

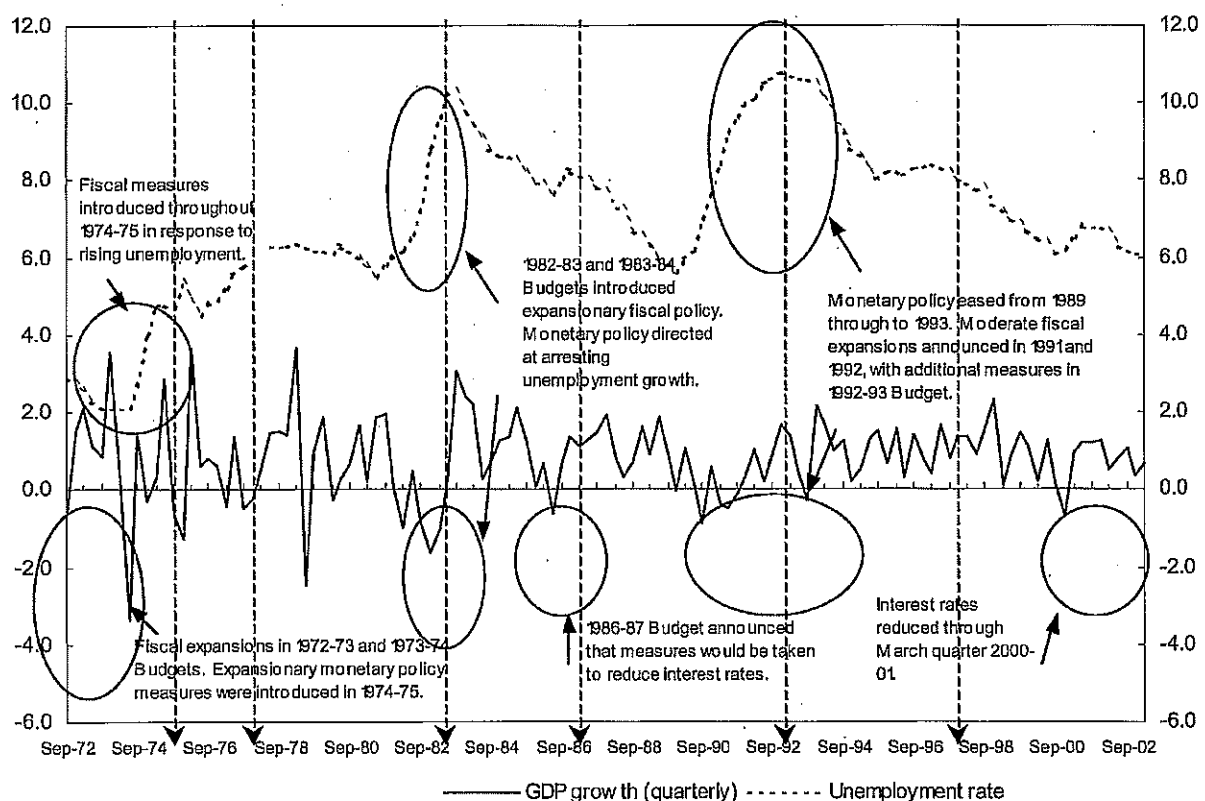
## BACKGROUND PAPER

### History of discretionary policy in Australia

Since 1972-73 the Australian economy has experienced six downturns, measured in terms of the growth cycle as estimated by the Melbourne Institute of Applied Economic and Social research. The quarters in which the troughs in the growth cycle are observed are illustrated by vertical arrows in Chart A.<sup>1</sup>

Chart A also shows quarterly GDP growth and the unemployment rate. Discretionary policy is considered in terms of reactions to negative GDP growth and increases in the rate of unemployment. Rather than attempting to assess the stance of macroeconomic policies through time, we have focussed on those occasions when explicit discretionary measures were introduced with the aim of influencing economic growth in the short run.

**Chart A Downturns in the Australian Economy Since 1972-73**



Since the early 1970s, discretionary monetary and fiscal policy has been used relatively infrequently in response to economic downturns.

- Notable monetary policy easings occurred during the early 1990s (with reductions in interest rates from early 1990 to mid 1993) and in 1974-75 when the Budget announced a range of expansionary measures.

<sup>1</sup> The months in which these troughs occurred are October 1975, February 1978, May 1983, March 1987, December 1992 and August 1997.

- Significant fiscal expansions were implemented in the 1972-73 and 1974-75 Budgets and in 1991 and 1992 through the *Statement on the Economy and Employment and One Nation*.
- Expansionary policies were also used in 1982-83 and 1983-84; however these were balanced against the need to restrain inflation.

Chart A indicates that discretionary policy measures generally coincide with peaks in unemployment, rather than contractions in GDP growth. Unemployment is, however, a lagging indicator; economic activity has usually declined for some time before the decline is reflected in the employment data.

These examples highlight the point that a considerable amount of time usually elapses between the initial signs of economic weakness and the discretionary policy response. Nevertheless, despite this delayed response, an IMF [reference] study suggests that Australian discretionary policy has typically assisted in dampening the business cycle rather than acting pro-cyclically. Historically, at least, swings in the business cycle in Australia have lasted for long enough that, even allowing for delays in the policy response, discretionary policy has been able to act counter-cyclically.

### **Implementation of discretionary policy**

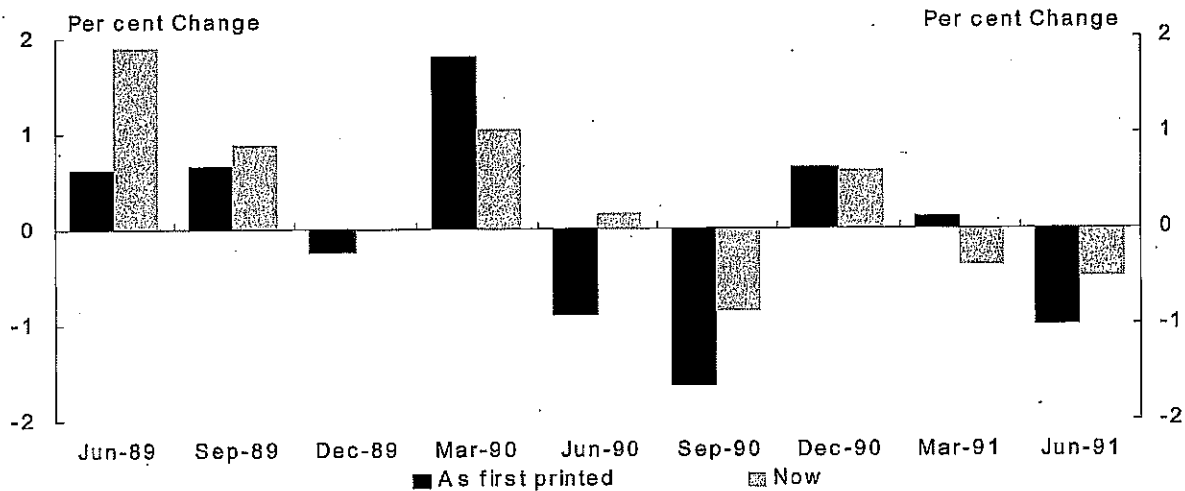
The observed delay from initial signs of economic weakness to the policy response arises from three types of lags:

- Recognition lags;
- Implementation lags; and
- Response lags.

#### *Recognition Lags*

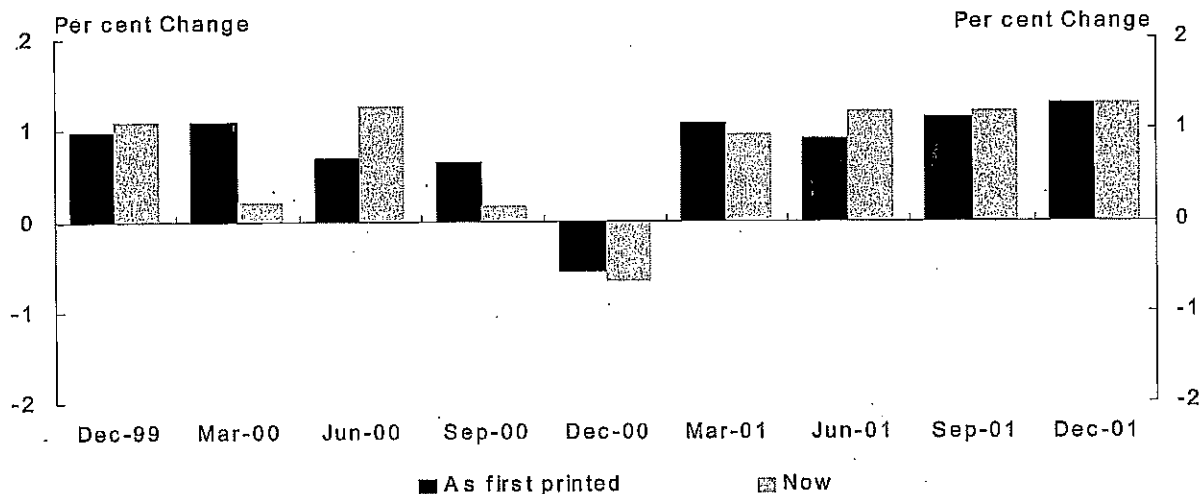
In a serious economic downturn, the economy is often in recession before policy makers, or economic commentators, realise it.

- The lags associated with reliably recognising changes in the economy, particularly turning points, can be a significant constraint on implementing timely counter-cyclical macroeconomic policy. Policy decision making is undertaken largely in a 'fog' of uncertainty with limited reliable information. This increases the chances of policy error.
- The National Accounts are published some time after the quarter ends and can be subject to significant revision. Chart B illustrates using the 1990 downturn. It can now be seen that the original published figures presented a misleading picture of both the magnitude of quarterly growth and the changing momentum of the economy.

**Chart B: The 1990 Downturn**

Note: Series is ABS cat. no. 5206 (using real GDP). The "now" growth is March Qtr 2003.

- As a period of economic weakness is unfolding, it is difficult to predict how deep it will be or how long it will last.
  - These difficulties are illustrated by comparing Chart B (1990 downturn) with Chart C (2000 downturn). The downturn in the December quarter 1989 is the prelude to a major recession. By contrast, the downturn in the December quarter 2000 is followed by sustained high growth. The appropriate macroeconomic policy response to these two episodes is clearly rather different, yet they started in similar ways in terms of GDP outcomes.

**Chart C: The 2000 Downturn**

Note: Series is ABS cat. no. 5206 (using real GDP). The "now" growth is March Qtr 2003.

It is therefore necessary to design discretionary policy responses recognising that, when such a policy is being proposed and implemented, the policymaker will be uncertain about both the severity and the duration of the economic weakness that is currently being experienced. This is one reason why discretionary monetary policy is often advocated in preference to discretionary fiscal policy; because of its relative flexibility and the capacity for discretionary monetary changes to be unwound relatively quickly, if that proves advisable.

### *Implementation lags*

Monetary policy can be implemented almost instantaneously (although response lags need to be taken into account and are discussed further in the next section).

For fiscal policy the implementation lags are often long due to:

- design of the intervention;
- getting agreement through both Government and Parliamentary processes; and
- putting in place the logistics or delivery aspects of the policy.

These long lags may mean that fiscal policy can become pro-cyclical (adding to the upturn) rather than its original counter-cyclical intention to support the economy when it is below potential.

For example [One Nation investment programme.]

### *Multipliers and response lags*

Multipliers (the actual change in GDP from a certain policy change) will vary in magnitude and timing depending on the policy action.

Changes in monetary policy have an impact on economic growth that is spread roughly evenly over about two years after the change. A one-percentage-point fall in the cash rate is estimated to raise through-the-year economic growth by about  $\downarrow$  per cent in both of the next two years after the policy change. The impact of fiscal policy can be considerably quicker. Some fiscal policy actions can influence activity from the point of announcement, before they are implemented.

We would expect the following policy actions to add around  $\frac{1}{2}$  percentage point to growth in a given year:

- a temporary 150 basis point reduction in the cash rate. This action would have no lasting effect on the budget or marked impact on Commonwealth net debt levels over time;
- a temporary  $\frac{1}{2}$  per cent of GDP boost to discretionary spending. This would detract from the budget position by around  $\downarrow$  per cent of GDP in the first year after the policy change but because of its small and once-off nature would have no marked impact on the Commonwealth net debt to GDP ratio over time.
- a permanent tax cut of 1 per cent of GDP would boost growth in the year of the policy change. However, this would see a deterioration of the budget position of around  $\frac{3}{4}$  per cent of GDP over time.
  - Tax cuts have a smaller impact than government spending on activity, as they are an indirect form of stimulus, feeding into disposable income, some of which is usually saved by taxpayers.
  - Credible permanent tax cuts are more likely to raise private spending than temporary tax cuts as they are more likely to raise a taxpayer's expectations of their expected life-time earnings.

The actual magnitude of these effects could be greater or less depending on whether the policy measures are judged to be credible and sustainable, and hence raise confidence. The multipliers associated with alternate policy options are illustrated further in Table 2.

**Table 2: Alternate Policy Responses to Raise GDP Growth by ½ a Percentage Point**

Policy Response	Budget		Net Debt	
	2003-04	Permanent <sup>(a)</sup>	2003-04	Permanent <sup>(a)</sup>
Temporary 150 basis point cut to the cash rate.	Some minor amount.	Nil	Nil	Negligible improvement
Temporary ½ per cent of GDP or \$3-4 billion boost in discretionary spending.	Shave \$2-3 billion or ↓ per cent of GDP off budget	Nil	Add \$2-3 billion or ↓ of 1 per cent of GDP to the level in Year 1	Add \$2-3 billion or ↓ per cent of GDP to the level in Year 4
Permanent 1 per cent of GDP or \$7-8 billion tax cut.	Shave \$5-6 billion or ¼ per cent of GDP off budget	Shave \$5-6 billion or ¼ per cent of GDP off budget	Add \$5-6 billion or ¼ per cent of GDP to the level in Year 1	Increase by 3 per cent of GDP by the end of Year 4 and rising.

(a) After four years.

### Judging the timing, magnitude and nature of the appropriate policy response

With these practical issues in mind we turn to what could trigger discretionary policy action. In general it is preferable to be forward looking in framing discretionary action. The level of uncertainty over forecasts can therefore play an important part in determining the scope and size of policy action. Having a forecast for the expected evolution of the economy, we believe discretionary policy action should be based on an analysis of the expected implications of the forecast for the output gap.

The output gap, the gap between potential and actual GDP, will widen for each quarter the economy grows below (above) potential. This of course assumes that the starting point is an economy already at potential. To maintain activity at potential, the economy must currently grow at about 0.9 per cent per quarter, or about 3½ per cent per year. A zero growth quarter therefore adds about 0.9 of a percentage point to the output gap which may, over time, add nearly ½ a percentage point to the unemployment rate via Okun's Law.<sup>2</sup>

So even a temporary shift away from potential can provide a justification for some discretionary action. However the serious recognition and implementation issues that we have outlined suggest that significant discretionary action should be reserved until the economy is judged to be some distance from potential. In practice some assessment is also required as to the risk that the economy is not where it is currently judged to be (or will be in the immediate future) and therefore the

<sup>2</sup> Okun's Law relates changes in the output gap to changes in the gap between unemployment and its natural rate. Okun originally estimated a 3 to 1 trade-off between real GDP growth and the unemployment rate. Recent research such as Freeman (2001) suggests that, on average, this trade-off is more like 2 to 1 for industrialised countries. Freeman (2001) and Lee (2000) suggest that the trade-off in Australia is also around 2 to 1.

likelihood of policy error. For example an unemployment rate above 7 per cent might provide an indication of a significant output gap that might be consistent with the need for discretionary policy action.

The level of the output gap will not be the only signal for discretionary action. The speed at which the economy appears to be deteriorating should also influence the policy response. An economy that appeared to be slowing rapidly as indicated by a quick increase in unemployment (say unemployment increasing by ½ per cent in one quarter) may require just as significant policy action as an economy that takes 18 months to reach an unemployment rate above 7 per cent.

### APPROPRIATE RESPONSE

The issue of recognition lags and other implementation considerations leave open the real possibility of policy error through the implementation of pro-cyclical discretionary policy. However, the risk of a pro-cyclical policy error must be balanced against the counter proposition of a significant recession in the face of no discretionary action.

We therefore propose a three stage response that relates to the output gap and would be implemented as our confidence of the likely outcome without discretionary policy action increases.

### Three Staged Response to Downturn

#### Stage 1

Stage 1 involves responding to the expected slowing in growth and the risk that the international economy will result in even lower growth to the Australian economy. Fiscal policy should remain broadly neutral and monetary policy should seek to be expansionary.

- Stage 1 is already under way. The 2003-04 Budget has moved the fiscal stance from mildly contractionary to broadly neutral and the RBA Board is considering easing monetary policy.

**Table 4: Stage 1 Policy Response to a Short ½ Percentage Point Downturn**

Initial Policy Stimulus	GDP		Budget		Net Debt	
	2003-04	Permanent <sup>(a)</sup>	2003-04	Permanent <sup>(a)</sup>	2003-04	Permanent <sup>(a)</sup>
Temporary 50 basis point cut to the cash rate.	Some minor amount	Nil	Nil	Nil	Nil	Negligible improvement
Permanent Tax Cuts as per Budget of ↓ per cent of GDP and a temporary \$1-2 billion boost in discretionary spending.	↓ per cent increase in GDP	Nil	Shave \$2-3 billion or ↓ per cent of GDP off budget	Nil	Add \$2-3 billion or ↓ per cent of GDP to the Year 1 level	Add 1 per cent of GDP to the level in Year 4 and rising

(a) After four years.

## Stage 2

*Stage 2* involves responding to a more pronounced slowing in the economy as possibly signalled by a negative quarter of GDP growth with a more aggressive policy.

- Monetary policy could move more aggressively than outlined in *Stage 1* with interest rates further reduced by another 100 basis points. Fiscal policy will become more accommodative through the automatic stabilisers. Temporary discretionary fiscal spending in the order of \$3 to 4 billion in 2003-04 could be examined although it is not an essential part of the policy response. Discretionary fiscal action would look to bring forward private sector consumption and investment.
- This may be expected to add around ½ of a percentage point to growth in late 2003-04 and during 2004-05 that may help to 'smooth' the full impact of the downturn without restoring normal levels of activity.
  - The point of such a strategy is to use the moderate rate of inflation in Australia to achieve low or negative real interest rates conducive to private investment.
  - The advantage of this approach is that it can be unwound should the economy rebound.
  - Supporting monetary easing would be a package of mainly temporary fiscal measures (around ½ to 1 cent of GDP) the main purpose of which would be to bring forward household and business spending. Depending on its composition, this package may add between ¼ to 1 percentage point to growth in 2003-04. Such a package could be characterised as a small-scale attempt to elicit a private sector spending response by designing policy measures that target private consumption and investment. Essentially the package would be to maintain the credibility of fiscal policy in the face of political pressure for a more significant response.

**Table 5: Stage 2 Policy Response to a Short 1 Percentage Point Downturn**

Initial Policy Stimulus	GDP		Budget		Net Debt	
	2003-04	Permanent <sup>(a)</sup>	2003-04	Permanent <sup>(a)</sup>	2003-04	Permanent <sup>(a)</sup>
Temporary 150 basis point cut to the cash rate.	Some minor amount (mostly in 2004-05)	Nil	Nil	Nil	Nil	Negligible improvement
Temporary ½ per cent of GDP or \$3-4 billion boost in discretionary spending.	½ per cent increase in GDP	Nil	Shave \$2-3 billion or ↓ per cent of GDP off budget	Nil	Add \$2-3 billion or ↓ per cent of GDP to the level in Year 1	Add \$2-3 billion or ↓ per cent of GDP to the level in Year 4

(a) After four years.

### Stage 3

*Stage 3* involves responding to a sustained slow down in the economy as signalled by unemployment reaching above, say 7 per cent, before year end 2004. The unemployment rate could be above 7 per cent after as few as three quarters of very low growth (three quarters of zero growth equivalent to a decline in output 2-3 percentage points below current forecasts for 2003-04 and 2004-05).<sup>3</sup>

- If it takes longer than, say, 18 months (6 quarters) to incur 7 per cent unemployment it is likely that we are dealing with a supply shock. Our advice for *Stage 3* would then be more focused on structural policy to influence potential output rather than temporary discretionary measures to deliver short-term stimulus.

Monetary policy would again look to be expansionary with further reductions in interest rates. The impact of further rate cuts may begin to progressively decline well before the nominal cash rate approaches zero.

- Further easing of monetary policy settings of the order of 150 basis points could be set in train if the level of unemployment reaches 7 per cent and this would bring the cash rate to a level below 2 per cent.

At this stage in the cycle significant fiscal easing may be warranted to address the burgeoning output gap and help restore something like normal levels of activity. The ideal would be an 'old style' Keynesian attempt to replace falling private consumption and investment with government spending. Additional stimulus of up to 2 per cent of GDP could be added to activity in the form of one-off discretionary items. This would be expected to add around 1 to 2 per cent to growth between 2003-04 and 2004-05 while maintaining net debt to GDP levels at below 10 per cent of GDP (depending on the mix of fiscal measures).

- The Government is well placed to deliver significant fiscal easing and still leave the nation with public debt levels low by historical norms and in comparison to the OECD average.

**Table 6: Stage 3 Policy Response to an Extended 2-3 Percentage Point Downturn**

<sup>3</sup> The earliest signal would be provided after the December Qtr *National Accounts* with the release of April 04 *Labour Force* figures (or after the release of the September Qtr *National Accounts* as signalled by the release of January 04 *Labour Force* figures).



Additional Policy Stimulus	GDP		Budget		Net Debt	
	2004-05	Permanent <sup>(a)</sup>	2004-05	Permanent <sup>(a)</sup>	2004-05	Permanent <sup>(a)</sup>
Temporary 150 basis point cut to the cash rate. <sup>(b)</sup>	Some relatively minor amount (mostly in 2005-06)	Nil	Nil	Nil	Nil	Negligible effect
Temporary 2 per cent of GDP or \$14-16 billion boost in discretionary spending.	Up to 2 per cent increase in GDP	Positive but negligible after 4 years	Shave \$9 -10 billion or 1↓ per cent of GDP off budget	Nil	Add \$9-10 billion or 1↓ per cent of GDP to the level in Year 1	Add \$9-10 billion or 1↓ per cent of GDP to the level in Year 4

(a) After four years.

(b) Assume Stage 3 interest rate cuts occur in the June Qtr 2004. Only a small stimulus from this cut would impact in 2004-05.

### What type of discretionary fiscal action?

Given the need for discretionary fiscal policy the options available to the Government can be thought of in four broad categories as outlined in Table 2.

- The Government can choose a broad-based policy that goes across a wide number of areas of the economy such as a personal income tax cut.
- The Government can choose a narrow sector based policy such as the First Home Owners Scheme (FHOS).

**Table 7 Discretionary Policy Options**

	Significant expenditure	Minor expenditure
Economy wide	Large Tax Cuts	Small Tax Cuts
Sector based	FHOS	Pension Payment

For fiscal stimulus to be effective it must take place at the same time as the weakness in growth. Counter-cyclical measures need to be able to be implemented quickly if they are to be effective.

Expenditure increases are more effective than tax reductions in terms of fiscal stimulus. However, in practice tax cuts may be more feasible in terms of delivering a timely fiscal stimulus.

- An effective fiscal stimulus needs to be large. Tax cuts of these magnitudes can be quickly designed and delivered through existing infrastructure. In practice it is very difficult to design and deliver expenditure programmes of a similar magnitude quickly.
- That said, an explicitly counter-cyclical tax cut should be temporary (for example with a pre-agreed sunset clause). A temporary tax cut is likely to have less effect on demand than a permanent tax cut.

The combination of all these factors suggests that discretionary fiscal policy initiatives should be introduced sequentially. First, measures to support and/or bring-forward private consumption and investment into the period of the downturn (for example, *Stage 2* stimulus). Second, the use of Government consumption or investment to make up for the shortfall in private activity during the downturn (for example, *Stage 3* stimulus).

We favour measures that maximise the multiplier on short term demand; could be considered as worthwhile in their own right; and have a minimal impact in terms of public debt and therefore long-term sustainability.

- Temporary or transitional measures uphold the structural integrity of the budget and do not interfere with the ability of the automatic stabilisers to return the budget to surplus once the downturn is over.
- Permanent measures (such as tax cuts) are more likely to impact growth rates and are desirable provided they are credible in terms of their expected budgetary impacts over the out years.

#### *Sustainability and discretionary fiscal action*

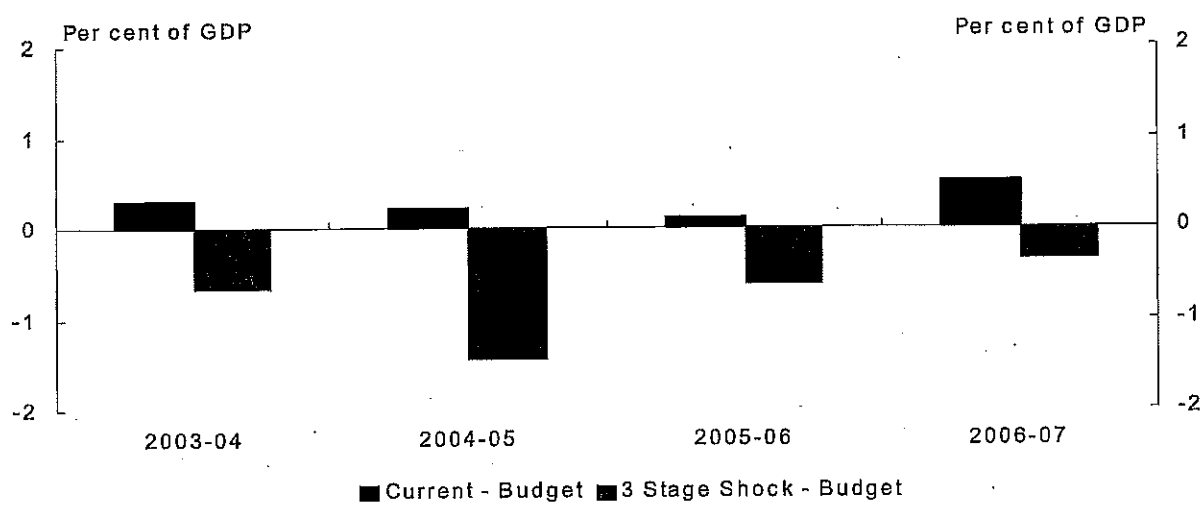
[Model results need to be updated after refinement of monetary response function in BARRY]

We have undertaken modelling to gain an understanding of the implications for the sustainability of the budget of significant discretionary fiscal action. Specifically we compare the implications of temporary measures relative to permanent measures.

Chart D

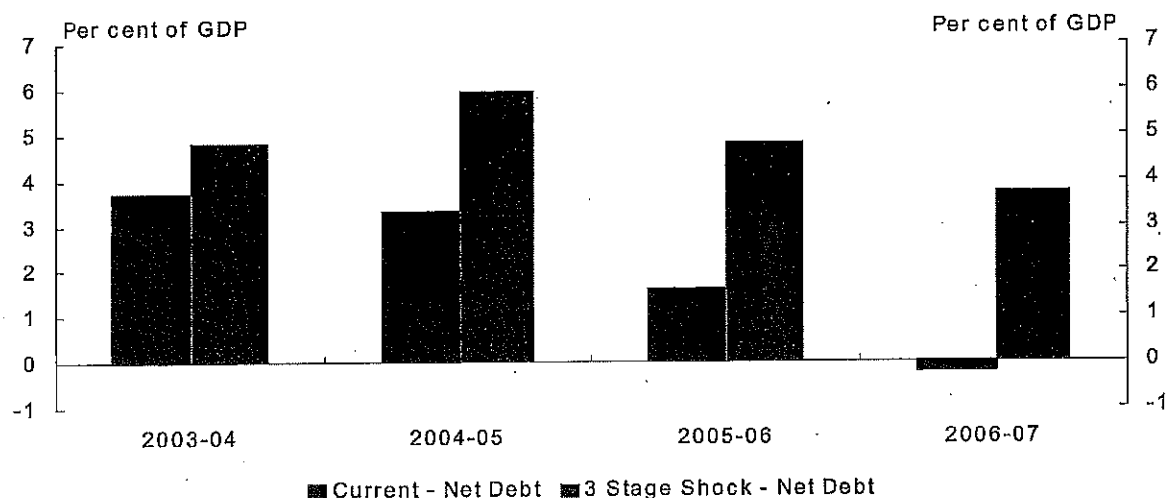
[New chart to be inserted.]

#### **Chart E: Budget impact of permanent tax cut**



Note: Budget balance referred to is underlying cash

- After running underlying cash deficits for four consecutive years, the budget will remain in deficit in 2006-07, but by less than  $\frac{1}{2}$  a per cent of GDP.

**Chart F: Net Debt impact of permanent tax cut**

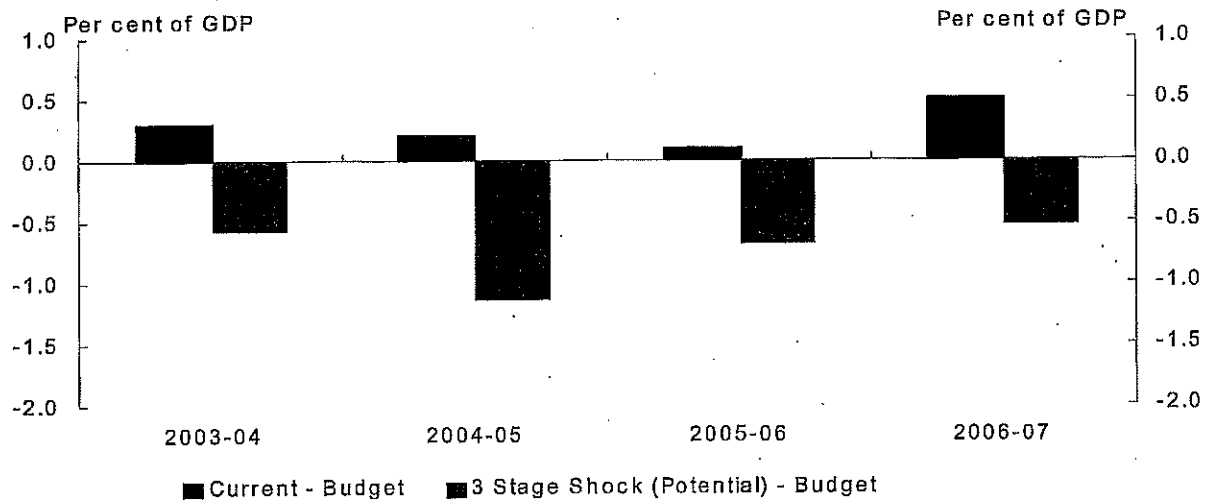
- The downturn and 3 Stage policy package is expected to leave Commonwealth net debt higher overall over the outlook period (Chart F) by around 4 per cent of GDP.

However, the budget position could deteriorate (and Commonwealth net debt rise further) under a number of conceivable scenarios.

#### **Policy Stimulus and a Decline in Long-term Potential Growth Rate of the Economy**

A downturn, followed by the 3 Stage policy package in combination with a decline in the long-term potential growth rate, say by around 1 percentage point, will leave the budget in worse shape by around  $\frac{1}{4}$  per cent of GDP by 2006-07 as is represented in Chart G.

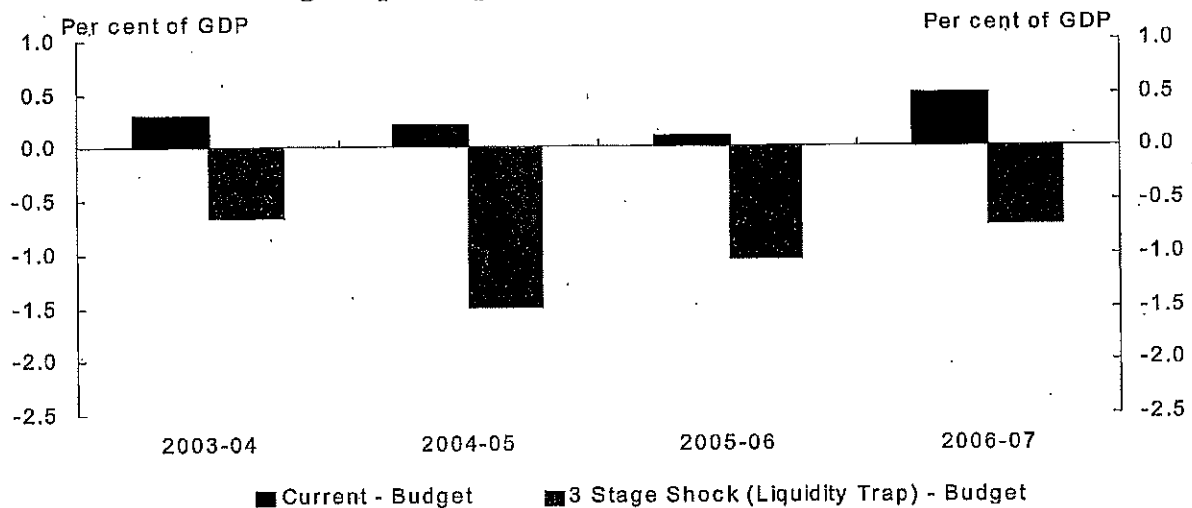
- Now after four years of consecutive underlying cash deficits the budget will be in deficit by more than  $\frac{1}{2}$  a per cent of GDP in 2006-07.

**Chart G: Budget impact of permanent tax cut and slowdown in the potential growth rate**

Note: Budget balance referred to is underlying cash

### Policy Stimulus in the Face of a Liquidity Trap

If we implement the 3 Stage policy package in the face of a downturn and the economy hits a liquidity trap after Stage 2, the resulting deterioration in the budget position is expected to be greater still over the outlook period (as represented in Chart H).

**Chart H: Budget impact of permanent tax cut in the face of a liquidity trap**

Note: Budget balance referred to is underlying cash

Now after four years of consecutive underlying cash deficits and the budget will remain in deficit by more than  $\frac{3}{4}$  a per cent of GDP in 2003-04.

## ATTACHMENT A PREVIOUS DOWNTURNS AND THE STANCE OF POLICY

Table A1 Episodes of Monetary and Fiscal Easing

Date	Change in GDP	Monetary policy response	Fiscal policy response
September 1972	-0.7	Budget noted that the 1972-73 Budget deficit was expected to facilitate 'strong growth in private sector liquidity and the volume of money.' (The 1973-74 Budget noted that there had been a large increase in the volume of money in 1972-73.)	Expansionary fiscal policy announced in the 1972-73 Budget, including reductions in personal income tax and increases in transfer payments, noting the need to stimulate consumption demand.  Substantial increases in industry assistance were also announced in the Budget.
June 1974	-3.4	Expansionary monetary policy measures introduced through 1974-75 included a reduction in the SRD ratio of major trading banks, creation of a special drawing facility with the RBA to support bank liquidity, reduction in short term official interest rates and amendments to the Government's savings bank regulations to encourage lending for housing.	Further expansionary fiscal policy was announced in the 1974-75 Budget, including further reductions in personal income tax and increases in social security benefits.
December 1974	-0.3		The 1975-76 Budget noted that 'as unemployment increased, its relief was accorded top policy priority' with stimulatory measures being introduced through the year. These measures included reductions in personal and company income tax, payments to the States and advances to banks for on-lending for housing.
September 1975	-0.7		
December 1975	-1.3		
March 1977	-0.5	Fiscal and monetary policy from the Treasurer's Press Release of 20 May 1976 through to the 1981-82 Budget was to reduce the Budget deficit and restrain the growth in money supply, including through a reduction in the PSBR. In successive budgets the Government noted the need to control inflation and foster private sector revival. Government reiterates the need to control inflation and not add to it through increases in public sector expenditure.	
September 1977	-0.5		
December 1977	-0.2		
June 1979	-2.5		
March 1980	-0.3		
March 1982	-1.0		
September 1982	-0.8	1982-83 Budget announced that monetary policy would be directed at enhancing the recent signs of slowing in the growth in wages and encouraging settlements in major wage agreements, to provide a basis for improving public sector profitability and arresting unemployment growth. The Budget announced that the Government would seek to restrain the growth of financial aggregates to a degree consistent with the growth of M3.	Expansionary fiscal policy introduced in the 1982-83 Budget, including personal income tax relief, home loan interest rebate, capital works expenditure (roads programme), increased transfer payments and increased job training opportunities.
December 1982	-1.6		The 1982-83 Budget speech noted that the Government had done all it could to "provide relief, assistance and incentive within the confines of a responsible economic policy" necessitating a need to increase the size of the Budget deficit.

Date	Change in GDP	Monetary policy response	Fiscal policy response
March 1983	-1.0	1983-84 Budget announced (in August 1983) that monetary policy would aim to move the "excessive present growth in M3 to within the recommended range" by containing its growth to below the projected growth in nominal GDP.	1983-84 Budget provided "the maximum fiscal stimulus to the economy consistent with [the Government's] anti-inflation objectives but without placing undue burdens on interest rates or the balance of payments."  Measures included stimulus to the building and construction industry and greater expenditure on employment and training schemes.
June 1986	-0.6	1986-87 Budget announced that the Government would take measures to reduce domestic interest rates. These included a \$2.5 billion reduction in total public sector gross borrowings and no net new bond raisings. At the same time, the Government noted the need to maintain a firm monetary policy, consistent with the need to reduce inflation and finance a large current account deficit. <sup>(a)</sup>	1986-87 Budget announced that the Government intended to 'spend less and borrow less, thereby improving the climate for lower interest rates and for private sector investment.  The Budget included a large cut in Government spending and borrowing, with major reductions in social security, health, education, defence and overseas aid. While personal income tax rates were reduced, other taxes were increased, including sales taxes, BAD tax, excise and Medicare levy.
December 1989	0.0	Monetary policy eased in second half of 1989-90 in response to slow-down. (Interest rates had been reduced by 4 per cent (or 400bps) by the 1990-91 Budget.)  Governor announced that RBA had acted in domestic money markets to reduce interest rates on 23 January, 15 February and 4 April 1990.	1989-90 Budget continued to target inflation, therefore restraining demand, with tight fiscal and wages policy.

(a) In 1985 and 1986 monetary management 'sought to provide a generally stable financial environment while policies of more fundamental adjustment took hold' (RBA Annual report, 1987). After monetary targeting ended in February 1985, a 'check list' framework was implemented. The check list encompassed a mixture of intermediate, final objectives and other objectives, including monetary aggregates; interest rates; the exchange rate; the external accounts; and the current performance and outlook for the economy, including movements in asset prices, inflation, the outlook for inflation and market expectations about inflation'.

Date	Change in GDP	Monetary policy response	Fiscal policy response
September 1990	-0.9	2 August 1990, Governor announced that the RBA would reduce interest rates by 1%.	1990-91 Budget remained in surplus with no expansionary programmes.
March 1991	-0.4	A further 1% reduction was announced on 15 October 1990.	
June 1991	-0.5	18 December 1990, Governor announced that RBA would act in the domestic money market to reduce cash rates by 1% to around 12%	
September 1991	-0.1	<p>The following reductions in official interest rates were announced over 1991 and 1992:</p> <ul style="list-style-type: none"> <li>• 3 September 1991, cash rate reduced by 1% to 9.5%.</li> <li>• 6 November 1991, overnight cash rates reduced by 1% to 8.5%.</li> <li>• 8 January 1992 overnight interest rate reduced by 1% to 7.5%</li> <li>• 6 May 1992 overnight interest rate reduced by 1% to 6.5%.</li> <li>• 8 July 1992 overnight interest rate reduced by 0.75% to 5.75%.</li> </ul>	<p>Additional fiscal stimulus through <i>Statement on the Economy and Employment</i> in November 1991 and <i>One Nation</i> in February 1992.</p> <p>Measures included reductions in personal income tax, accelerated depreciation for plant and equipment, increased funding for vocational education, increased assistance for low income families, upgrading roads and other infrastructure programmes and additional funding for labour market programmes.</p>
September 1993	-0.3	<p>On 23 March 1993, the Governor announced that RBA would act to reduce overnight interest rates by 0.5% to 5.25%.</p> <p>On 30 July 1993, the Governor announced that RBA would act to reduce overnight interest rates by 0.5% to 4.75%.</p>	<p>1992-93 Budget announced new initiatives that moved the Budget from a surplus of around 0.5% of GDP to a deficit of around 2.4% of GDP.</p> <p>Outlays cost of new measures in the 1992-93 Budget, together with those announced in <i>One Nation</i> were estimated at \$4.5 billion over 1992-93 and 1993-94, including employment package (capital works programmes, education, Defence housing and labour market and training programmes) and measures to enhance exports.</p>
December 2000	-0.7	<p>On 7 February 2001, the Governor announced that the cash rate would be reduced by 0.5% to 5.75%.</p> <p>On 7 March 2001, the Governor announced that the cash rate would be reduced by 0.25% to 5.5%.</p> <p>On 4 April 2001, the Governor announced that the cash rate would be reduced by 0.5% to 5.0%.</p>	None



## ATTACHMENT B: FISCAL POLICY INSTRUMENTS AND THEIR EFFECTIVENESS

- The main fiscal instruments are government investment and consumption expenditure, personal and indirect taxes and benefit payments.
  - Broadly speaking, changes in government investment and consumption expenditure affect economic activity directly by changing the demand for goods and services and the derived demand for factors of productions, labour and capital.
  - Changes in personal income tax rates, transfer payments and indirect taxes influence economic activity indirectly by changing the level of real disposable income by households.
- Relevant criteria for assessing the merits of alternative fiscal instruments include: the size and duration of the impact on the economy and the associated budgetary impact; the length of implementation and impact lags; the scope of measures to influence economic activity and limitations to the symmetrical use of the instruments over the economic cycle.
- Government consumption and investment expenditure have the largest and most immediate impact on the economy with a modest budgetary impact relative to other instruments. However, the scope to implement changes to government investment on the scale desired both quickly and symmetrically about the cycle is limited. Government consumption spending appears to offer more scope to impact on the economy with relatively short implementation lags, although there may be some constraints to implementing changes symmetrically over the economic cycle.
- Personal income taxes potentially offer the broadest scope to influence economic activity, because they are such a large component of the budget. They have implementation lags that are potentially very short, and their potential for symmetrical application around the economic cycle is greater than some other instruments. However, they have a smaller impact multiplier than spending items as they are an indirect form of stimulus, feeding into disposable income, some proportion of which is saved by taxpayers. As such they have a smaller 'bang per buck' in budgetary terms. The long impact lag and the long duration of the impact arising from these instruments could make the operation of a well-timed counter cyclical fiscal policy more difficult.
- The economic impact of changes in indirect taxes is broadly comparable to that of personal income taxes but the budgetary impact is lower. Symmetrical adjustment of tax rates over the cycle would also be difficult when compared to some other instruments, but the size of the Goods and Services Tax base allows scope to influence economic activity.
- Changes in company taxes may only have a small effect on GDP in the short term. This is because, under Australia's dividend imputation system, much of any change in the company tax rate would be clawed back through the personal income tax system, although differences in the timing between the collection of company taxes and personal income tax may have some impact. Further, non-labour income is likely to accrue mainly to individuals with above average incomes and these individuals are likely to have a lower marginal propensity to consume out of after tax income than individuals in lower income brackets.
  - However, a temporary tax break for investment could work well, because it would encourage firms to bring forward capital spending. Permanent tax cuts may not encourage firms to invest today, as business investment is more influenced by profits,

excess capacity and confidence. A policy needs to provide an incentive to change the timing of investment.

- Benefit payments are likely to have a larger and more timely multiplier effect on economic activity than changes to personal income tax rates of a comparable size, particularly if targeted to low income households. However, the ability to implement adjustments to benefit payments symmetrically through the economic cycle, and the scope to implement large changes in benefit payments relative to GDP, may both be limited.