Week 5 Lecture (21/3/2016)

Fiscal Policy and the Public Debt

1. Federal Government Finance

Federal Expenditure Social security and welfare; Specific purpose grants (E.g. Education)

Federal Revenues Personal Income Tax

- Average tax rate
- Marginal tax rate (tax rate paid on additional/ incremental income)

$$Income \uparrow \rightarrow marginal\ tax\ rate$$

Company income tax

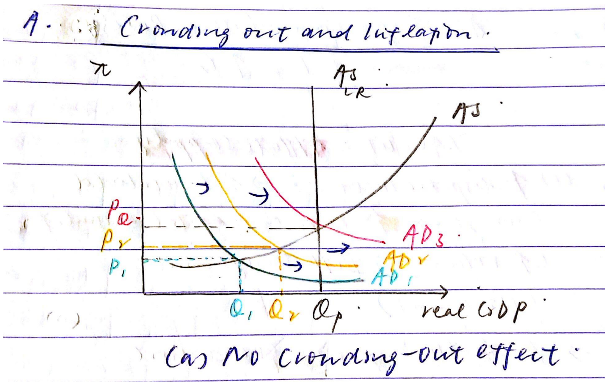
Indirect and other taxes

2. Discretionary Fiscal Policy

Deliberate changes in government spending and tax revenues →Eliminate either inflationary pressures or the impact of recession on real GDP

2.1 Expansionary Fiscal Policy (While Recession)

-Financial Deficits



Q_p: Non-inflationary full-employment level of real GDP

AD_1: Unemployment Equilibrium

Expansionary Fiscal Policy (Recession)

(1) Borrowing from the public –Selling interest-bearing bonds:

(2) Issuing new money to its creditors –More Expansionary way of financing deficit spending than is borrowing

- Reserve Bank issuing new money: Government spending can ↑ without any adverse effect on investment or consumption as long as the Reserve Bank maintains the level of cash rate
- Crowding out effect can be **avoid**

AD_2: P↑

Since ↑ in aggregate demand →Dissipated higher prices → **Aggregate Supply** upward sloping (as P↑) →↑ in government expenditures will be partially offset by declines in C, I, NX → ↑ in real GDP is diminished (Achieves output only to Q1, rather than Q_p)

AD_3: Much more Expansionary Fiscal Policy

→More the economy from recession to full employment without inflation at **Q_p** (Assumed no pressures of an upward-sloping short-run aggregate supply)

→Crowding-Out Effect (Weaken the expansionary fiscal policy)

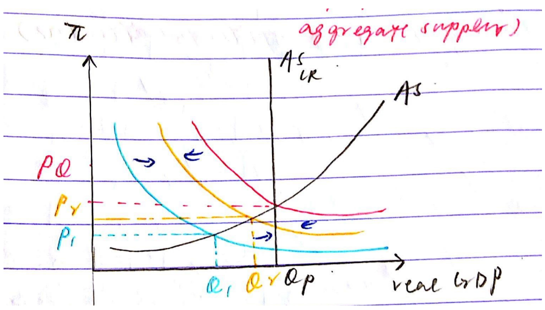
(1) Government goes into the mkt for investment (Mkt for loanable funds)

(2) Competing with private business borrowers for funds

(3) Add D for funds (Borrowers: Government & private sector)

(4) i/r ↑

(5) Investment ↓ (Private investment spending; investment sensitive consumer spending)

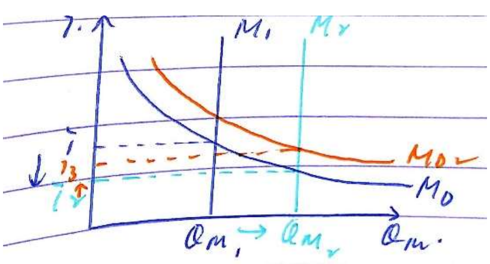


- **Policy and Equilibrium GDP**

Situation 1: Easy Monetary Policy (Expansionary)

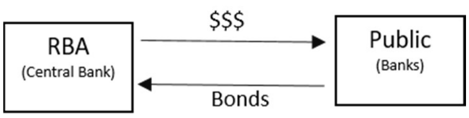
Dealing with Recession

(1) Money Market



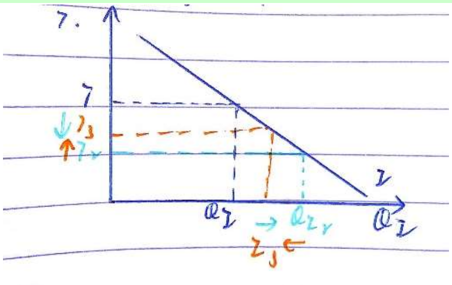
To ↓i/r →RBA buy bonds → ↑MS

(M_2)



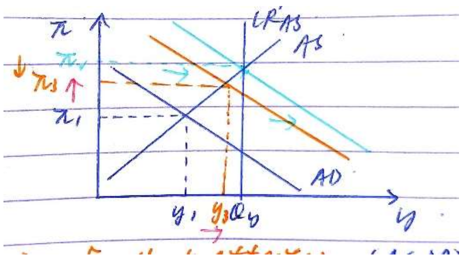
→I/r →i/r₂

(2) Investment Demand



↓i/r → ↑I (since lower costs)

(3) Real Domestic Product



↑I →AD↑ (↑ y)

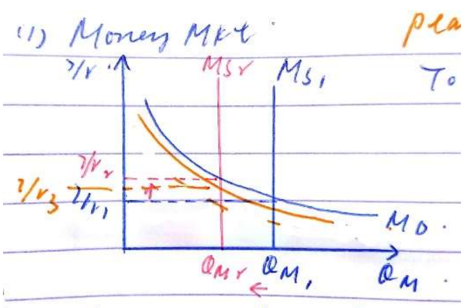
Feedback Effect: level of GDP affects company profits, determines company investment plans, which determines their demand for investment funds

Since ↑y →**Wealth Effect**→ **transaction demand ↑** → i/r ↑ →Offset/ Blunt the i/r reducing effect of easy Monetary Policy

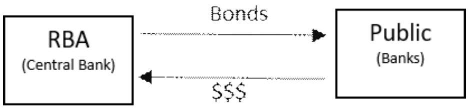
Situation 2: Tight Monetary Policy (Contractionary)

Dealing with Inflation

(1) Money Market

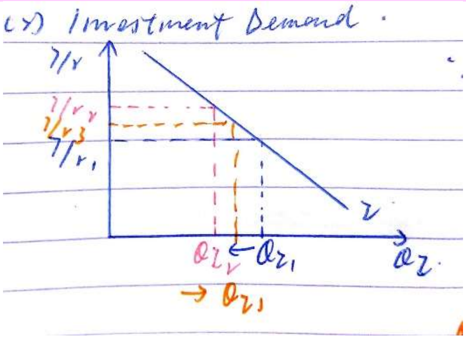


To **↑i/r** →RBA should **↓MS (Sell Bonds)**



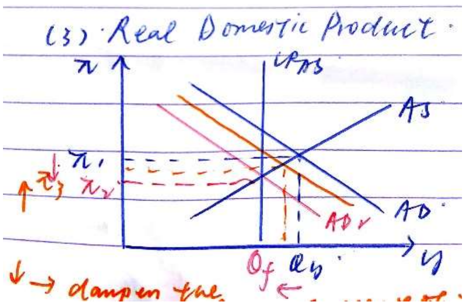
→i/r ↑

(2) Investment Demand



Since **i/r ↑** → **↓I** (Higher costs)

(3) Real Domestic Product



↓I →↓AD (Reducing the equilibrium level of output top Q_f)

Feedback Effect:

↓y →**Wealth Effect** →**Transaction Demand ↓** →Dampen the initial i/r of rising effect of the tight Monetary Policy