lower growth

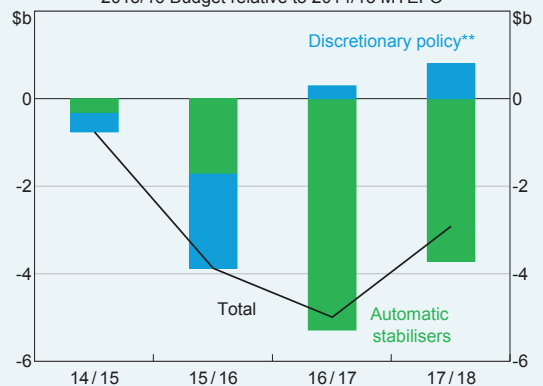
Graph C1
Australian Government Budget Balances



* Headline cash balance adjusted for cash flows from investments in financial assets for operational (or policy) purposes and net Future Fund earnings

Sources: Australian Treasury; RBA

Graph C2
Change to Australian Government Budget Balance*
2015/16 Budget relative to 2014/15 MYEFO



* Changes to the underlying cash balance

** Includes provisions made for changes to Paid Parental Leave Scheme

Sources: Australian Treasury; RBA

1 The Australian Government accounts for around 55 per cent of total federal and state government spending, excluding grants from the Australian Government to the states. If the grants are included in spending of the Australian Government (and stripped out of state government spending), the Australian Government accounts for 70 per cent of total spending.

2 The size of the deficit will depend on the accounting approach taken, although the main approaches yield similar results in this case. The key difference between the headline and underlying cash balance is that the headline balance treats investments in student loans and the National Broadband Network Corporation as operational, whereas both are excluded from the underlying balance. The projections also depend on whether the flows are measured using cash or accrual accounting principles. Broadly speaking, accrual measures record when commitments between two parties are created, whereas cash measures record when payments are actually made.

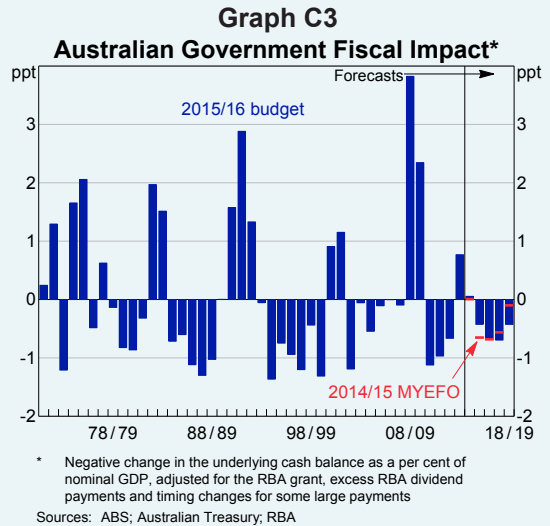
of tax revenues and somewhat higher growth of expenditures, such as unemployment benefits. The effect of changes in government policy is also apparent in the revisions, but is relatively minor. The 'structural budget balance', which abstracts from the effects of the automatic stabilisers, has changed by less than the outlook for the overall budget balance since the MYEFO.³

Summary Measures of Fiscal Impact

There is no single 'correct' measure of a budget's effect on economic activity – commonly termed its fiscal impact. The measures proposed in the literature vary widely in complexity, and are all approximations for the relative size and direction of the true impact. The Bank uses a combination of measures and a degree of judgement to assess the fiscal impact.

The simplest measure is based on the change in the underlying cash balance between years, expressed as a share of nominal GDP (the slope of the underlying cash balance line in Graph C1). A narrowing in the cash deficit entails a mix of lower payments and/or higher receipts, both of which can act to reduce aggregate spending across the private and public sectors. This measure implies that the direct effect of the plan outlined in the Australian Government budget would be to dampen economic activity by around ½ percentage point of GDP growth per year over the next four years (Graph C3).

One of the problems with this measure is that, being based on changes in the underlying cash balance, it mixes the effects of changes in government policy with the effects of automatic stabilisers, which are generated by other aggregate economic outcomes rather than causing them. This can complicate interpretation, particularly when forecasting. The

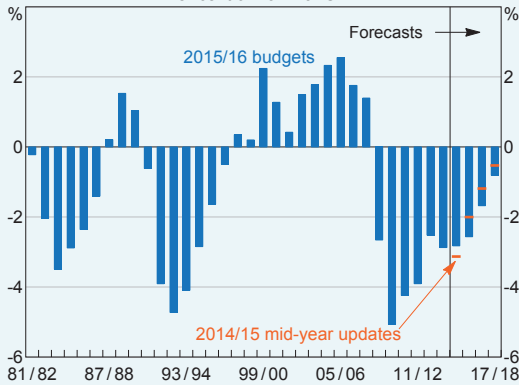


structural fiscal impact measure, which explicitly abstracts from the effect of automatic stabilisers, can provide a useful alternative measure of the fiscal impact. The structural fiscal impact measure suggests that the direct effect of the federal budget projections would be to reduce the growth of economic activity over the next few years by a similar amount to the simple fiscal impact measure.

Over the next few years, changes to the consolidated fiscal balance (which combines the state and federal fiscal balances) largely reflect developments at the federal level (Graph C4). Although there has also been some increase in the combined deficits of the state governments, due mainly to the effect of the lower-than-expected terms of trade on royalty revenues in Queensland and Western Australia, this is small relative to the recent revisions to the federal deficit.

3 The structural budget balance is an estimate of what the budget balance would have been if economic activity had been operating at its long-run or potential level.

Graph C4
Consolidated Budget Balance*
 Per cent of nominal GDP



* Federal, state and territory governments; underlying cash balance adjusted for the RBA grant, excess RBA dividend payments and timing changes for some large payments

Sources: ABS; Australian Treasury; RBA; State and Territory Treasuries

Implications for the Bank's Forecasts

When considering the implications of any individual budget for forecasts of economic activity, the Bank assesses how the various fiscal impact measures have changed from previous estimates. The estimates above suggest that the overall fiscal impact of the recent federal budget over the projection period is little changed since the MYEFO and mid-year reviews from the state governments.

The Bank also incorporates budget information into its forecasts for some of the main expenditure components of GDP, the labour market and prices where appropriate. Incorporating the effects of policy changes requires some judgement. One obvious and direct effect is via public demand, although public demand only captures the component of expenditure that contributes directly to economic activity, such as spending on work done by public servants and on public infrastructure projects. The budget can also affect economic activity through transfer payments to households and businesses, and the revenue the government receives from taxes and royalties. Some of the fiscal consolidation over the next few years is expected to operate through these transfer channels, and policies announced in the recent federal budget have not changed the assessment of the strength of these channels noticeably. To date, there seems to have been some response by businesses to the small business tax cuts and accelerated depreciation allowances announced in the latest Australian Government budget. At the same time, real household disposable income is expected to be marginally lower than was forecast at the time of the *May Statement*, partly due to reductions in transfer payments and increases in tax receipts. ↗